L.E.K.

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The Biggest P&L Line Item You're Not Paying Enough Attention To

Optimizing Retail Trade Spend

When is the last time you discussed religion and politics openly and honestly during a business meeting? Chances are probably never. For some of our clients, the same can be said at some level regarding trade spend. Many organizations avoid this topic for a variety of reasons despite the fact that trade is often the second largest line item on the P&L and may account for 30% of gross sales or more in some categories.

Businesses with sub-optimal trade spend programs generally fall into one of a few camps:

1) **Ivory tower advertisers**

Let's face it, although we find trade spend to be an incredibly fascinating topic, it's not as glamorous as celebrity endorsements or product placement in cinematography. No one who gets an M.B.A. with a concentration in marketing is aspiring in the classroom to understand how to maximize the effectiveness of coupons or which among BOGOs (Buy One, Get One Free), FSIs (Free Standing Insert), displays or combos are delivering the best results. Trade is a topic generally avoided altogether in marketing classes. Consequently, in organizations where brand managers control the P&L, there is a tendency to overinvest in advertising relative to trade and not give enough attention to the less glamorous guerilla warfare required to win consumers at the shelf. In categories where brand awareness for the competitive landscape is high or there is high seasonality, you often need to stand out at the point of sale rather than in consumers' living rooms.

2) **Head in the sand**

Some miss the boat entirely, either across the board or at key levels throughout an organization (the latter is more common). Some suppliers in the traditional channel don't know how to play the so-called high/low game upon shifting to the conventional channel. A number of old school CPG companies try to squeeze fractions of pennies out of ingredients, packaging and manufacturing overhead. However, they miss the big-bogey out there with trade and write it off as the cost of doing business, which can otherwise be translated: "I don't really understand it." We have observed this phenomenon mostly at smaller CPG companies, but also found it to be true among select executives at established Fortune 100 organizations who won't admit their limited experience with trade spend until we get into one-on-one conversations. Unfortunately, decentralized decision makers closest to the customer (e.g. sales) generally lack the understanding of how trade impacts profitability, which is well understood by centralized functions (e.g. finance).

3) **Creatures of habit**

Some companies fall between #1 and #2 and simply follow past trade policies because "that's how we've always done

The Biggest P&L Line Item You're Not Paying Enough Attention To was written by **Vassilis Economides**, a managing director in L.E.K. Consulting's London office, **Alex Evans**, a managing director in L.E.K. Consulting's Los Angeles office, **Manny Picciola**, a managing director and **Rob Wilson**, a senior manager in L.E.K. Consulting's Chicago office. For more information, contact retail@lek.com.

it." This may be attributable to insufficient knowledge to do anything more sophisticated, a fear of rocking the boat too much with key customer accounts, or perceived lack of controls to drive change throughout the organization.

4) Diagnosed but lacking treatment

This is the most common camp across organizations – "Houston, we have a problem"… but mission control isn't sure what to do about it. Some organizations instinctively know they are not maximizing their trade dollars but aren't sure how to measure effectiveness, while others know the issues but aren't able to strike the right balance between central control rules vs. the need for local, customer-specific flexibility with commercial teams. For example, we've learned that sales managers in some Fortune 100 organizations run events simply to spend their budget so they will get it again next year – resulting in events that are marginally productive and meaningful.

Regardless of what camp your organization falls into, we'd like to offer three ways to reorient your approach to maximizing trade spend effectiveness.

1) Understand what consumers really care about

All too often, the link between the consumer and trade spend is limited. For example, the channel asks for a promotion and the manufacturer agrees to it, without a clear understanding of whether this is the best use of the money. Consider the following suggestions:

