Dollar Auction

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The Rules for the Dollar Auction

1. Bidding starts at $1 and proceeds in dollar increments. And, yes, this is for real money.

2. No jump bidding.

3. The auctioneer will give all bidders fair warning before the auction ends.

4. Cartels and collusion among bidders are strictly prohibited. This means no communication, verbal or nonverbal, is allowed.

5. The highest bidder pays the auctioneer what they bid and receives $20.

6. The second highest bidder pays the auctioneer what they bid.

Imagine the following Situation:

- Company C is worth $1b
  It announces that it would not mind being sold
- Company A and Company B are the dominant companies in Company C’s industry
- Wall street expects that A and B will find C to be an attractive acquisition candidate
- Both firms, due to synergy, are likely to find that C is worth about $1.2b to them

But the rub comes in here:

- If A acquires C, B would lose around $½b
- Similarly, If B acquires C, A would lose around $½b
- A and B cannot speak with each other
- You are company A

  What is your next move? What would you do?

What do you want

B to do?

Not Bid

This is just like the auction we just ran.

I have sold a $20 in this kind of auction for less than $20:
one first auction – for $15
a rare few 2nd, 3rd, or 4th auctions

The question is Why?

Many responses: “it’s a good deal”

That is, bidding $4 for a $20 bill is a good deal

But if you bid $4, what is the $3 bidder likely to do if no one else enters the bidding??

- *Answer #1 to the Why? Question:*

  People don't think enough about other, relevant people's likely decisions.

- *Another factor, Answer #2*

  We often continue to escalate our commitment

  Especially after we have made a public act (like bidding in this auction)

- *Example:*

  Many Banks don't let loan officers review loans:

  They might be tempted to succumb to requests for more $$ to stave off bankruptcy

- *Factor #3*

  In the $20 auction, when two people are isolated and get to the $30+ range: they want to **win**. And the costs become less important

Let’s return to Companies A, B, and C

- A is United Airlines
- B is American Airlines
- C is USAir (known to be acquirable in 1995)

- If A or B bid, the other would be likely to bid and both would be likely to escalate the bidding for the above three reasons

- Even if you lose less than your competitor (i.e., you win the auction and your acquisition costs them more than it costs you), this is still a <u>**losing**</u> strategy (unless they are likely to go out of business and you will gain more in the long run due to their absence).

The actual solution:

- Robert Crandall, CEO of American (who has been guilty of fueling competition via fare wars and frequent flier programs) devised a strategy and communicated it via an internal memo to all of his 118,000 employees.

- The strategy? “We will not be the first to bid on USAir. If someone else bids, we will bid, too.”

- This example was reiterated by Lee Iacocca when he was CEO at Chrysler. To the press, he promised that he would not reinstitute rebates on new cars unless others did. Then he was prepared to institute them, too.

The moral of these stories

– one difficult to implement in the $20 auction:

- Don’t do nothing and pray
- Send a legal signal
- If they bid, you analyze and bid and push both sides to equal losses.

The end of this airline story

What Happens
When People Keep Bidding?

When Winning Is Everything

by Deepak Malhotra, Gillian Ku, & J. Keith Murnighan

to appear in
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Have you ever made a decision
in the heat of competitive battle
only to wonder,
when faced with the consequences,
“What was I *thinking*?”

Competitive Arousal

Guidant, 2004-6

- Dec ’04, J&J: $25.4b ($70/share) for Guidant
- Guidant recalls 56% of its defibrillators
- J&J reduces its offer to $63/share; they also have FDA approval and can move ahead fast if they make this acquisition
- Boston Scientific offers $68/share; they do not have FDA approval
- A bidding war, even as Guidant continues to encounter problems with its products

Guidant, 2004-6

- J&J responds $67/share; Guidant accepts
- Boston Scientific offers $72/share
- J&J responds $70/share; Guidant accepts
- Boston Scientific offers $80/share
- J&J could not go higher than their original offer, so they bowed out
- Boston Scientific pays $27.2 billion, Jan ’06

A Good Acquisition?

