Perspectives on Customer Value Analysis
May 2004

This month's newsletter discusses how cross-functional purchasing teams can use the Customer Value framework. In many companies, half or more of the value of products going out the door consists of purchased inputs, including services, components, and supplies. So, assuring high value (low cost, high performance) in purchasing is a key to enabling your company to offer your customers superior value. Our topics:

. • Under *Strategies*, we cover using the Customer-Value Dialog process with potential suppliers to develop sources for products that deliver good performance for price.
. • In our *Features* section, we review methods for using the Digital War Room to make purchase decisions.
. • *Tips* shows how to use the Head-to-Head chart to explain the choice of a higher priced, but better performing supplier.

Strategies: The Purchasing Team's Best Friend

In our April Newsletter, we discussed how the customer value framework is being used by account teams to structure insightful dialog with their key customers. In this month's Newsletter, we turn the tables and look at how the same customer value framework, and the same structured dialog, can be used by the purchasing team to widen its options and improve its ability to select the right supplier for its company.

Imagine a purchasing team that has dealt with the following four potential suppliers:
. • Alpha: our current supplier, offers great service, understands our business, but is pricey.
. • Beta: a viable alternative, is generally more cost competitive, but doesn't quite have the dependability and performance we would like.
. • Gamma: Makes a good product, but for one reason or another, never passes our standard certification hurdles
. • Delta: A respected company, does not make exactly the product that we need, but makes some related products.

The value map below depicts our choices at the time our most recent contract was awarded. Only Alpha and Beta offered products that passed our initial screening:

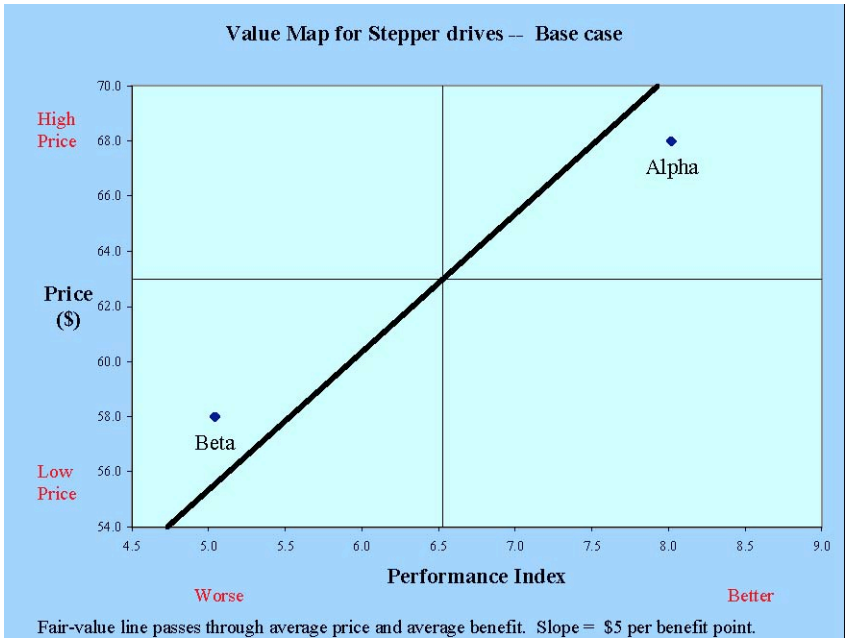


Exhibit: Historically, economy product Beta and premium product Alpha were ouronly choices. Both are plotted fairly close to the fair-value line.

Value maps are an excellent tool for purchasing analyses. They show the price of each supplier's product plotted against the product's performance. The performance index, plotted on the horizontal axis, is based on ratings of each product along a set of separate criteria. These separate ratings are then combined into a single index of performance. The diagonal fair-value line shows the degree to which it is worth spending more money to get better performance. In general, the best values are those found furthest from the fair-value line in the lower-right direction. Neither of the choices pictured here is an obvious "best value."

The objective in structuring customer-value dialogues with the various suppliers is to change this value map so that, when we renegotiate this contract, we will be looking at more choices in the lower-right, high-value sector of this plot. The process to do this should be started well in advance of contract negotiations, say in the weeks and months following the awarding of the most recent contract. The idea is to widen the selection you will have at the next contract review period.

