Supplier Insider Round Table

Data Center Cost-Plus Pricing EXPOSED

It's a Cat and Mouse Game

The cat and mouse game of compressing spend is a very tricky business. For every move a procurement officer makes, you can bet that your supplier has a counter move if they are motivated to increase their margin/commission. In this eBook we will looking at a channel perspective of Cost-Plus Agreements for Data Center acquisitions.

The Magician's Secrets

The goal isn't to expose the tricks of the supplier trade, but to give procurement a real look into what the other side considers to be in a company's best interests when negotiating directly or indirectly with suppliers. The magic tricks of maintaining healthy margins in thew channel… will remain with the magicians. So… let's take a look at what your suppliers really think...

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The Easy Button

The consensus is in, and all of the experienced account executives we spoke with believe cost-plus models, particularly for datacenter acquisitions, to be the least effective at truly compressing spend year-over-year… and the easiest to circumvent.

They know the proposition… economy of scale… partnership… the carrot of more business… but honestly, your suppliers really don't believe in the value proposition and/or the procurement teams' intention to live by the agreement. Furthermore, they all viewed the agreement as more of an inequitable guideline because it usually does not prevent the company from purchasing from their competitors, while attempting to lock channel into anemic margins and corresponding commissions.

Large VARs will consummate an agreement when there is no way out, or if they are in a competitive bid and it is used a concession. Small and mid-size VARs will happily agree, but if they cannot cost effectively scale to accommodate the thin margins on promised, but never guaranteed, volume, a large cost-plus agreement can either burn them out, or drive them to insolvency. Hence, finding ways to increase profit margins regardless of contractual guidelines can become necessary for the reseller… the account manager… or both.

The bottom line is, if your goal is to hit the easy button... and set it and forget it… then a cost-plus pricing model for datacenter acquisitions (servers, storage, network, and certain software & SaaS) is a viable option. Just know that the agreement fosters an environment where market forces will proactively be working in their own best interests and not yours.

Below are the **TOP 10** reasons the participants in the roundtable agreed that Cost-Plus Agreements, particularly for datacenter acquisitions, do not work as intended, and may not be in anyone's best interest.

#10 – Cost-Plus Agreements are Counterintuitive

Think about it… your company is in a cost-plus agreement with a VAR… whether you know it or not, your supplier now considers you a transactional customer and there is little motivation to provide value… and less than zero incentive for them to help you compress spend as it only penalizes them.

For example, your company places a $100,000 order through XYZ Reseller at a cost plus 2% margin. The gross profit that is tied to the account managers' compensation is 2% of the $100K purchase... or $2,000. Why would anyone make a consorted effort to reduce the cost 10% to $90,000, resulting in $200 less gross profit @ $1,800 and reduce their commission? Now scale that to $1MM… Can you see how this is counterintuitive at best… Or counterproductive at worst?

The common procurement view of this is, "Well… what about the rebates?", which is a fair question, but the reality is that your account manager isn't typically compensated on rebates… they are the company's to keep. So, the person on the front line that is supposed to be your advocate could care less about the rebates and will resent this sentiment if presented. They won't say it, but they do.

#9 – Can There be Value Add in a Cost-Plus Agreement?

The channel hears it all the time… "Where is the Value Add?"… they hear it from the OEMs,… they hear it backdoor from some customers… and the reality is that from the resellers perspective, although they will never say it, a cost-plus agreement is a transactional agreement and you are getting what you pay for.

The VAR, more times than not, will assign some rookie to manage the account and your senior account manager will pay attention to higher margin, higher touch customers. The harsh reality is that, outside vendor consolidation, a VAR in a datacenter hardware/software acquisition has little value unless engineering is pre-negotiated… and even then you will still be paying for it somewhere… somehow.

#8 – Cost-Plus Models are Not Ideal During Adverse Economic Circumstances

In strong economic conditions cost-plus agreements can be more favorable, but unfortunately there is going to be tough sledding for the foreseeable future. Many of you reading this have been battling cost increases attributed to the complexities of rising transportation costs and component shortages. Cost-plus agreements are not conducive to your partner battling the increase, as those exact increases will improve the company's gross profit and the account manager's commission. The more you pay… the more they make. How hard do you really expect them to work at managing increases? How hard would you? Is it ethical? Maybe… maybe not… but it is capitalism… it is human nature… and it can represent a bigger payday for the account executive.

