

E-Procurement: Reverse Auctions and the Supplier's Perspective

Like buyers, suppliers can benefit from online auctions; intelligent research can elucidate how low to bid while continuing to make money

As discussed in the companion article in last month's issue of *BioPharm*, many needs of pharmaceutical development and manufacturing, from excipients to contract laboratory services, increasingly are being purchased through e-procurement processes (1). One such process, the online reverse auction, allows buyers to exchange information with sellers and solicit and accept bids from multiple sellers in a Web-based electronic marketplace.

The allure of lower prices, a broader supplier base, faster cycle times, and a more efficient procurement process attracts buyers to reverse auctions. Online buyers often save money on purchases of goods because the nature of the reverse auction tends to force a supplier to progressively reduce its asking price.

As a result, it is not surprising that suppliers can feel threatened by reverse auctions. Many established suppliers have trouble adjusting to online arrangements because of the personal nature of the relationships and negotiating tactics that they have formed with buyers through the years. Familiarity with, or fear of, technology also may come into play. "If a

company is 40 or 50 years old, the computer is not its first tool of choice — the phone is," said Dr. Bruce Diel, president of Chemfinet Services, Inc. (www.chemfinet.com).

Power to the purchasers. Major buyers may compel suppliers to participate in auctions, and smaller suppliers are more susceptible to such pressure. Carol Rozwell, vice president at GartnerG2 (www.gartnerg2.com), said that such a supplier should determine the probability that it will need to participate and then plan accordingly.

By forcing bidders to progressively lower their bids, reverse auctions can reduce supplier profit margins and even threaten corporate viability. "Yes, there are winners and losers in reverse auctions," said Roddy Martin, a service director for AMR Research (www.amrresearch.com). According to a report by research and consulting firm IDC (www.idc.com), "the power in the sourcing process defaults to buyers. They are, after all, the ones who control whether, with whom, and how money is spent" (2).

However, Martin noted that suppliers, drawing from their online auction experiences, are getting smarter and have learned how to retain profitability. If a supplier researches an online auction intelligently, it can determine how low to bid while continuing to make money.

Supplier Benefits

Like buyers, suppliers can benefit from online auctions in various ways. For example, in traditional auctions, bids are sealed. By contrast, suppliers can alter their bids during an online auction, increasing

their chances of winning the contract. They also can bow out of the process at any time. By opening up the bidding process, an online auction gives suppliers access to buyers with whom they may not otherwise have contact. "Suppliers who don't have the business should participate [in an auction] because it's a chance at getting the business," said Michelle Hincks, marketing vice president for ChemConnect (www.chemconnect.com). This is particularly true for smaller companies, which can leverage an auction to boost their public exposure. If a purchaser reviews bids with an open mind, a new supplier with a carefully prepared bid may land the contract. Just as buyers can use auctions to increase their supplier base, suppliers can regularly check the e-marketplaces of buyers for new selling opportunities.

In addition, some suppliers have adopted the attitude, "If you can't beat them, join them." Such suppliers purchase their own supplies in reverse auctions. This approach can produce savings throughout the supply chain for buyers and suppliers alike. Of course the supplier, like the buyer, must calculate carefully whether the cost of establishing and maintaining electronic auctions will improve the bottom line.

It is critical that suppliers fully understand the auction process. A supplier must become completely familiar with the auction's rules, requirements, and software tools. All the details of a complicated bid must be worked out beforehand. Otherwise, suppliers can easily make "rookie mistakes" under the pressure of online bidding, according to industry observers. One way to

Edward P. Moser is a freelance writer, and contributing editor **Jim Miller** is president of PharmSource Information Services, Inc., and publisher of *BioPharmaceutical Outsourcing Report*, a monthly newsletter covering the contract drug development industry. A trial subscription can be obtained by calling 703.914.1203, by faxing 703.914.1205, by e-mailing info@pharmsource.com, or by visiting www.pharmsource.com.

Jim Miller's Outlook

The chemistry, manufacturing, and controls (CMC) outsourcing industry continues to be reshaped by acquisitions and divestitures. This activity reflects the maturing of the industry and the changing strategies of key participants.

The big news is the acquisition of **Magellan Laboratories, Inc.** (www.magellanlabs.com) by **Cardinal Health** (www.cardinal.com). Magellan is a leading provider of CMC development services, including analytical and structural chemistry, pharmaceuticals, chemical synthesis, and bioanalytical testing. The company had revenues of \$60 million in 2001 and has been averaging 30% revenue growth in recent years. The purchase price had not been announced at press time.

