

Consortia, Buying Groups and Trends in Demand Aggregation

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Purchasing consortiums are rapidly establishing themselves as a vital link in today's world-class supply chain strategies. There now exists a significant body of evidence indicating purchasing consortiums are commonly being utilized as a powerful tool to significantly drive down costs by supply chain managers in the best-run procurement organizations in Corporate America. This paper will review the recent history of group purchasing models and discuss the benefits and challenges to Supply Chain Managers and their suppliers.

Consortium Defined

A purchasing consortium consists of two or more independent organizations that join together, either formally or informally, or through an independent third party for the purpose of combining their individual requirements for purchased materials, services, and capital goods. The main goal of these alliances is to leverage aggregated purchasing power of the group to optimize cost reduction and value added contractual terms and conditions from the external supplier relationships.

Recent History

Although consortiums, co-ops, aggregation groups, purchasing alliances, group purchasing organizations, buying groups, etc... have been around in one form or another for hundreds of years, the last few years have seen an explosion in this type of procurement model. The rise of "dot com" marketplaces/vertical consortiums since 1999 has been unprecedented, while at the same time a number of Horizontal Consortia and Master Buying Consortiums have sprung up. While most of the vertical "dot com's" have fallen by the wayside during the dot com melt down, some of the strongest electronic marketplaces are at least still operating. A few Master Buying Consortiums are still operating, whereas the Horizontal consortiums seem to be the dominant model gaining the traction with Supply Managers.

Group Buying Models

Vertical Consortium: Consortium of companies that are in the same industry

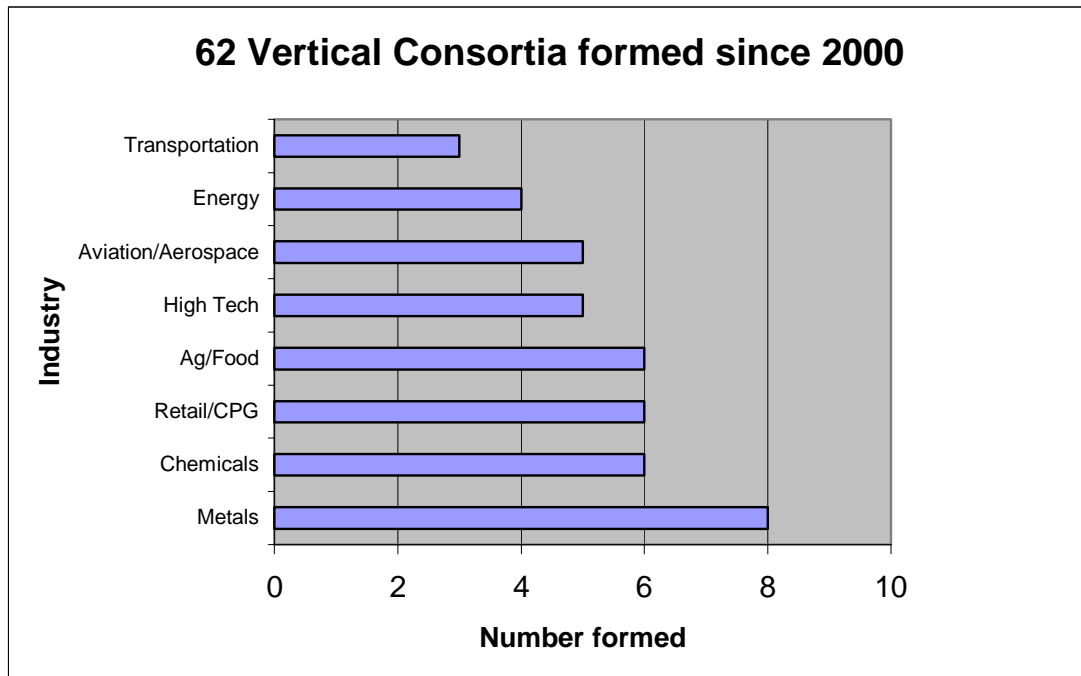
Horizontal Consortium: Consortium of companies that are in diverse industries

Master Buyer Consortium: Large multinational company attempting to extend its supply agreements to customers and suppliers with a percentage added on its baseline cost so as to act as a profit center

