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Differentiating value through contracts

Bob Endres *SYNAPTIC DECISIONS*

Key points

- "Value-based contracting" represents a radical departure from traditional approaches to deal development, evaluation and execution. It enables sellers of goods and services to shift the negotiations agenda with their customers away from a concentration on price and towards trading value and risks.
- Companies that have adopted this approach are achieving margin improvements of 10% or more, while accounting for risks — even at a time of generally falling prices and aggressive buyer negotiation.

This shift to value-based proposals is achieved by:

- taking a holistic approach to potential opportunities that results in an understanding of both the buyer's and the seller's perspective;
- creating multiple versions of contract offerings and aligning them according to value;
- presenting terms through a "commercial menu" that creates a broad trading space;
- price differentiating offers according to value, cost of deal obligations, risks, and options; and
- deliberate trading of provisions to discover the optimal deal.

Introduction

Many business leaders believe that trading relationships should become more collaborative — and top negotiators agree. A survey by the International Association for Contract and Commercial Management (IACCM) showed that over 80% of negotiators expressed the view that relationship outcomes would be more successful if the traditional focus for negotiations could be changed.[1][i] This view was similar for both buy-side and sell-side dealmakers.

Why isn't negotiation focused on value creation and distribution?

The primary reason, according to negotiation professionals, is simply a lack of trust in the other side. A readiness to talk value depends on trust, and trust tends to depend on a long-term relationship. No wonder newcomers and innovators find it hard to break into established markets or unseat incumbent providers!

So the challenge for sales is how to shift the nature of their conversation with customers and prospects. And the answer, instead of avoiding contract terms, is to equip sales with the tools for proactive value discussions.

What is different about value-based contracting?

Deals are a compilation of obligations, risk allocations and options. The fundamental product or service of a company is only one aspect of a deal. Too often, companies focus only on the differentiating aspects of their products and services in the marketplace and fail to recognise the differentiating advantage and value that can be created by the other aspects of the deal — ie, other key terms and conditions.

As a result, many companies begin the sales process by presenting a single offer to their customers (or responding narrowly to a customer's standard terms), which can quickly lead to "price-only" negotiation and then a tough battle over the allocation of liability and indemnity risks. Presenting or responding to a single offer:

- misses opportunities to discover buyer preferences and willingness to pay;
- does not create a linkage between provision changes and pricing; and
- limits the negotiating trade space.

If the focus is on a single offer, a customer will naturally concentrate on the price of what is being offered. Indeed, without visible alternatives, they will frequently assume that price is the only real source of value and differentiation. If any of the contract terms are not to the customer's liking, they will simply ask that these be changed to what they think they prefer. Thus, little true discovery of buyer perceived value across alternative offers occurs, and it takes a very skillful negotiator to maintain deal integrity and link changes in the deal's terms to costs and pricing. In short, it fails to adequately differentiate price based on differences in terms and conditions. Furthermore, with the focus on a single offer, there is limited exchange of information and innovative "win–win" outcomes are not uncovered or explored.

What is required is a proactive and systematic way of soliciting and discovering customer preferences and a willingness to pay within a framework that logically ties price differences to variations in risk allocations, options and obligations

An approach addressing these shortcomings is based on a "commercial menu". A menu of alternative offers with price points is presented to the customer. Each offer on the menu is described by a bundle of terms and conditions. The menu offers a trading space that guides negotiation and a more deliberate exchange of value and risks. A change in a bundle's terms and conditions (tradable) to match a buyer's preference is offset with another tradable matching the supplier's preference or a change in price, and can result in a better deal for the supplier.

Contract terms are like product features

Importantly, this is not a "cafeteria-buffet" style approach to deal formation where the individual prices of each element of an offering are given and a customer simply chooses all the elements they desire to come up with the total price. Instead, the commercial menu is a set of carefully constructed bundles of provisions, and each bundle is priced to take advantage of the collective and synergistic value of the provisions. Best practices in offering design and bundling are applied and the best decisions for bundled versus component pricing are made. This allows the seller to most effectively price the bundle while managing costs. Negotiations guided by a commercial menu facilitate a controlled exchange of information that leads to better trades and the discovery of win–win opportunities that ultimately yield optimal deals for both parties.

As an example of this, a client included in one of its offerings the option to substitute a raw material feedstock that was different from that which it traditionally used for a particular customer. This "wild idea" came out of discussion with the client's supply chain group and risk management group. The supply chain group recognised the feasibility of the substitution, while the risk management group identified the potential of an advantaged future market price for the substitute feedstock. This had never been offered before, as the client had always presented a single offering to the customer and it was not known how the customer would react to this option. However, by being able to value this option and include it in a commercial menu of multiple offerings, the client discovered that the customer was able and willing to accept the alternative feedstock. The customer obtained better pricing because, by providing this option, the client was better able to manage their supply chain costs and risks to obtain better margins. Thus, the ultimate trade-off was beneficial to both parties. In short, a menu allows a company to distinguish its offerings in terms of value and to price-differentiate them according to their different values, different allocations of risk, different levels of obligations, and different options.

Another problem with presenting a single offer to all customers is that it assumes all segments of the market and all customers are the same — with homogeneous preferences and capacities to bear risks. By creating multiple versions of contract offerings through commercial menus, a company can gain a higher price from premium offer seekers and effectively compete to win low price seekers in more competitive segments.

This value-based approach is, of course, directly similar to value segmentation of the functions and features of a product or service. It is, therefore, most effectively done as part of the product development and lifecycle management process. The commitments offered must, after all, be capable of delivery. Constructing commitments "on the fly" (ie, during the proposal or negotiation phase of a specific customer deal) is highly inefficient and dramatically increases supplier risk. In certain industries, such as construction or outsourcing, a certain amount of deal-based customisation is inevitable, yet even here the supplier must base this offer on a known and tested set of performance capabilities.