In the customer-value dialog, the purchaser and the supplier discuss (a) the criteria (attributes) important to the company and their relative importance, (b) the perceived performance strengths of the supplier and where that supplier stands relative to competitors, and (c) the importance of costs, both initial price and costs in use. Within this framework, here are a few of the specific ideas you might want to explore with the four potential suppliers:

. • With Alpha (the current supplier): "Here are our expectations of performance. Here is how we will measure you this year. Here are areas where we'd like some performance breakthrough ideas next time. What can you do to lower our costs?"

. • With Beta: “Here are the areas where we found your performance lacking relative to Alpha. Can you make a higher-performance, more dependable product? How much extra would we have to pay?”

. • With Gamma: “Why can’t you pass our certification requirements? Have we put unreasonable hurdles in your path? Can we work together to help you put together a viable bid next time?”

. • With Delta: “Here’s what we really need. Can you develop a product concept for us to look at next time?”

If these conversations are successful, here is what the suppliers might be prepared to offer as the time approaches for a contract review:

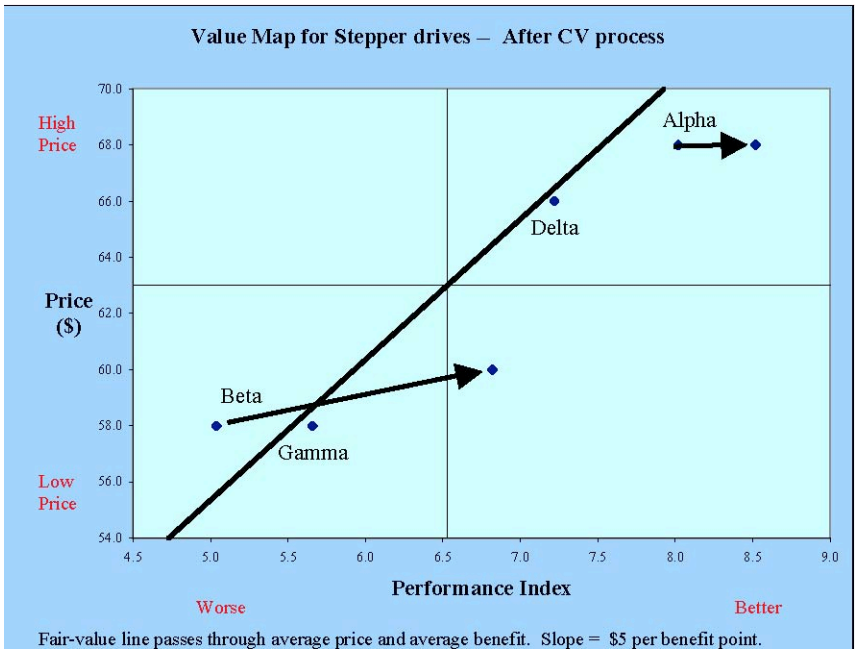


Exhibit: The objective of the process is to create additional choices and higher-value options.

The changes triggered by the customer-value dialog sessions are diagramed in this value map:

. • Alpha pushes the performance of its product to new high levels without incremental cost.

. • Beta offers an improved product, competitive with Alpha, meeting our performance needs

. • Gamma gets its certification act together and is in a position to make a competitive, low-cost bid

. • Delta develops a product that could meet our needs.

With these moves, we've widened our choices and improved our potential for getting better performance for price. However, the best part, from Purchasing's perspective, is yet to come. With the earlier contract, there were only two viable bidders, and only one that truly met our performance needs. Therefore, neither of the potential suppliers had much of an incentive to lower prices. Now, with a number of competitors making interesting offers with acceptable performance, and with no supplier clearly dominating our choice, each supplier knows that we will be taking a hard look at price. In fact, intense competition is more effective than the most aggressive bargainer in forcing bidders to lower their prices. So, we hope and expect that the prices will drop – something like this:

