

by Jon Stevens,
 Director Corporate Exchanges,
 Arthur Andersen

Achieving Digital Market Liquidity

What's liquidity
 and how do I get
 there? There's
 more to the story
 than size and
 volume.

Predictions vary widely, but virtually all analysts agree that B2B commerce conducted through digital markets will flourish over the next three years. With estimates in the trillions, the potential impact on global business commerce is staggering.

Equally prevalent are predictions of doom. Most analysts agree that at least 50 percent of online markets will fail outright or be absorbed by other markets during the same three-year period. The implications should be cause for concern among both market makers and market participants.

Why so many failures? Reasons abound, including participant friction, potential for antitrust actions, technology issues, and buyer and supplier participation levels – all of which are linked to the concept of digital market liquidity.

Liquidity defined

What constitutes liquidity? Trans-

action volume and size, marketplace worth, and transaction quality are three common definitions used by analysts and consultants. Yet a more encompassing and accurate description of liquidity is: *A composite of market participants engaged in an ecosystem for business.*

More specifically: *A composite* means that a market's liquidity relies upon participants of all sizes, not just mega-companies. "Small cos" give depth to the interactions that take place within the digital market and fill potential voids – geographic, organizational and competitive.

Liquidity depends upon a variety of *market participants*, including buyers, sellers, traders (participants who are both buyers and sellers) and service providers (financial, logistics providers, etc.). It's important that all players in the digital market find short-term and long-term value in their participation, and that there be a reasonable balance to the level and



frequency of their interactions.

To be *engaged in* a marketplace, participants must do more than just subscribe to the digital market services. The services must become part of the fabric of their organizations – their people must be passionate about wanting to use the services. Achieving this often requires comprehensive training and active change management.

Ecosystem means simply that the digital market must be self-sustaining. It must be a community of companies functioning as a unit with a purpose.

And, ... *for business* relates to “engaged in.” Digital markets must serve as more than a transaction environment. They must offer services that solve participants’ business issues and enhance the relationships between organizations.

Components of liquidity

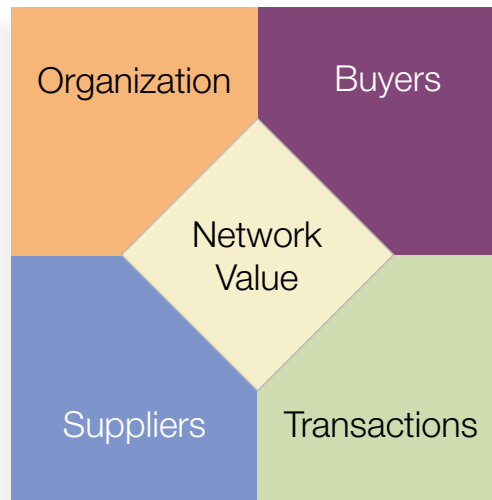
Given our definition, digital market liquidity is comprised of five key components. There are four cornerstones that create and drive the centerpiece of overall network value in a digital market: organizational, buyer, supplier and transaction liquidity.

■ *Organizational liquidity* derives from the market maker’s internal assets. To achieve liquidity, digital markets must have a strong strategic focus and a highly competent leadership team that has well

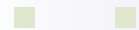
established industry relationships. This team must drive alliances based on its relationships, and it must understand how to make internal systems and processes achieve optimum performance.

■ Digital markets achieve *buyer liquidity* by successfully identifying the core drivers, such as procure-

Liquidity Decomposed



Liquidity has five components that need to be understood to drive it into the marketplace.



Source: Arthur Andersen

ment savings and industry leadership that create the compelling reasons for joining, and encourage buyers to move their structure spend to the digital market. Additionally, the online marketplace must be easy to use and contain a wealth of content that is rich with



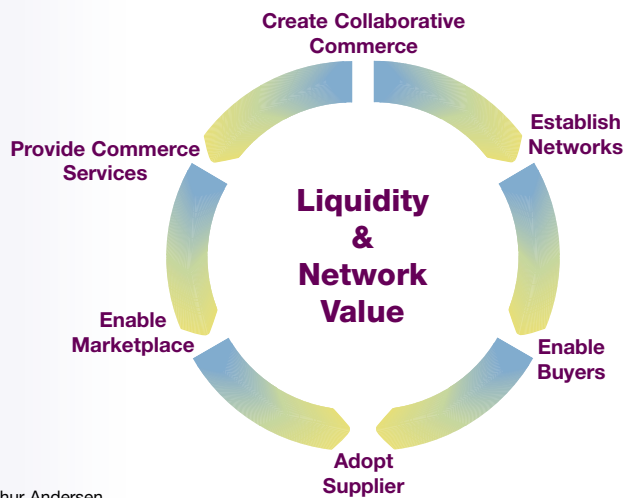
unique industry and product information, product comparisons, and other elements to help participants make better business decisions.

