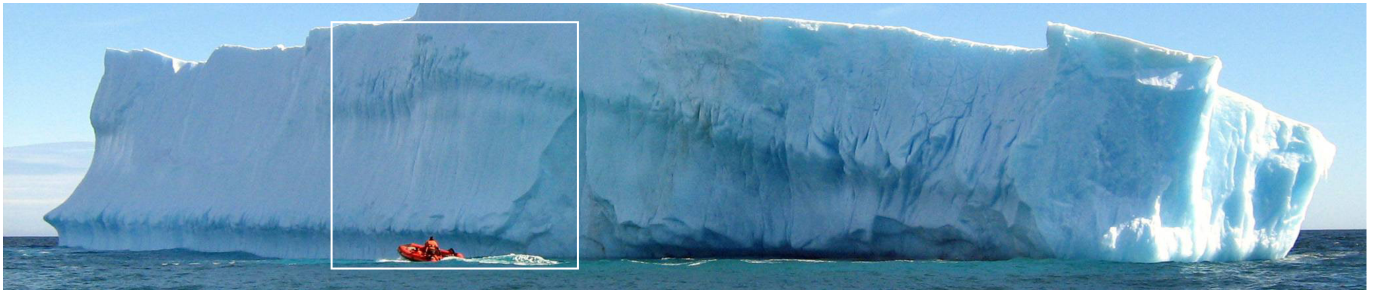
No Stone Unturned?

Purchasing alliances between portfolio companies in private equity context



The recession means that Private Equity Associations must face the challenge of supporting their investments. For many, a ruthless reconstruction of redundancies is necessary, which regularly leads to friction. Without doubt, reducing purchasing costs would be a more amicable solution, and would also have a positive effect on the short-term cash flow. The following approach demonstrates how Private Equity Associations can support their portfolio companies' purchasing process through joint purchasing. When grouped together, even unattractive assets can offer appealing potential. In recent projects, Arthur D. Little's customers achieved savings of up to 25%, with the overall average being 6.3%.

Saving through joint purchasing of "indirect material"

When grouping demands together, the results reveal increased multiple purchase volumes in contrast with the demands of individual portfolio companies. This is not only due to the financial implications of economies of scale, e. g. in production, but also due to the increase in sales. Suppliers are more willing to significantly reduce their prices because of increased volume.

Because the requirements for the so called "indirect material", e. g. IT requirements, communication and travel costs, energy, insurance, logistics etc, are not dependent on the specific industry and are used by companies of all trades, joint purchasing is very effective. Even if the demands of companies differ in detail, they can still be sourced by the same suppliers. As a result, these demands can be bought together for the entire portfolio of companies.

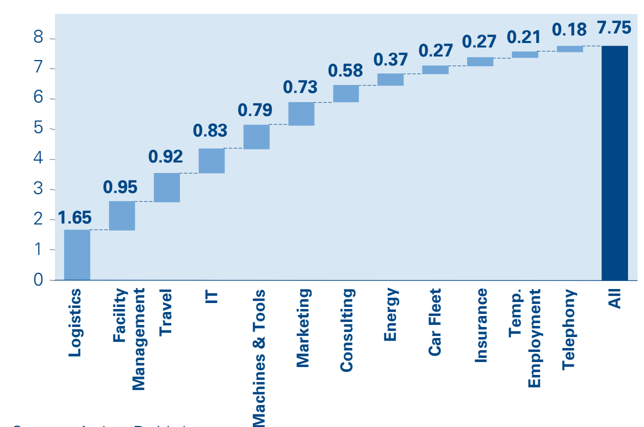
Usually, indirect material account for about 8% of the revenue. figure 1 shows the corresponding groups of indirect materials in % of revenue.

The challenge – avoid exit barriers

One of the challenges for private equity businesses is not to create exit-barriers for individual portfolio companies. All conditions that have been agreed with the suppliers should remain valid for individual portfolio businesses, even after a sale. Otherwise, the value of the individual business would be lower or at worst, the business would hardly be sellable.

In extreme cases, companies have lost their insurance protection after they've been sold because their insurance cover originally depended on conditions agreed by their previous portfolio.