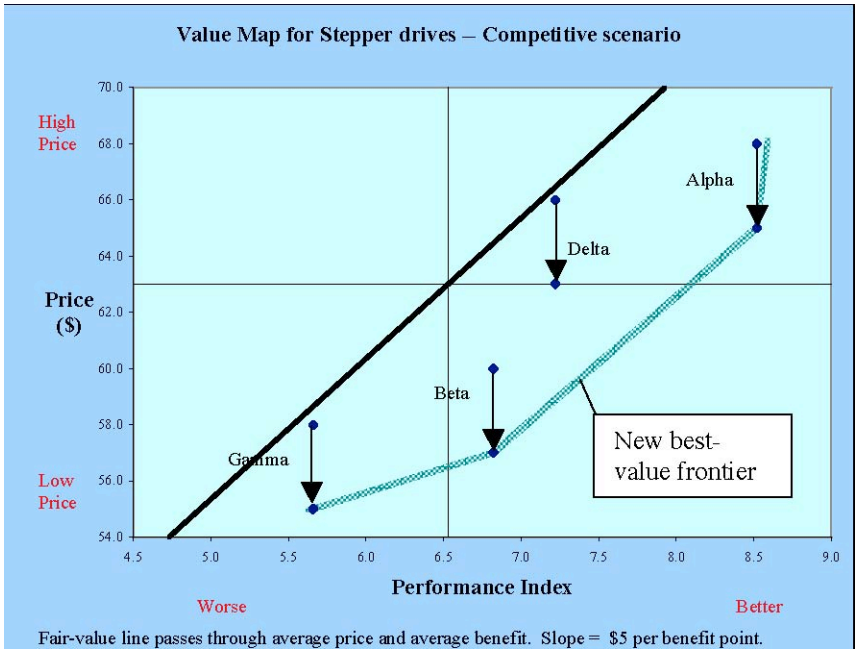


Exhibit: Increased competition within our acceptable performance range will pushsuppliers to lower prices

With the addition of new competitors, the improved performance levels, and lower prices, we've created a set of strong alternatives for ourselves at different price/performance tradeoffs. The best alternatives at different price/performance levels are connected by a line called the "best-value frontier." This line is now located well to the lower right of the original set of choices offered by Alpha and Beta.

The purchasing team's best friend is … competition! As in this example, effective use of the Customer-Value dialog at strategic points in the contract cycle can give a company a wider variety of viable suppliers, better performance options, and lower costs – in short –

better value choices in its selection of supplier.
Features: Using the Digital War Room to Select a Supplier

Purchasing departments often use a numerical rating system to evaluate competitive bids. They identify (and usually share with potential bidders) the criteria that they will use. They rate each bidder on each of the criteria using, say, a 1-to-10 scale. They weight the scores according to the relative importance of the criteria. Finally, they compare the weighted scores for each bidder to select the winner. (This is precisely the same customer-value logic used by many marketing and sales teams to measure the comparative value they are delivering to their customers.) The Digital War Room can automate these purchase-evaluation calculations and help you make the comparisons.

This month we'll focus on a particularly tricky aspect of this process, that of setting the weights for the different attributes. It might be expected that purchasing teams, through an open dialog among all of the company's stakeholders, should be able to get an accurate fix on what their own company values. In practice, however, any group that has been through this exercise will tell you that the process doesn't always work smoothly, and doesn't always lead to the choice that, in retrospect, they wish that they had made.

The problem is that setting weights is trickier than it appears. To illustrate, think of buying a car. What is more important to you, safety or the number of cup holders? Most people (at least those who care about their families) would unhesitatingly say "safety". If forced to give weights, they might give safety 95% of the weight and cup holders 5%. However, once in the showroom, customers might be hard pressed to discern differences in safety among models ("they're all safe"). They might well end up basing their decision on amenities (like cup holders.) The problem is that concepts like safety are very abstract until you are presented with actual alternatives. It is only in the context of examining actual alternatives that most people can judge what is really important to them.

Market researchers tackling this problem from a different perspective, have generally found that the best way to figure out what customers really value is to show them concrete examples of different products, and use their choices to estimate what different things are worth to them ("conjoint analysis"). An approach in the same spirit (but much simpler) can be used by purchasing teams. The idea is to make the abstract concrete by developing qualitative descriptions of performance that the team would evaluate as strong or weak.