Cardinal is recognizing the strength of Magellan's reputation and management by making it the flagship of its development services effort. Cardinal's new unit will do business as Magellan Pharmaceutical Development Services (MPDS), reversing a trend to rebrand acquired businesses under the Cardinal Health name. Magellan founders Lowry Caudill and Al Childers will manage the operation, reporting directly to George Fotiades, president of the Cardinal Health Pharmaceutical Technologies and Services group. Caudill and Childers will take over Cardinal's new \$80-million, 265,000-ft² development center in Somerset, NJ, and the parenteral products development operation in Albuquerque, NM, which had been part of **SP Pharmaceuticals** (bought by Cardinal Health in 2001).

Cardinal and Magellan view the mission of MPDS as driving new business into Cardinal's commercial manufacturing and drug delivery businesses by capturing clients at an earlier stage in the development process. At the same time,

they know that the business must stand on its own. "We're going to work on anything the customer wants us to work on, including conventional dosage forms," Fotiades said.

Other Deals

According to industry buzz, another big deal in the works is the sale of clinical packager **Clinical Trial Services** (CTS, Philadelphia and Craigavon, UK) by parent **Galen Health, Inc.** (Craigavon, UK). No official word has come from Galen, but the sale has been expected ever since Galen expanded its proprietary products business by buying Warner-Chilcott in 2000 and then sold its Syngal and Quchem chemical synthesis businesses in February 2002.

In addition, the CMC industry is losing a participant as **Omnicare Pharmaceuticals** (www.omnicarecr.com) closes its development operations. The company had achieved sales of almost \$20 million and was profitable, but a flood decimated its facilities in June 2001, and its parent company decided not to rebuild the business. Omnicare will reestablish a clinical packaging business at its Toledo, OH, repackaging facility.

CROs Feed on Biotech

Large CROs have been actively courting smaller biopharmaceutical and pharmaceutical companies, and the results are beginning to show. According to Wall Street analysts David Windley of Jefferies & Company and Eric Caldwell of Prudential Securities, smaller sponsors now account for 25% of the revenue of the public CROs, up from 10 to 15% historically. Caldwell estimates that small pharma and biotech companies represent as much as 33% of the CROs' order backlog.

Smaller companies have become more attractive clients because of their maturing pipelines and success in raising money through the past several years. The year 2000 was unprecedented for the biotech sector in the capital markets. According to industry watcher **Burrill and Company** (www.burrillandco.com), biotech firms pulled in an estimated \$39 billion, more than three times the amount raised in 1999.

The pace slowed significantly in 2001, however, as total capital raised fell to \$13 billion. Market conditions were considerably more difficult in 2001: Seven companies that filed IPOs withdrew them, and the companies that were successful had relatively stronger and more advanced pipelines than companies that floated IPOs in prior years.

Even though 2002 may be a disappointing year for fund raising, the biotech and small-pharma segment should continue to spend aggressively in development services. Analysts estimate that many companies raised as much as five years' worth of capital during 2000–2001 and are only now beginning to spend those funds.

It is unlikely that biotech will ever supersede big pharma as CROs' principal business source. Big pharma's already massive R&D budgets are forecast to expand 8–10% this year, and 20–30% of those funds will flow to CROs. Still, recent events have demonstrated that big CROs must diversify their client base because they cannot rely on the stability of their big pharma relationships. The stock of **PPD Inc.** (www.ppd.com) recently took a sharp drop because of investor concern that problems at **Bristol-Myers Squibb** (www.brms.com), which analysts estimate provided PPD with 10% or more of PPD's revenue, would hurt its profitability.

reduce error is to select an experienced, well-established e-marketplace that can serve as a stable training ground for the novice online participant.

If a supplier decides to use a public auction house, it should select one that fits its business strategy. A report from GartnerG2 states that some of the less-

successful chemical industry e-marketplaces have "alienated sellers by bypassing their services and eroding their brand identities" (3). The report suggests that a supplier should register with an e-marketplace that supports and enhances its existing business processes instead of one that tries to change the way the supplier conducts its business.

"**Seller beware.**" Suppliers, like buyers, must make many decisions before participating in an on-line auction. They must decide, for example, how low they can bid and still obtain an acceptable return. Suppliers also must factor in the buyer's location to calculate shipping costs.