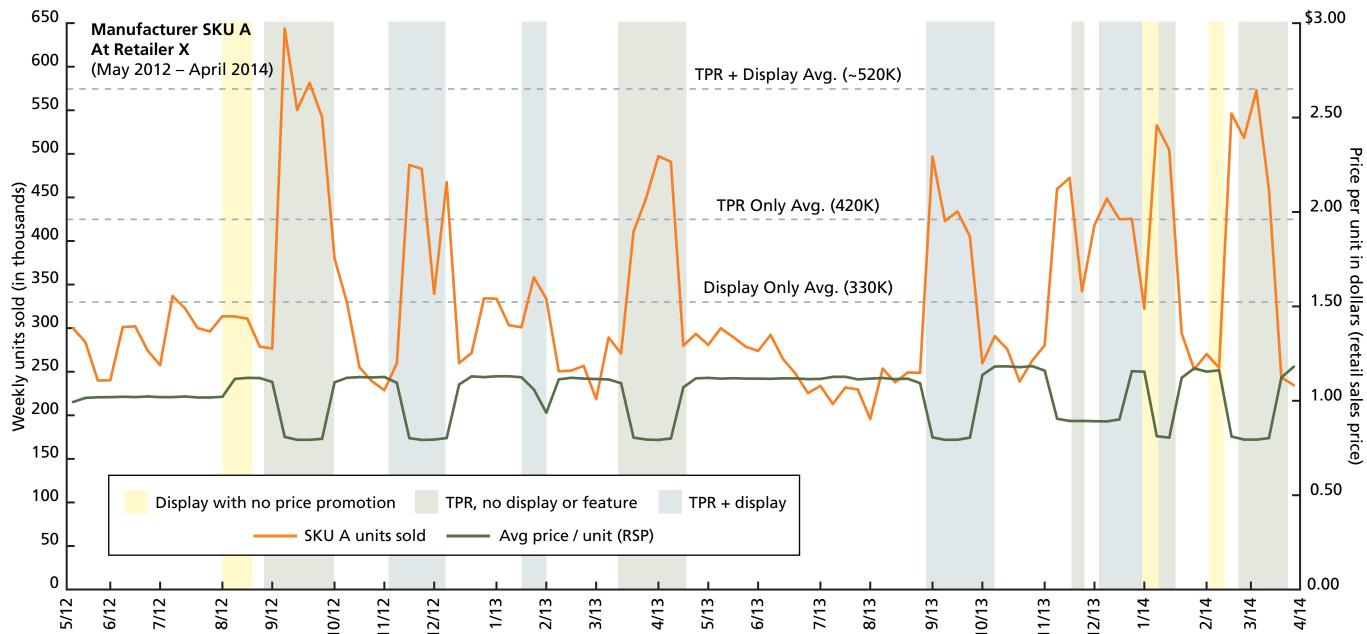
- **Go for the multi-pronged approach –** Multi-pronged promotion techniques are often more effective than singular approaches. For example, combine a digital coupon with a BOGO or run displays with your TPRs (Total Price Reductions) to drive lift (see Figure 1).

- **Don't ignore a potential shift to EDLP –** Be sure to evaluate a high/low strategy vs. every day low price. Although most conventional retailers want their suppliers to play the high/low game, there are instances where shifting to EDLP (Every Day Low Pricing) can be surprisingly more effective, even outside of Walmart.

- **Understand what the others who matter are doing –** Companies need to have an active program to monitor trade actions of branded competitors and

Figure 1

Multi-pronged Promotions Improve the Effectiveness of Promotional Activities



Source: L.E.K. Analysis

private label players (the latter is especially dangerous given already competitive list price). POS tracking data is imperfect and comes with lags, so you need to have eyes on street to monitor action in key accounts/key locations and an internal process to aggregate internal POS data and analyze for trends.

- **Get the creative juices flowing –** Differentiated, outside-the-box trade events can be remarkably successful. For example, one of our client's most successful system events (for the retailer and the manufacturer) involved a competition to drive execution, with "5 lucky winners" (retail district managers) selected to go on a fishing trip with the client – driving better results and relationship building.

2) Engage channels as equal partners in the trade investment strategy

Change the way you define your trade strategy and how trade is negotiated with channel partners. Consider the following suggestions:

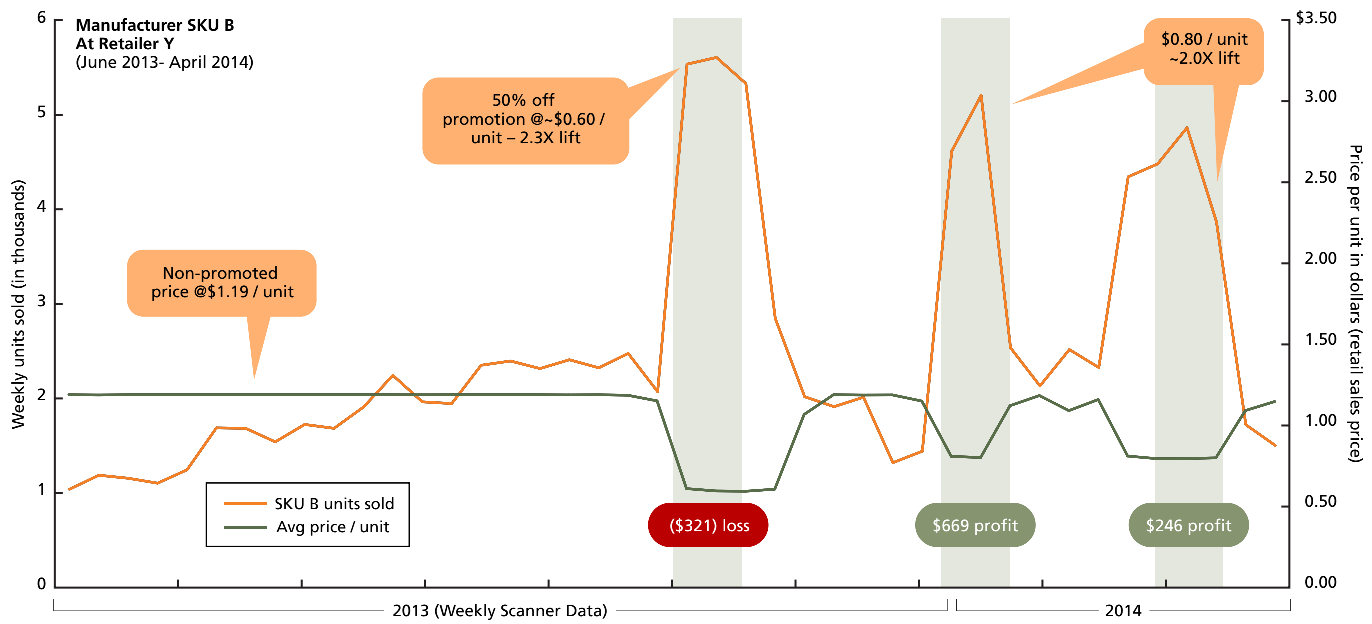
- **Work jointly with channel partners to unlock the power of effective trade –** Move from a transactional situation (where the manufacturer tries to impose specific trade programs on the channel, or the channel tries to procure specific investment from the manufacturer) to a situation where they jointly define the strategy based on a common understanding of the consumer context and the best use of the trade spend.

- **Use a system approach –** Many CPG companies only evaluate trade spend effectiveness from their point of view, while the best events are profitable for both the retailer and manufacturer.

3) Establish a system to measure trade event effectiveness and build real capability to optimize future effectiveness

In order to effectively track returns and constantly optimize trade allocation across products, channels and program types, organizations need go beyond establishing a system

Figure 2
The Magnitude of Price Reductions Should Be Evaluated Carefully to Maximize Profitability



A 50% TPR promotion for SKU B resulted in units sold to increase from ~2,100 to 4,800 per week; a 33% TPR resulted in similar lift at much higher profitability levels

Source: L.E.K. research and analysis

to track ROI by creating a process to act on it. Measuring post-event ROI the right way is no small task and building a strong capability to optimize spend and predict ROI before the event is the real challenge. Consider the following:

- **Embrace big data –** Understanding trade spend at its core requires creating hundreds, if not thousands, of mini-P&Ls. This requires aligning data from a variety of sources including detailed financials, coupon clearinghouse data and millions of lines of scanner data to evaluate the lift vs. cost of each event.

- **Get granular –** There are meticulous details that make all the difference between profitable and unprofitable events. For example, offer discounts, but only to a certain level. In a recent evaluation, we found that discounting a $1.00 pack to $0.80 created nearly the same lift at $0.60, with vastly different impacts on profitability (see Figure 2).

- **Strategy activation –** Ensure trade spend is understood outside of finance; empower your commercial organization to drive profitable events and measure effectiveness (you get what you measure). Finally, ensure you have the right organizational strategy in place to manage trade, with clear decision rights, performance metrics and procedures in place that allow for local flexibility while adhering to centralized parameters.

An important first step to optimizing trade spend effectiveness is recognizing that a business-as-usual mindset will only leave your firm stalled and exposed to continued eroding margins. A combination of deeper analysis, new systems and processes, and stronger collaboration with channel partners are essential to increasing profitability and improving overall competitiveness across the distribution chain.

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For further information contact:

Boston
75 State Street
19th Floor
Boston, MA 02109
Telephone: 617.951.9500
Facsimile: 617.951.9392

Chicago
One North Wacker Drive
39th Floor
Chicago, IL 60606
Telephone: 312.913.6400
Facsimile: 312.782.4583

Los Angeles
1100 Glendon Avenue
19th Floor
Los Angeles, CA 90024
Telephone: 310.209.9800
Facsimile: 310.209.9125

New York
1133 Sixth Avenue
29th Floor
New York, NY 10036
Telephone: 646.652.1900
Facsimile: 212.582.8505

San Francisco
100 Pine Street
Suite 2000
San Francisco, CA 94111
Telephone: 415.676.5500
Facsimile: 415.627.9071

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