- Fortune: “arguably the second-worst ever” “a stark lesson on how the single-minded pursuit of victory can blind even brilliant execs to the true costs of a deal”

Other arenas: auctions, negotiations, legal disputes, mergers and acquisitions, employee promotion contests, or the pursuit of hot managerial talent

Incurring a cost to win may <u>not</u> be irrational, but it <u>requires</u> a clear, <u>upfront</u> analysis of the limits of acceptable losses and the actual benefits that winning will yield.

How many times have you heard that you should be cool and calm when you make big decisions?

Competitive Arousal is the Opposite

Three Causes of Competitive Arousal

1. Rivalry

2. Time Pressure

3. Audience Scrutiny (the “Spotlight”)

Rivalry

The Cow Data

Intense Competitors: “We don’t care if they are willing to pay $100 million more than everyone else. We won’t sell to them. We don’t want to give them the satisfaction… Now we have what they want, and we’re not going to let them win.”

Time Pressure

"He Who Feels Time Pressure Loses"

1. Auctions
2. Deadlines
3. Self-Inflicted Time Pressure

The Spotlight

-Live vs. Internet Auctions: Price = 2x

-Blackstone pays $23b - $3b more than the next bid, for Equity Office Properties Trust

- the largest ever private-equity deal.
- Would they have paid so much without media attention? *WSJ*: “The culture of private-equity giants is built on the reluctance to lose any deal …”

The Perfect Storm:
Rivalry, Time Pressure, + a Bright Spotlight

To the underbidders in a charity auction:

"We hope you will continue to support this charity" OR "The competition is heating up… are you up for the challenge?"

The latter led to a 50% increase in repeat bids ***if*** it was the last day of the auction and only one other bidder remained

A Reverse, B-to-B Auction

-in attendance: me, the VP, and 10 colleagues

-a computerized, anonymous auction, with intense time pressure to bid. In the end, the VP bid $1/2m less than their walk-away price. Luckily they lost the auction.

-But if he had known that the winning bidder was his biggest competitor:

"I would have kept on bidding."

Redstone vs Diller; Viacom vs QVC
The Purchase of Paramount

- -Redstone admitted that he paid $1.5b more than he had intended.
- -Why? In a meeting of Viacom execs, they worked hard to discover “how to throw a knockout punch that would be, as one of them put it, a ‘Diller-killer’.”

cool & calm??

VC competition

1. When they want to seize what they see as a great opportunity - or to ensure that they don't lose out to another firm
2. Time pressure is intense: often only 6-8 weeks from initial meeting to term sheet offer
3. The spotlight usually shines on one or two people who have identified the opportunity and who are competing with their own colleagues to get noticed in a flat organizational structure (not to mention the tight VC community itself)

- If all three come together, **the beneficiary is the start-up**

Antidotes

- Anticipate – and <u>avoid</u> competitive bidding wars
- Defuse rivalry – your competitors are probably <u>a lot like you</u> - smart, reasonably rational, somewhat emotional, and they probably see *you* as the nemesis.
- Hire someone who has the power to stop you
- Don’t put time pressure on yourself – get away!

More Antidotes

- Get out of the spotlight

  e.g., diffuse authority: create a policy in which responses to large pushes for price concessions are made ***collectively*** – this takes the heat off individual salespeople.
- Evaluate managers on a collection of accounts, never on just one
- Scenario Planning: What if …??

Our own biases

We tend to think of ourselves as

rational, careful, and logical

and **the more we think this**,

the more likely we are to make mistakes

- Other Stimulants: Lawyers
High Stakes

The PUNCHLINE:

- Smart people make systematic decision making mistakes on a regular basis.

- This affects many managerial and executive decisions

- Why? We are emotional beings.
  And we are occasionaly competitive.

Some Lessons from the Dollar Auction

- Know the Rules (and Their Ramifications) **Before** You Play
- The Monetary Value of Pride-People will pay a lot to avoid losing, particularly in front of people they know. What about you?
- Emotions can Interrupt Learning and Strategic Thinking
- The Temptation to win a buck (or 2) has amazing appeal
- "It is better to keep your mouth shut and be thought a fool than to open it and remove all doubt." - Abraham Lincoln
- Set limits for Yourself before beginning - even if you don't strictly conform to them, you'll still be better off.
- Ignore **Sunk Costs**: Once we've invested (time, effort, or money) we value the investment and have a very hard time abandoning it.