Figure 1. Indirect material expenses



Source: Arthur D. Little

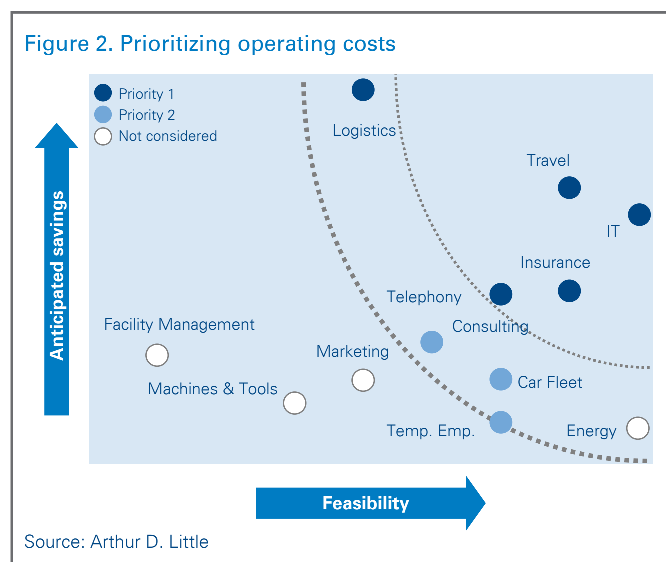
Such situations can be avoided by the purchasing association of an investor closing bilateral contracts between the individual portfolio businesses and their suppliers. This is a pure "economic bundling", which doesn't involve "legal bundling". This approach is often supported by suppliers as it comes with key advantages: every individual portfolio company gained as a customer will stay a customer even if there is a change in ownership, which would mean a withdrawal from the original union. This will effectively increase planning assurance for the supplier.

Only a small number of suppliers prefer a different approach, often due to the nature of the internal organization structure. If the portfolio companies are spread out geographically, the coordination of consistent offers by the sales representative is made difficult. In such cases, very different structures have been reported. Ultimately, the more flexible supplier has achieved a considerably better advantage in his costing.

Analysis: Identifying potentials

The spend volume for indirect material is initially collected in a similar way. As such, the latest actual as well as the best available forecast data is relevant. Indirect materials are subdivided into so-called "material clusters", which generally relate to the relevant purchasing markets (see figure 2.)

Figure 2. Prioritizing operating costs



Source: Arthur D. Little

The stakeholders of portfolio companies should check each of their "material clusters" for joint purchasing potential with other portfolio companies. It also must be clarified how long current contracts are running and if suppliers can be changed. The actual price and potential have to be discussed, and based on mutual assessments, the "material clusters" can be prioritized or excluded.

Reducing costs: tendering and negotiating with suppliers

The target of this initiative is to improve suppliers' conditions for every "material cluster" or even a change in supplier. Synchronizing decisions across the portfolio companies is a basic strategy of joint purchasing which results in stronger negotiations. To systematically develop and use this, the following six steps should to be followed:

1. analyze purchasing markets
2. set up a competition matrix
3. evaluate preferences
4. develop negotiation strategies
5. approve negotiating mandate
6. carry out negotiations and make agreements

To a larger extent, the "material clusters" can be managed independently and embedded in staggered overall project plans. It is recommended to start a project with basic "material clusters", e. g. communication or travel costs. This will create a positive signal for further cooperation between all portfolio businesses.

The private equity association usually runs through these necessary steps with the portfolio companies. However, based on our experience, the introduction of a particular system is recommended. Purchasing conditions should be checked in regular intervals and renegotiated if necessary. It is important to observe that no overall structure between portfolio businesses and private equity associations is established.

Step 1: Analyze purchasing markets

The relevant suppliers and competitive environments are analyzed for all "material clusters." With the help of previously achieved price dynamics data and benchmarks, an estimation of current price levels can be carried out.

Furthermore, suppliers will be analyzed in relation to their motivation and interest in a business connection with the portfolio business as well as their importance to that business.

Step 2: Set up a competition matrix

In addition to the awareness of the analysis, a so called "competition matrix" should be established. This sums up the actual and potential business of the individual portfolio companies with all suppliers. With this, it will be decided which suppliers might be suitable for which portfolio company in the event of a possible change in supplier. As a result, the suppliers will try to make the best offers in any price negotiation.

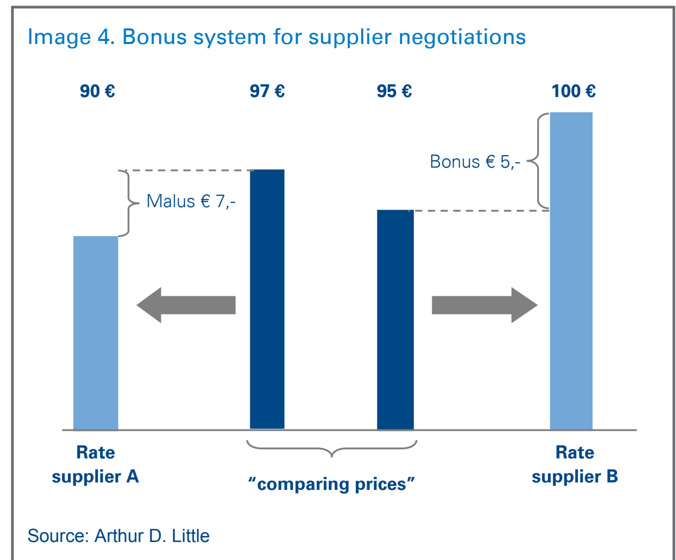
Image 3. Competition matrix

material cluster	Telephony									...
material field	Mobile Network				Fixed Network				Inter-net	...
supplier	Voda-fone	T-Mobile	E-Plus	...	Voda-fone	T-Mobile	Colt	...	...	...
Portfolio-company A: Incumbent supplier	X				X		X			
Potential supplier		X	X			X				
Volume Plan 2009	€ 100,000					€ 200,000				
Prices / Conditions						negotiated in 2008				
Comments	Individual contracts		Net density		Via Arcor		Preselect-vendor			

