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Lowest Price or Lowest Cost?

By:
Justin M. Caron
Council Director and
Sales Manager
jcaron@mapi.net

1600 Wilson Boulevard, Suite 1100, Arlington, Virginia 22209-2594 Phone: 703.841.9000 Fax: 703.841.9514 www.mapi.net

Lowest Price or Lowest Cost?

In today's economic environment it is essential that an organization's sales people be able to articulate to customers the differences between lowest price and lowest cost. According to Todd Snelgrove the Global Value Officer of SKF Inc., "Best in class companies have taken the time, effort, and focus to quantify the value of their products and services. If you can't, purchasing will have no choice but to ask for a lower price." Customers are not in the business of buying products or services, they are in business to add value for their customers. No longer are vague promises of "quality" enough. In Aberdeen Group's 2010 Chief Procurement Officer white paper[1], the number one priority for procurement is the "top down directive to cut costs". It is the job of suppliers to demonstrate and document how they can take sustainable costs out of their customers' businesses. The good news is that advanced procurement departments are now asking suppliers how to take costs out. This was recently reaffirmed at the Aberdeen Group's 2010 Chief Procurement Officers summit held in Boston, MA, where Mr. Snelgrove explained the concept of TCO (total cost of ownership) and how procurement should engage suppliers in continuous improvement cost reduction programs.

Value Selling—Quantifying the Intangible

During the inaugural Manufacturers Alliance/ MAPI Sales Forum meeting held in August of 2010, Mr. Snelgrove presented the framework of value selling[2] and its applied success throughout the manufacturing industry. Now more than ever, sales teams are pressured for growth, ownership of the bottom line and added market share. Value selling has emerged as an effective approach to accomplishing all of this without providing pricing concessions to win sales. According to Mr. Snelgrove, the adoption of a value selling framework must begin with modeling all features and benefits of a company's products or services in quantifiable monetary terms. Value selling requires companies to assign monetary value to the benefits behind vague terms like "quality" and "reliability" by mining data around maintenance costs, replacement costs, cost of failure, etc. Asking for an X percent premium over the competition can be a hard pill to swallow if the only justification given to the customer is a promise that, for instance, the product or part is "higher quality." A TCO sales approach like this makes for a much more compelling argument: while our bearing costs X percent more than the competition, it lasts twice as long (saving X percent in replacement costs) and uses X percent less lubricant (saving X percent in lubricant costs). When all is said and done, the bearing with the highest price actually has the lowest total cost of ownership. Having this type of data can justify a premium price position and provide concrete defenses against low-cost competition.

Other industries like information technology and automotive manufacturing have employed a TCO selling model with marked success for a number of years. In the case of the IT industry, TCO quantifies the costs of implementing and operating a new technology over its entire life cycle. This includes programming, support, operational expenses, upgrades, and long term replacement costs. TCO is also applied to the sales of hybrid and battery-powered vehicles on a daily basis. The average upfront purchase price of a hybrid or electric vehicle will likely be higher than its combustion engine counterpart. However, the quantifiable TCO across the life of the product from a fuel costs perspective alone is significantly lower. In fact, within the consumer automotive sales industry, TCO has become a de facto standard with virtually all of the larger manufacturers offering a "true cost to own calculation" along with new product launch information. Variables commonly used for consumer automotive TCO include depreciation, fuel, maintenance, repairs, interest on financing, taxes and fees, and insurance premiums.

To be successful, an organization must train and compensate their staff for selling based on total cost, rather than initial price. Leading companies provide their sales people with the knowledge and tools to do this through robust databases comprised of past successes. Data from case studies can be leveraged across other industries or applications, and lends credibility to a TCO proposal. Marketing collateral that focuses on value and total cost, rather than price, supports this sales approach, and emphasizes the cost savings created for customers by purchasing based on value as opposed to price. For SKF and other companies, "shared value agreements," in which the company guarantees their cost calculations, are increasingly popular. These

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[1] S. Pezza, C. Dwyer, Aberdeen Group, *From Preservation to Prosperity: The CPO's Agenda for the New Decade* White Paper, December 2010. http://www.aberdeen.com/ (Membership required).

[2] MAPI Sales Forum Presentation, Demonstrating Your Value So Customers Appreciate And Are Willing To Pay For It, August 2010.

agreements typically outline a comparison between TCO versus initial purchase price. To ensure the value selling framework's success, it helps to have a champion in place with management access to oversee its implementation and day to day operations.

Strategic Sourcing—Other Side of the Coin

Procurement departments operate under similar pressures as those facing sales organizations. Bob Rudzki, President of Greybeard Advisors LLC and former Chief Procurement Officer of Bayer Corporation and Bethlehem Steel Corporation, presented a unique take on the evolution of "strategic sourcing" during the MAPI Sales Forum meeting.[3] In its most basic sense, strategic sourcing is "the selection and management of suppliers with a focus on achieving the long term goals of a business." In Mr. Rudzki's experience it has evolved into a "disciplined, multi-stage process, typically involving cross functional teams that examine, address and optimize the TCO and value." Sound familiar?

With the adoption of strategic sourcing comes a new set of behaviors in which suppliers need to be proactive. Procurement professionals are increasingly aware of life cycle costs and suppliers' costs, rather than just quality and services provided. Taking a page from the value selling handbook, a TCO selling approach provides an opportunity for procurement teams to deepen the relationship with their suppliers (and vice versa). Sales departments need to do their homework in order to provide a proposal that provides long-term value to both parties. This can set them apart from competitors who focus on initial price. It also adds value to the customer, because they a e able to capture savings that are based on total cost rather than simply the initial purchase price.

Quantify Value

Margin pressure leads to adaptation; organizations have proven they are more than willing to make significant investments in people, processes, and technology to obtain the payoff from strategic sourcing, and suppliers must react accordingly. By implementing a value selling strategy suppliers will be able to demonstrate in quantifiable monetary terms the ability to deliver significant cost reductions and efficiencies while staying in line with strategic procurement. Tom Johnstone, President and CEO of SKF Group put it best; "In today's global business environment, customers are perceiving more and more products as commodities. Therefore, it is vital for a company to be able to prove why its products are able to deliver REAL VALUE. One of the most important tasks we have today throughout the SKF Group is to create, deliver, and document the value that our products and solutions bring to our customers."[4]

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[3] MAPI Sales Forum Presentation, Selling Strategically: How To Win in a World of Strategic Sourcing and Reverse Auctions, August 2010.

[4] James Anderson, Nirmalya Kuman, and James Narus, *Value Merchants*, Boston: Harvard Business School Press, 2007.