- *Supplier liquidity* is much the same. Digital markets must have a well conceived and executed “supplier adoption” formula for bringing sellers on board. They must then prove that they are capable of helping to extend the suppliers

actual volume, size, quality, type, format, and “vintage” – i.e., most relevant to the participants’ core business – of transactions. It’s critical for the digital market leadership team to know the industry being served and its players, and to focus on delivering products and services in the areas that participants will understand well, and that will produce the highest value for the participants. This will help attract new participants and reinforce the experience for existing participants to gain their commitment over the long haul.

Liquidity in these four cornerstone areas leads to the result of *network value*. Because network value is derived – meaning it is the result of other steps – it is managed through the use of metrics such as revenue, volume, marketshare, commitment levels and usage levels. So instead of these metrics defining liquidity, they are the Key Performance Indicators (KPIs) of the broader measure of success: network value.

Collaborative commerce is achieved through liquidity and network value.



Source: Arthur Andersen

into the value chains of the buyer population, to achieve a collaborative commerce experience that benefits all concerned. Once again, a compelling value proposition – one that evolves with time – is very critical for the members of the digital market.

- *Transaction liquidity* relates to the

Steps to liquidity

How can digital markets build liquidity? There are a number of best practices that we have documented and implemented in existing exchanges.

First, the importance of a *liquidity partner team* cannot be overstated. This is a team comprising members from all initial participant organizations. Its focus is solely on understanding and meeting the needs of participants through prod-



uct and service offerings, systems and processes, training and change management, and anything else required to drive their participation and satisfaction.

ness case, as well. These should go far beyond “burn rate” and cash flow to include liquidity-specific types of metrics, including market-share, participation levels and commitment levels, which can be integrated into the more traditional financial metrics.

Cash and stock no longer suffice for digital market *equity structures*. Membership agreements today should include specific requirements for participant usage; e.g., “participant agrees to a spend rate of a specified amount within commodity groups during the first year in return for” This best practice leads to entirely different, and higher levels of commitment, both in the near term and ongoing.

Similarly, the *unique value propositions* for all participants should tie directly and clearly back to the revenue and operating models. Participants must understand that their use of the marketplace is not just an opportunity for cost savings. It has the potential to dramatically impact the very manner in which they conduct business.

And finally, digital markets must develop both *short-term* and *long-term approaches* to liquidity. For example, short-term approaches should include a liquidity roadmap that dissects the commerce that will be conducted in the marketplace, and attaches detailed metrics to all the components.

Another short-term best practice is called “jumpstarting” a marketplace by making sure that a member

Steps to Liquidity

What should marketplaces do to build liquidity?

1. Develop a liquidity partner team.
2. Designate a liquidity manager.
3. Identify effective liquidity metrics.
4. Utilize different equity structures to motivate shareholders.
5. Develop solid value propositions for all market participants.
6. Develop short-term and long-term liquidity approaches.

Within every liquidity partner team, there should be a *liquidity manager*, responsible for building the business case for the marketplace. This person must define how liquidity will be achieved, including transaction types and structure, what the user experience will be for buyers and sellers, as well as the other elements of liquidity. The liquidity manager must also identify gaps that will prevent the achievement of liquidity and address these issues with the marketplace’s leadership team to help drive solutions.

The liquidity manager must define *liquidity KPIs* for the busi-



Once liquidity and network value are created, buyers become empowered and suppliers more connected to the value chains.

history is in place the day the market is launched. With buy and sell history to draw upon (surrounded with adequate security, of course), participants will feel more at ease

dologies, thereby helping the digital market to avoid reinventing the wheel and sidestepping potential pitfalls in the development and deployment of the marketplace.

Collaborative commerce – the result of liquidity and network value

Digital market liquidity is ultimately about ensuring that the buyers and sellers in a marketplace are using the tools that have been provided to their fullest potential. The steps described above can be taken by market makers themselves. But there are other actions required that can only be taken by market participants, and this is where network value is created.

and be more comfortable conducting business in the marketplace.

Long-term approaches should include:

- Identifying the proper marketplace participants for potential liquidity focus; i.e. ensuring the anchor tenants of the digital market to attract other participants;
- Developing rapid assessment techniques of liquidity performance and results;
- Conducting assessments of the capabilities of the participant and the process of the marketplace to ensure complete integration;
- Synthesizing results and business implications for knowledge management purposes.

This is the area in which a consulting organization specializing in digital markets – with deep experience in the specific industry served by the marketplace – can introduce best practices, processes and metho-

Once liquidity and network value are created, buyers become empowered and suppliers more connected to the value chains. The marketplace becomes enabled, and it delivers products and services at tremendous value. The end result is an environment characterized by collaborative commerce among participants. In this environment, participants complete the supply cycle – design, development, source, trade, plan, procure, sell and fulfill – faster, take products to market faster and, as a result, gain a sustainable competitive advantage in their industry. ▲

Jon Stevens is director of corporate exchanges, Arthur Andersen, Atlanta, Ga. He can be reached at jonathan.t.stevens@us.arthurandersen.com.