Competition matrix for mobile telephony

Source: Arthur D. Little

Image 4. Bonus system for supplier negotiations



Source: Arthur D. Little

The competition matrix also contains information that is essential for sending tendering documents to all concerned: actual volumes, possible gains and potential (new) customers. Figure 3 is an extract of a typical competition matrix.

Step 3: Evaluate preferences

Subsequently, a bonus system is developed – see figure 4. This system shows the decision preference for individual portfolio companies in terms of the "total-value-of-ownership". This leads to the use of "comparing price language" in negotiations and empowers the negotiator in two ways:

- First, he can rely on the commitment of the portfolio companies, with which he has already agreed the bonus system in the preparation phase.
- Second, the communication of the bonus system strengthens the competition argument for the supplier (even if the competitive environment is rather weak.)

Generally, the necessary early involvement of all parties leads to positive understanding, as portfolio companies can already identify growth potential.

Step 4: Develop negotiation strategies

By considering all general and market conditions that have been included in the analysis, the optimal strategy for negotiation can be decided. These strategies offer argument schemes and suggest ways of implementing them into future markets. The strategies of the negotiator will be specifically coordinated with the portfolio companies in simulated trials.

Step 5: Approve negotiating mandate

The bonus system as well as the chosen negotiation strategy will be pre-approved by the internal decision panel of the portfolio company. This will result in synchronized decision making for all portfolio companies. A clear mandate for the negotiator will be established so that he will be able to negotiate on behalf of all portfolio companies.

Step 6: Carry out negotiations and make agreements

Tender and subsequent price negotiations take place for the portfolio companies strictly within all of their agreed and approved rules and regulations.

Arthur D. Little has actively conducted the communication of the bonus system and supported final price negotiations as a facilitator / leader or as a bargaining agent.

This strategy achieved results in every "material cluster" by extending or renewing a contract with suppliers on more attractive terms.

In a variety of projects, by working with Arthur D. Little, a significant reduction of purchasing conditions for "material clusters" has been achieved.

Factor of success – Leadbuyer-Concept

The crucial factor for the success of this initiative is to provide motivation and support to all portfolio companies. This challenge is solved by the Leadbuyer-Concept. The "lead buyer" will be a representative of his portfolio company but will also act on behalf of all portfolio companies in the project team – relative to his "material cluster." He will be actively involved in the implementation of all the above steps, especially in gathering all data for the competition matrix, discussions with stakeholders regarding the bonus system, the draft for tender and conducting negotiations. He is responsible for implementing the results into his company.

Management Summary

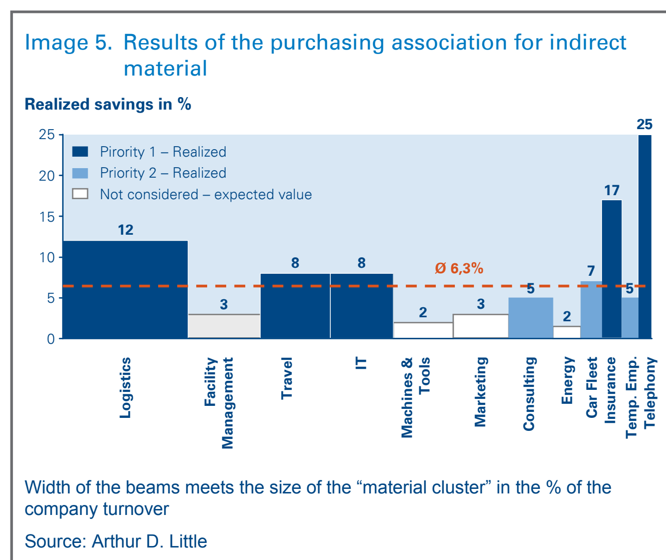
No stone unturned?

With this approach, Arthur D. Little shows an easy and effortless way that portfolio companies can manage overheads successfully, where beforehand it was thought to be difficult and unattractive.

Due to the Arthur D. Little's strategy, companies have seen savings of up to 25%, with the overall average at 6.3%, (average savings are displayed on figure 5.) Compared to the sales the savings seem small, however depending on the business situation, they should be measured in relevant EBIT%.

As an important side effect, the portfolio companies have learned a new way of cooperating with each other.

Image 5. Results of the purchasing association for indirect material



Width of the beams meets the size of the "material cluster" in the % of the company turnover

Source: Arthur D. Little

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Arthur D. Little

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