For More Information

Carol Rozwell, vice president at GartnerG2, carol.rozwell@gartner.com

Roddy Martin, service director at AMR Research, rmartin@amresearch.com

Michelle Hincks, vice president of marketing at ChemConnect, lyoungs@upstart.com

Bruce Diel, PhD, president of Chemfinet Services, Inc., tel. 877.372.2436

ChemConnect, www.chemconnect.com.

Rozwell noted that suppliers must keep close tabs on their buyers because buyers are sometimes "lax in administering their procurement process." In a sluggish economy and in the pharmaceutical sector where many e-marketplaces have shut down, a supplier also should examine a buyer's financial status.

Market conditions will influence the value of an auction for both buyers and suppliers. Suppliers should be wary of auctions in which market prices are falling because supply is exceeding demand. They can be more confident with an auction in which market prices are rising and production capacity is tight. Suppliers have a better negotiating position when their numbers are few and the supplier base is less fragmented. A supplier that can outbid competitors in the sale of highly commoditized products that are common in reverse auctions is likely to dominate the market. In the end, suppliers benefit most when their relationships with long-term buyers are mutually beneficial.

For both buyers and suppliers, electronic auctions help spur the automation of what can be a painstaking procurement process. Indeed, one factor blocking some suppliers from online auctions is their lack of basic Internet capabilities. E-marketplaces or in-house online auctions rationalize inventory management and transaction tracking and automate time-consuming tasks such as calculating shipping costs and exchange rates.

Online exchanges provide the storage and exchange of standardized, electronic documents that are critical to procurement such as requests for quotations, proposals, and information. The mere conversion of paper documents to electronic forms can free employees for higher value tasks such

as price negotiation and postbid analysis. E-marketplaces offer databases that store evaluative data about companies, including industry certifications and production techniques. They even can enable the holding of traditional, sealed-bid auctions through electronic means: Bids may be distributed to and collected from suppliers without any give-and-take on prices. When choosing an online exchange, find one that offers all the required functionality. In addition, the exchange should be market-savvy enough to upgrade services regularly based on user feedback.

Along with selecting the right auction service, "there's a whole lot of stuff that participants need to do behind their own firewalls," said Martin, who added that the availability of integrated information and decision-support information systems is critical. In-house or contract expertise in information technology is vital in accomplishing this integration.

Every auction is unique and will differ according to price trends, data availability, the number of suppliers, and other variables. E-procurement demands considerable time and resources from companies to make it work. According to Rozwell, a key question for a would-be auction participant is, "Are you willing to make the big commitment to online purchasing?"

Private and Public Auctions

One way of gaining the electronic benefits of online auctions while retaining traditional supplier relationships is to use private reverse auctions, also referred to as *corporate trading rooms*. These auctions can be hosted on public trading sites or individual company sites.

Several analysts detect an industry trend toward private auctions and away from public ones. "Consortium trading exchanges have not lived up to expectations," said Martin. According to Rozwell, most online auctions are private with a limited, but specialized, supplier base: a "small circle" of suppliers focused on one sector.

Private auctions enable buyers to retain trusted, credit-worthy suppliers without risking a decline in service quality with new suppliers. Furthermore, they can minimize security concerns about the exposure of sales data, buying patterns, and other sensitive information to competitors and customers. For those reasons, private auctions often are

geared toward high-dollar transactions of critical goods. At the same time, buyers can rapidly exchange key information with customers and suppliers by drawing on e-commerce technology (4). Private auctions, Martin noted, may make it easier to consolidate data management and business process management systems, including the so-called "back-end applications" such as product scheduling, sales forecasting, and purchase order tracking.

A private auction, by definition, has a more geographically restrictive supplier base than a public consortium. However, one way to broaden the supplier base of a private auction is to hold multiple private auctions for suppliers from different regions.

Auctions conducted through public trading consortia have their own advantages. They can benefit suppliers and buyers who are keen on expanding their client base by advertising a company to an audience that is potentially global in scope. They enable one-stop shopping in which a buyer can find a number of suppliers in one place instead of searching through the web sites of many suppliers. Public auctions also are particularly well suited for "spot" transactions in which the emphasis is on rapidly finding sufficient players to make a quick transaction (4). And established e-marketplaces offer a wealth of experience and functionality that private companies might acquire only with considerable time and expense. Public consortia also can help companies bolster their in-house business and data management capabilities.

When deciding whether to use a private or public auction, or even whether to use a reverse auction, preparation is paramount. Both buyers and suppliers should consider carefully what strategies make the most sense for their businesses before committing themselves to the new electronic marketplace.

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Edward P. Moser