Here's how it is done: First, for each criterion, the purchasing team develops a qualitative description of a level of performance that would qualify for a good score and one that would qualify for a poor score. These descriptions might be based on the team's past experience, or on actual proposals that were evaluated for past contracts. After the descriptions are developed, both the good and bad performance is given a score, where, say a 10 would represent the best conceivable performance and a 3 would represent a minimally acceptable level of performance. We will use a hypothetical case in which there are two benefit attributes, ease of use and weight. In this scenario, the

purchasing team would start by building a table something like this:

Attribute	Low Performance Example Score	High Performance Example Score
Ease of assembly	Description 5 •Separate mount and gasket •Balky interface	Description 8 •Integrated mount and gasket •Consistent, high quality interface
Component weight	3 14 oz.	7 9 oz.

Exhibit: Developing concrete examples of how performance might vary fromproduct to product makes it easier to estimate importance weights

At this point the team has developed a concrete picture of realistic alternatives that they might face when the day comes that they look at real bids. Next, they have to evaluate how much more they would be willing to pay to get the high-performance alternative for each attribute. This involves considering whether, the high-performance alternative is enough better than the low-performance one that you would actually pay more for it. If there is no incremental worth, the attribute should carry no weight in the final decision. In this case, the team judged that the high performance option on ease of assembly would be worth as much a $9.00 extra, and the high performance option for component weight would be worth an incremental $4.00.

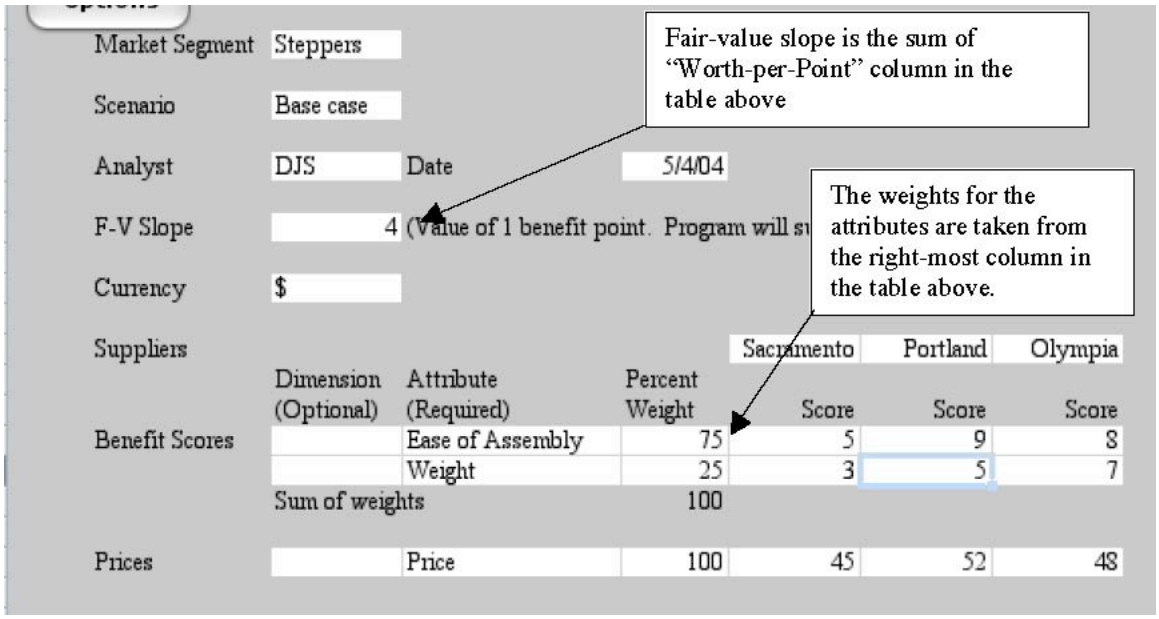
Once the team has finished estimating an incremental worth for the high-performance alternative, a table such as the one below can be constructed. The scores for the low and high-performance can be copied from the table above, and the difference calculated (marked as column (c) below.) The team's estimate of the incremental worth of the high-performance description is in the column marked (d). The next column shows the worth per incremental point of performance score. Finally, the numbers in the worth per point column are scaled upward so that they sum to 100.