For example… six months ago you purchased a server solution for a refresh project and the solution list price for the servers was $160,000 per server @ a 50% discount off list price, resulting in an acquisition cost of $80,000 per server. At cost-plus 2%, the reseller's gross profit is $1,600 per server. Now, you just received a quote to add capacity, and the list price jumped to $180,000 per server. At the same 50% off list price your company is now paying $90,000 per server; and at the same 2% cost-plus margin the gross profit to the reseller is $1,800, which represents a 12% increase in gross profit.

#7 – Who's Watching the Hen House?

During the term of the agreement list prices will fluctuate, and in a cost-plus model, there is no incentive for the reseller to monitor increases to list prices, or declining discounts, past the initial purchases to ensure that the cost of your IT investments won't increase year over year and erode your perceived spend compression.

Large commercial and enterprise customers may have resources dedicated to monitoring price fluctuations, but it is an additional tax on the enterprise that reduces the true net spend compression that you are delivering to your company. And, if you are really searching for net spend compression, you'd have to consider the additional human resource tax on auditing the agreement.

#6 – Recapturing Margin is an Account Managers Fulltime Job

Have you ever filled out an executive escalation for special pricing trying to penetrate an account or win a competitive bid as a supplier? If you had, you would know that it is not unusual that the escalation will ask something similar to, "If the pricing request is granted, what is your plan to recapture margin in the future?" Does this suggest that it is part of the account manager's/partner's job to proactively attempt recapture margin in the future? We'll let you decide. However, those of us on the supplier side of the equation understand that once the pricing, or discount structure is granted, the procurement department will typically either expect, or contractually demand, that it will continue as the new benchmark.

Rest assured that there will be attempts, legally, and usually ethically, to circumvent the agreement and improve profitability. The attempts, which are too numerous to identify in this eBook, will come in many different forms that only the creative souls on the supplier side will understand. Have you done a solution-based price analysis over a reasonable period of time to validate that you are actually getting compression past the initial order? Most don't… and again another tax that needs to be considered when determining net compression.

#5 – Cost-Plus Agreements Erode Trust in Reciprocal Partnerships

Once procurement officer has inked a cost-plus agreement, and later realizes that their company has moved the goal post on their compression goals, they may be forced to renegotiate the pricing, which your supplier/partner will resent, and will typically erode the trust in a reciprocal partnership further fueling the account team to find another/better way to skin the cat and improve margins.

Should you decide to live with the agreement, and not renegotiate, you may fall short of your compression goals… and now your only choice is to find another supplier and start negotiating all over again. There are innovative paths less traveled that are more efficient, that will keep your suppliers on their toes, and will be far effective at compressing spend. Think outside the box.

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#4 – Cost-Plus Agreements Demotivate and Drive Complacency

Cost-Plus agreements don't just disincentivize sales people, but they demotivate procurement officers from searching for new ways to further compress spend in a given category because the perception is that the work has already been done. They move on to other responsibilities, lose touch with the industry movements, and quickly get out of negotiating shape for the affected categories.

#3 – It's a Pay Me Now… Or Pay Me Later Proposition

There are many ways to recapture margin on thin hardware agreements, and one of them is to attempt to soak customers on services. The pressure on the account teams to improve overall margins is significant and if goals aren't met it will have a disproportionate effect on the account managers commissions… and necessity is the mother of invention. Don't take our word for it, the P & Ls for the publicly traded VARs are public domain and not a single one of them is living on 2% margin. And, it isn't magic.

#2 – Companies with Cost-Plus Agreements are Prime Targets

Seasoned account executives agree that customers with Cost-Plus models tied to datacenter acquisitions are prime targets for account penetration. Showing value by compressing spend is a tricky proposition that can be met with opposition from procurement teams, but all agreed that when given a chance to prove it, the success ratio is high.

#1 – Cost-Plus May Not be in Your Best Interest on Data Center Spend

The round table concluded, that Cost-Plus Agreements are better than nothing for a customer, and safer for the account executive, but they are not the optimal vehicle for year-over-year spend compression. Competitive bidding still remains the #1 threat to any account executive or OEM.

Of course, there are many reasons why soliciting competitive bids on run rate/incumbent categories do not make business sense. The amount of time, and the technical sophistication it would require for a procurement and/or engineering continually bid suppliers against each other are two of the biggest obstacles. However, all agreed, that if anyone could ever automate the RFP/RFQ process in the fluid world of commoditized datacenter products, it would be a game changer.

Is IngenewIT™ that game changer? Demos are free😊!

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