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WHY RFPS DO NOT WORK IN MANY INDIRECT CATEGORIES

Do RFPs really produce the best results in high SKU count indirect categories? Unless you are willing to take a very long time to complete the additional necessary steps, we would argue that they do not.

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While your organization churns through hundreds of RFPs in the indirect space, have you ever stopped to think, "is this actually working?" Every few years we polish off some data, send it out to a few participants, and pick the best fit, which is usually the lowest overall pricing. But did we really achieve the best outcome? How do we continually find savings when prices increase over time, not decrease? There are four fundamental reasons why RFPs in the indirect space, especially in high item count categories like MRO and Office Supplies, do not produce optimal results. These fundamental reasons include, information asymmetry, high item count managed by a market basket approach, high SKU turnover, and invisible deviations.

Information Asymmetry

Information asymmetry describes a situation where both parties in a transaction do not have the same information, and typically to the advantage of one of the parties involved. As an individual company, you will only know what you bought and how much you paid. If you participated in the last RFP and spent a long time digging into the suppliers' economics, you might have some insight into how that pricing was created as well. For direct items, it will be worth your organization's time to perform intense research and learn more about individual item costs and markups, but in the indirect space this is almost never going to be a worthwhile investment. The suppliers in the RFP will learn all of that information, plus they will have insights into their costs and changes in the marketplace since your last sourcing event. While you know what you paid in the past, you have no idea what others are paying for the same items or similar items from the suppliers, where each supplier is well aware of the pricing dynamics in the marketplace. This gives them insight not only into your pricing, but also into the pricing that their competitors are likely to bid, limiting their need to be as aggressive as possible. You are set up to fail from the beginning.

Managing High Item Count

Often in the indirect space we pull together so much into one "category" that we are literally talking about creating an RFP for thousands of different items. Suppliers have built businesses around these needs, but they have spent a significant amount of time and energy ensuring that the contracts that they construct with customers only tightly manage a small portion of the pricing in their catalogs. To ensure that their RFP process does not run excessively long, most companies create market baskets to run an RFP. While you may include hundreds of items in your analysis, this may only represent a minority of the spend in the category due to the fragmented nature of the spend. Suppliers in the indirect space take full advantage of this shortcoming and aggressively price items in the basket, fully knowing that they will represent a minority of the spend and they will make their money on all of the other purchases. Unless you both understand the right mechanisms to price future unknown purchases aggressively and can spend the time to manage pricing lists throughout the life of the contract, suppliers margins will grow over time as purchases shift away from the market basket. The alternative is to add all purchases into the evaluation, which will significantly extend the effort required to complete the analysis. This is a step very infrequently taken.

High SKU Turnover

Even if you have completed the perfect RFP, changes in purchasing patterns can quickly erode the value of the program. In some areas of indirect like MRO, companies may only repurchase 30% or less of products from year to year. Unless you are able to put mechanisms in place to ensure that new, high volume items receive assuredly good pricing, your savings will evaporate in years 2-3 of a new contract. This requires not only the foresight into how to build the pricing model, but also the diligence and time to review the core item list repeatedly throughout the course of the contract. The right pricing model differs with the category of goods and requires experience to identify as it can change over time. This is just another barrier to creating successful programs. It can be overcome with effort and outside intelligence, but the next barrier is even larger.

Invisible Deviations

When your RFP involves bidding a program with distributors, their margins are severely limited by the price that their manufacturer partners place on the goods. Distributors often seek to receive price breaks from manufacturers for particular pieces of business that are larger in order to be able to drive down their pricing and win programs. This process of setting up manufacturer deviations takes time, and is rarely a part of a sourcing plan because it would significantly lengthen an RFP process. To learn a bit more about these deviations, check out another of our whitepapers here. If your RFP process does not include building deviated pricing programs with manufacturers (which they rarely will) then you are leaving money on the table, potentially a significant amount of money. Negotiating with manufacturers in the indirect space often extends the time needed to complete the process. Furthermore, for many of the key manufacturers, your individual company spend may not meet the required criteria needed to engage. Even if the rest of the process drives down the distributors' margins to the lowest acceptable level, you still aren't going to receive the best price because manufacturers have not been engaged.

Manufacturer pricing creates more serious issues, such as incumbent bias, for the RFP process. Frequently distributors will go back to manufacturers over the course of a contract and ask for pricing relief for items that they bid low in the last RFP process. If successful, the resulting deviations will be put in place, likely without the knowledge of the customer. This effectively lowers the cost of an item for that distributor only. In the next RFP, the incumbent has an explicit cost advantage that is very difficult to overcome, even if you know that it exists (which you may not). You would have to inform every effected manufacturer that you are engaging in an RFP process and that you would like to have that manufacturer share your bid pricing with each of the distributors in the process. Some are willing to do so, others are not until the business is officially moved, so you would have to factor that into your selection process to eliminate the incumbent bias. That is difficult since the actual amount of the deviation is generally only shared with the supplier, not the customer. Even if you are successful at leveling the playing field, you haven't improved any of the deviations, which should be your goal.

Conclusion

Creating a successful RFP in the indirect space is difficult due to all of these factors, but it can be done. To create an ideal RFP, companies need to use valuable time to eliminate the information gap, build a comprehensive RFP, and avoid a market basket approach. Even more, companies will need to engage not only with distributors, but also with all manufacturers in the space to negotiate mechanisms to ensure that RFP results will not erode overtime due to SKU turnover. However, companies could consider engagement with a GPO, who will do all of these things and even create reports and analyses.

At CoVest, we frequently encounter companies that recently underwent an RFP process and we can still save relative to their new agreement, and the savings climbs even higher when time has passed and SKU turnover has degraded the program further.

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