Attribute	Scores (1-to-10) for			How much more	Worth	Weight =
	"Low"	"High"	Difference	is "High" worth	per point	Scaled worth
			High - Low	to us ($)	($)	per point
	(a)	(b)	(c) = b - a	(d)	(e) = d / c	100 (e / f)
Ease of Assembly	5	8	3	$9.00	$3.00	75
Weight	3	7	4	$4.00	$1.00	25

Total of Worth per Point (f)	$4.00

Exhibit: The key to estimating benefit-attribute importance weights is figuring outhow much you might be willing to pay for better performance.
This table is the source for some key inputs into the Digital War Room. The numbers in the right-most column are the "Attribute Weights" for a Digital War Room input form. The cell marked "Total of Worth per Point (f)" is the slope of the fair value line.

Armed with these inputs, the team is ready to start evaluating bids as they come in. In the following fictitious example, there are three bidders: "Sacramento", "Portland", and "Olympia". To organize the evaluation process, each attribute is assigned to a group of team members. The same group scores all of the bidders on the attributes that have been assigned to it. The end process is a completed Digital War Room input page.



Market Segment	Steppers					
Scenario	Base case					
Analyst	DJS	Date	5/4/04			
F-V Slope	4	(Value of 1 benefit point. Program will s				
Currency	$					
Suppliers				Sacramento	Portland	Olympia
	Dimension (Optional)	Attribute (Required)	Percent Weight	Score	Score	Score
Benefit Scores		Ease of Assembly	75	5	9	8
		Weight	25	3	5	7
	Sum of weights		100			
Prices		Price	100	45	52	48

Exhibit: The Digital War Room's input forms are used to record both the criteriaused to evaluate suppliers and the identities and performance scores of the bidders.

After the team finishes scoring each of the bidders on each of the attributes, and after the Digital War Room input form is completed, the various tools of the software can be brought into play. The Value Map tool will tell you much of what you need to know in selecting a supplier:

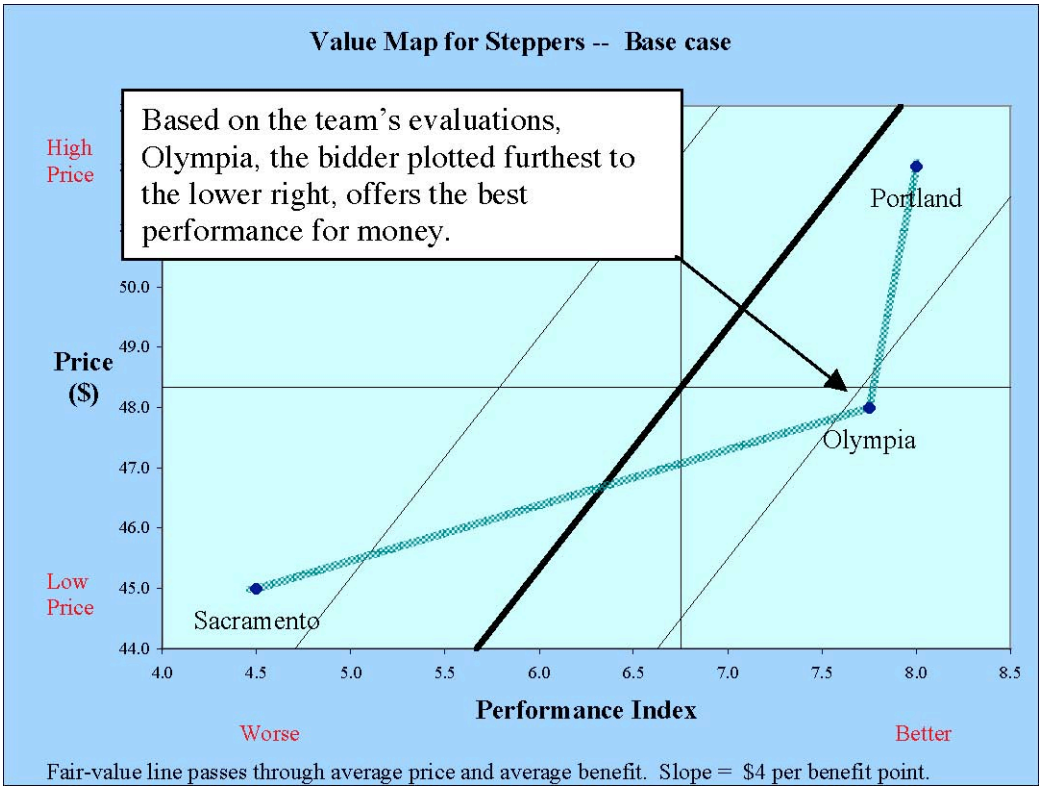


Exhibit: The Value Map shows the Price/Performance tradeoffs reflected in yourpurchase options.

The value map shows you at a glance which products are worth considering. In the case above, "Olympia" is the product that stands apart in the highest value sector of the diagram.

Tips: Head-to-Head analysis can help explain your choices

Uh oh! Your management just found out that you signed a contract for $48 with Olympia where Sacramento had bid $45. Now they're asking you to justify why you missed the opportunity to save money.

The head-to-head chart can show the boss exactly why Olympia was the high-value choice. The head-to-head chart shows, in monetary terms, the advantages that Olympia's product offers. These numbers are ultimately derived from the exercise described above in which the team decided in advance which attributes were important enough to justify extra money for better performance, and on the actual performance ratings the team assigned to the suppliers.

In this case, Olympia outscored Sacramento 8 versus 5 on Ease of Assembly and 7 versus 3 on Weight. Since performance on both attributes is worth something, we would expect Olympia to be worth more. That is what the head-to-head chart shows.

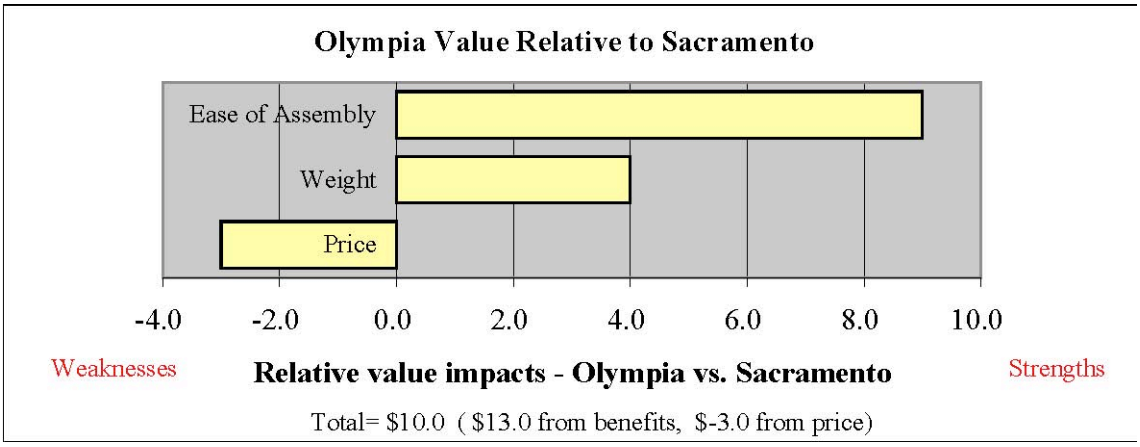


Exhibit: The head-to-head chart shows why the Olympia product offered morevalue

The top bar shows that Olympia's superior Ease of Assembly alone makes it worth $9.00 more than Sacramento. Throw in an extra $4.00 of incremental worth because of the Olympia product's light weight, and we find that the total worth of the benefit advantages amount to $13.00. Olympia's $3.00 incremental cost relative to Sacramento is a small price to pay to gain extra performance worth $13.00.

(Incidentally, the eagle-eyed reader may have noticed that the scores the team assigned to Sacramento and Olympia in this fictitious case "just happened" to match the scores in the hypothetical "Low Performance" and High-Performance" examples they developed in the weight-setting exercise above. So, it's not surprising that the $9.00 and $4.00 incremental values calculated in the head-to-head exhibit exactly match the incremental amounts that the team originally said it would pay for the hypothetical "High-Performance" option.)