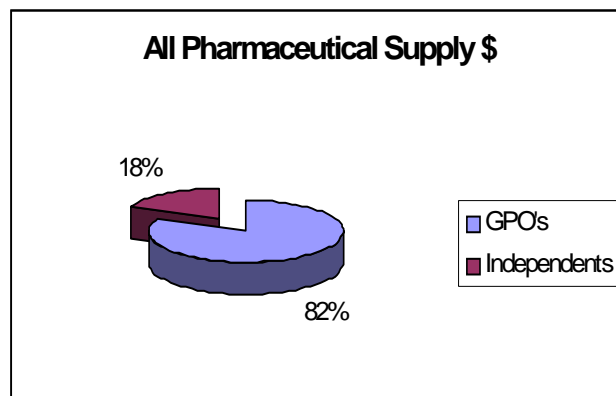
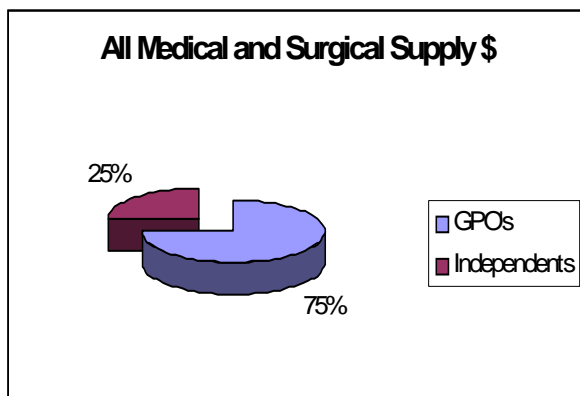
Vertical Consortiums

Many of the Internet vertical consortium models such as Pantellos, Exostar, Transora, WWRE, Covisint, RubberNetwork were formed by single industry participants to spread the cost of e-Procurement platforms (like Ariba & Commerce One) and sourcing software (such as B2eMarkets, Perfect Commerce, Emptoris, etc...) among their members and to source industry specific needs, run reverse auctions and provide a common electronic buying

platform. These endeavors have faced major hurdles based on incompatible technology issues, mistrust among competitor participants and the confusion created by ever changing business models. Literally hundreds of millions of dollars were invested by the participants with little public information available regarding the investment's return to date.



In contrast, Group Purchasing Organizations (“GPO’s”), vertical buying groups in the medical industry, have been around much longer and have proven to be a very successful model as they dominate procurement dollars in this space. . The Directory Of Healthcare Group Purchasing Organizations, 1999 edition, reports that GPO’s control over \$90 Billion in buying power and that almost 75% of all medical and surgical supply dollars and 82% of pharmaceutical supply expenditures are negotiated through these influential GPO’s.



One purchasing magazine wrote, “Driven by the advent of large hospital and HMO buying groups, as well as government initiatives to reduce medical costs, Baxter launched a company-wide strategic initiative to reduce total systems costs by 15% by 1998.” For reference, Baxter International is a \$7.6 Billion Fortune 500 manufacturer and distributor of Medical Equipment and supplies. The above quote implies that large buying groups can “drive” the supply chain and wield significant influence over manufacturers and service providers.

Horizontal Consortia

Formed within the last 5 years, Horizontal Consortia have fared much better than their vertical brethren. Groups such as Corporate United, WorldCrest, O’Hare Group and the Leveraged Sourcing Network have proved value to members and gained significant traction among Corporate America Procurement leaders. The most successful of this group, Corporate United, counts over 25 Fortune 1000 companies, representing over \$100 Billion in combined revenue, as members that participate in the group’s 14 supply category contracts. These groups are not saddled with the deep-seated competitor conflicts like the Vertical Consortia.

Master Buyer Consortia

The Master-Buyer consortium model has been attempted many times by industry giants such as Raytheon, 3M, IBM and Siemens among others. Some of these programs such as Raytheon’s have met with marginal success but have suffered from the issue. One program manager stated, “So far we have not seen a marked success in these models. Typically the problems lie in the fact that participating member companies have no voice in the contract & third party firewall issues (other companies have issues sharing their data for analysis & master buyer won’t share pricing until smaller company has committed) resulting in a stalemate to progress.”