Case studies of value-based contracting

A transportation provider now offers three offerings to buyers aligned with three distinctive value propositions: low price, flexibility and immediacy. The basic service is transportation, but the offering versions for flexibility and immediacy are defined (and differentiated) by special quantity options and service levels respectively.

In another example, one maintenance service provider had always competed on the basis of a cost-plus–fixed-fee contract. The key negotiables were the fixed fee percentage and an escalation factor. Contracts only promised conformance to specifications and efforts commensurate with industry standards. The supplier created a performance-based fee-at-risk offer, whereby it took on more risk but earned a share-of-buyer savings. The two offers were made to buyers using a commercial menu. It allowed a cleaner and crisper separation of the two offers, whereby the fixed fee offer was stripped of risks and the fee at risk offer had supplier risks, but the risks were priced. And the buyer would only pay a premium if savings were realised. This differentiated the supplier in the marketplace.

These are cases where suppliers saw their "offer" as being broader than the product or service they provided. They saw the full offer — as described by terms and conditions — as much broader, and a way to differentiate themselves from competitors.

Identifying, costing and pricing obligations, risks and options

Every deal is a compilation of obligations, options and allocated risks. In order for a company to maintain deal quality, it must first understand these components and be able to cost and price them. If this is not properly accomplished, deals will either be priced too high and not provide the company with the ability to most effectively compete for business, or — worse — deals will be priced too low and provide lower than expected, or even negative, margins. Therefore, as a first step to effectively competing, especially in today's increasingly demanding market, companies must identify and then fully cost and price the obligations, allocated risks and options in deals.

Most suppliers are proficient at identifying and costing known and fixed obligations where the attendant costs to meet these obligations are certain and deterministic. But few companies are proficient at costing risks or uncertainties. Risks, or simply uncertainties, fall into three categories: supply chain risks, external risks and transaction risks.

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Supply chain risks

Supply chain risks are uncertainties along a company's supply chain that drive costs. For example, uncertainty in buyer demand affects a supplier's asset utilisation and is, and should be, important to a supplier employing significant capital assets to deliver a product or service. Steady or predictable demand can allow that supplier to more efficiently size and allocate its resources — thus lowering the overall cost to serve buyers. Many suppliers either make assumptions or bet on the size and pattern of demand realised under their contracts, and do not account for demand uncertainty and its affect on their costs. In so doing, suppliers also miss key opportunities to positively affect these costs by shaping buyer demand using contractual provisions. Other potentially important uncertainties along the supply chain include design, production, supply, quality, liabilities associated with infringement, and general liability.

External risks

External risks are uncertainties outside of the direct control of either the buyer or the seller; these risks are important to the proper costing of deals. A simple example of an external risk is raw material input pricing. While raw material prices can fluctuate widely, many suppliers routinely fix the prices of their end products or services over specified time periods without considering the appropriate "price" of that risk, or who is able to fund the risk at the lowest cost. Thus, risks are either priced too low and result in a sour deal or too high and result in a lost deal. Suppliers (and buyers) also miss opportunities to allocate these risks in different and creative ways to lower the total cost of the risks. Potentially important external risks are tied to economic, technology and legal/political uncertainties.

Transaction risks

Transaction risks relate to the interaction of the two parties and are tied to uncertainties in the areas of payment, the fulfilment of contract obligations, the effectiveness of governance mechanisms, and the buyer–supplier transition at the end of the deal. These risks also should be considered by suppliers in the proper costing and pricing of deals. A simple example of transaction risk is payment. Most suppliers correctly price payment terms; some even correctly price credit risk. Another example of a transaction risk is the case of a supplier who has invested in an asset whose value is low outside of a specific buyer relationship (transition risk). The right pricing and right risk treatment are obviously different from what they would be in the case of an asset with alternative use. In failing to properly consider and distinguish transaction risks in deals, suppliers either apply a blanket policy of assuming them altogether — at a cost — or apply a blanket price risk premium to all their deals. This misses the opportunity to price-differentiate the risks of a deal — and, again, either price too high and lose the deal, or price too low and lose money.

Analysing and valuing options

Embedded options are the final component of a deal. There are obvious options, such as an early payment right (usually for a discount off invoice), which most suppliers know how to price. There are others that, while obvious, most suppliers don't understand how to value — such as a contract term extension right, the right to subcontract, or the buyer's right to acquire or sublicense intellectual property. There are also less obvious options that require a trained eye to uncover. For example, a supplier of a commodity chemical offered a buyer a formula price that could diverge significantly from market pricing. The contract also allowed the buyer a generous degree of quantity flexibility from quarter to quarter. The buyer was taking their full contract allowance when market pricing was at or above contract pricing, and taking less when market pricing was lower than contract pricing. Unknowingly, the supplier had given the buyer a "best-of-price" option with a value of $6.6 million per year! Accurately valuing contract options requires financial engineering expertise and advanced analytical tools drawing on empirical data and expert judgment. While performing options analysis can be complex, the benefits are substantial.

Conclusion

In today's highly competitive markets, suppliers must take steps not only to differentiate their products and services, but also to protect their sales margins. Value-based contracting is a critical tool for those determined to flourish.

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About Synaptic Decisions

Synaptic Decisions is a specialty consultancy focused on helping clients achieve step change improvements in business results through integration of strategy, risk management, negotiations and contracting. Value-based sales contracting is a core offering of Synaptic Decisions.

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Footnotes

1. IACCM's worldwide survey of "Most Frequently Negotiated Terms". This annual study receives input from negotiators (sales, procurement and legal) in more than 1100 companies and has been tracking trends in negotiation since 2001. Information about the latest survey is available at www.iaccm.com.