Consortium Benefits

There is no doubt as to the number one benefit of consortium purchasing—significant cost savings. The 1997 study by Dr Thomas Hendricks from CAPS (which is the definitive written work on the subject), documented purchasing consortiums’ considerable success rate:

“[Organizations participating in purchasing consortiums] reported that purchasing through their consortiums saved them about 13.4 percent, which yielded an average annual savings of about \$2.3 million for each member. Comparing this to the average annual cost of \$300,000, and using a liberal interpretation, this results in an average return on “investment” of 767 percent!”

An often-overlooked benefit of purchasing alliances is the ability to network with other leading procurement organizations to benchmark best practices and supply market expertise. Hendricks concluded that, “...consortia also seem to hold the potential for creating a new dimension of “partnering” strategic alliances beyond those of individual buyers collaborating only with individual suppliers.”

Common Challenges

Organizations both join and avoid consortium purchasing for a variety of reasons. With such benefits as cost reduction, increased product availability, and improved efficiencies, some

organizations are eager to be members with other businesses. However, issues such as trust, cooperation, and a limited supply base instill reluctance from some companies to test the consortium environment. While risks may exist, horizontal purchasing consortiums, mediated by a third party, are eliminating many of the drawbacks associated with consortiums and bringing the advantages to the forefront.

The largest challenge for these groups, besides getting them off the ground, is intelligently leveraging the collective buying power of the group while tailoring contracts to fit individual member's needs.

Larger members often times believe they are the Alpha Dog and deserve better pricing and terms than the rest of the group. This is the type of thinking is a detriment to these alliances. In a recent article for Inside Supply Management, this topic was covered by Ed Leddy, (e-Procurement Manager at Progressive Insurance, and founding member of Corporate United Purchasing Consortium), when he wrote:

"In a horizontal consortium, organizations may benefit from each other disproportionately from contract to contract. For example, a \$5 billion manufacturer could have an MRO spend that may be 10-20 times that of a \$5 billion service organization. And that \$5 billion service organization may have an office products spend that is significantly greater than the manufacturing organization. Each organization will ultimately benefit from the others, so they must have the foresight to understand and embrace this concept for the benefit of all members."

"Benefits of membership vary from agreement to agreement, says Mark Connar, director of supply management for equipment, materials and services, Air Products & Chemicals, a member of the consortium for nearly two years **[PURCHASING: May 2, '02; p. 16C38]**. "We're using some of the agreements (office supplies, temporary labor and some MRO items) and find them to be quite successful. In some cases, we've seen double-digit cost reductions, depending on the commodity.""

The number one reason for supplier resistance as reported by the Hendricks study is that "...strong suppliers may insist on keeping individual consortium members as separate customers to continue to extract higher margins." Any professional supply manager realizes that the profit goals of suppliers don't necessarily match his procurement organization's and can logically conclude that consortiums can help shift the odds in his favor.

Yet, suppliers must benefit for consortiums to ultimately succeed. The goal is to reduce the winning supplier's margin percentage, but increase their total margin dollars with the consolidated volume of the group. Suppliers fear loss of margin percentage and eventual loss of business. A good consortium model should allay this concern by providing suppliers with committed volumes and long-term contracts; thus, reducing the supplier's selling costs and allowing these reductions to offset the margin % losses. In industries where customers change suppliers frequently, this will greatly reduce a supplier's need to spend money and time defending market share, as it is effectively locked up for the contract period.

Critical Factors for Success

There are a number of critical factors for success that supply managers looking to form a consortium must take into consideration. These include:

- 1) *Actual Cost Savings*: To rapidly win the necessary confidence of its members for success, consortiums initial endeavors much show hard dollar savings that translate into bottom line profit increases to its members.
- 2) *High Degree of Trust Among All Participants*: Most easily established in horizontal consortiums, as members are not long time direct competitors. Consortiums may also allay this concern by specifically targeting non-strategic or non-proprietary items for group contracts.
- 3) *Safeguards to Prevent Possible Anti-Trust Violations*: In its charter, the group should have clearly defined firewalls for member company. Careful research into other such by-laws to reveal proper safeguard language and philosophies.
- 4) *Similar Buyer-Supplier Relationship Philosophies*: Members must have common goals for group purchasing and agree on the weight of non-price factors for contract award
- 5) *Communication and Commitment*: Communication of the ultimate goal of the alliance to the member organizations and gaining commitment to actively participate and add value to the group is essential. The best model for success is to attain upper management understanding/support of the endeavor and appointing champions within each member organization charged with formal objectives for a successful engagement with the group and to perpetuate the model within the organization.
- 6) *Critical Mass*: These alliances must attain a critical mass of companies whose volume, in aggregation, will command more attention from the supply base.
- 7) *Do what you say you are going to do*: It is critical that when you approach the supply base as a group you do not overstate the volume that will be awarded to the winning supplier(s). Suppliers are leery of consortiums because of the recent un-met volume commitments by many of the unsuccessful start-ups & a general misunderstanding of the benefits. Make certain your members and suppliers fully understand the value proposition of the group & that this endeavor is intended to be a win-win for buyers and suppliers.

Typical Supply Categories for Consortiums

The Hendricks study reveals that most buying groups target MRO items (54% of respondents), followed by services (46%), direct materials used in production (42%), and capital goods (35%). This is logical as MRO, or commodity type purchasing is the least threatening and presents the slightest resistance from members and supply base to initially target. The area with the most potential return, but correspondingly the highest degree of risk is direct materials. Although significantly more difficult to attack, nearly half of these alliances target direct materials and, when successful, reap tremendous rewards.

Most consortiums have focused on “low hanging fruit” for MRO and general services initially. For instance, Purchasing in a 2001 interview with a consortium founder reported, “... we needed to find a common buy, so we started with office products,” says Mylett, now CEO of Corporate United. “In the office products buy, we did strategic sourcing with the six companies. We pulled individuals from each of those companies to create a committee with about 15 people and we created baselines, wrote a request for proposal (RFP) as a group, analyzed the responses as a group, scored them based on agreed upon criteria and awarded business as a group.” The result of the endeavor was that each of the 6 Fortune 1000 members companies to save between 12-25% on their office products spend.

Initial Strategy

Consortiums must begin with a value proposition that is not only agreeable to, but also excites it’s members and potential members to take action. Following this the initial structure of the alliance must be spelled out in it’s by-laws so that all anti-trust considerations have been addressed. The by-laws should also define exactly who shall be eligible & the process to join the group. Utilizing a third-party to handle all sensitive information is the most reliable strategy to create the necessary firewalls for anti-trust concerns. The three Federal regulations with which each consortium’s structure must be compliant are: 1) The Sherman Act 2) The Robinson-Patman Act 3) FTC Anti Trust Safety-Zone for Collaborative Purchasing.

Message proliferation both internally and externally is critical. Members must “sell” early successes (cost savings, better terms, etc...) throughout their organization to gain support for the endeavor. Externally members should present the successes to other potential members. Participants need to recognize that they benefit from bringing on new members’ additional buying power just like a conglomerate adding another division’s requirements to the fold.

Attack the low hanging fruit. Consortiums run into more difficulty as the categories they pursue need greater customization to accommodate diverse member needs. Considerable savings can be generated quickly based on the group’s volume and knowledge of a specific supply category and its inherent cost reduction opportunities. Locate the categories that best fit the demographic of your group and then pursue them with unified vigor.

Finally, you must secure written commitment from the founding members that they will participate in the process are move (if necessary) their businesses to the awarded supplier(s). The members must recognize that they not only have the responsibility, but the benefit of being part of the decision making process. Mylett later states in the 2001 Purchasing article, “One thing we learned from the healthcare industry was the need for commitments,” he says. “Some [healthcare] GPO administrators were making the decisions as to who the suppliers were, often through secret or privately negotiated deals and members had no say in who won the contract. We formed committees to ensure the decision-making would be open for all members.” Each committee member gets an equal vote on contracts, regardless of their company's size, length of participation or amount of spend it has in the consortium. “

Today, a large enough contingent of consortiums exists for Supply Managers to investigate before attempting to start their own. Supply professionals should exhaust their search before endeavoring to attempt to start their own.

Conclusion

Purchasing consortiums or similar alliances can be a valuable strategic initiative worth serious consideration by Supply Managers today. There is undeniable evidence that properly managed consortiums are bringing significant and immediate value to their members. Moreover, with today's climate of "doing more with less" these purchasing alliances can help Supply Managers not only leverage the group's spend for more competitive pricing but also leverage the group's resources where he may be understaffed. Participation in a consortium is rewarding experience for not only the organization, but for the Supply Manager as well.

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