

Four Steps to Optimizing Trade Promotion Effectiveness

Trade promotion programs are pivotal to driving sales, building brand equity with consumers and strengthening channel partnerships. The average consumer packaged goods (CPG) company allocates 14% of its total revenue to trade promotion activities¹, which underlines the importance of these programs. Despite growing trade promotion budgets, many companies simply anniversary the prior year's trade spending practices without identifying ways to optimize these initiatives.

Many CPG companies and their retail channel partners don't consider all of the factors required to accurately measure a trade promotion program's true success. Companies that fail to understand the level of influence that trade promotion programs have on their customers may be needlessly ceding pricing power and missing significant opportunities to maximize revenues.

To address the complexities associated with tracking and calibrating trade promotion programs, L.E.K. Consulting has

developed a simple four-step framework that provides senior executives with a model to diagnose trade spending effectiveness and potentially identify opportunities to improve their top- and bottom-lines (see Figure 1).

The following example outlines the trade promotion evaluation and optimization process for a CPG company or retailer in an established category. (Please note that brands would use different trade promotion strategies to launch new products or enter new markets.)

Step 1: Observe Trade Promotion Effectiveness

First, we need to understand a category's current trade spending baseline and how it drives sales volume. We do this by tracking the historical trade promotion calendar and correlating changes in unit share with the duration of specific programs. Figure 2 illustrates an example of this analysis.

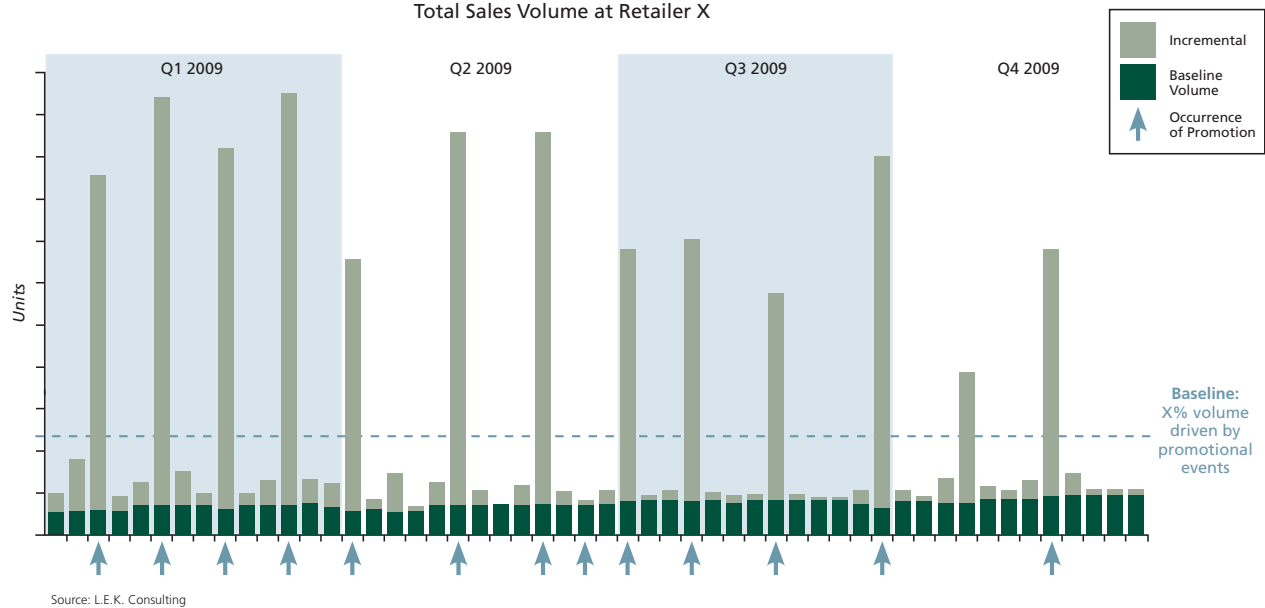
Figure 1

L.E.K.'s Four-Step Framework for Improving Trade Promotion Programs



Four Steps to Optimizing Trade Promotion Effectiveness was written by **Alex Evans**, Vice President, and **Julie Wherry**, Manager, of L.E.K. Consulting. Please contact L.E.K. at consumerproducts@lek.com for additional information.

Figure 2
Sales Volume Correlation with Promotional Events
Total Sales Volume at Retailer X



This data provides historical insight into the effect that trade spending has on a category and provides a basis for analyzing alternative scenarios. However, this analysis does not typically show how consumers respond to pricing changes in a given sector. Understanding a category's elasticity is critical to assessing trade spend effectiveness because observed volume changes illustrated in Figure 2 typically reflect share shifts rather than overall category volume increases.

Step 2: Measure Category Price Elasticity

Next, we need to understand the intrinsic price elasticity of consumers in a given category. In a traditionally promotion-driven category, historical sales data is ill-suited to assess category price elasticity because brand share shifts are not readily disaggregated from overall category volume shifts. (CPG companies and retailers typically do not run the same trade promotion schedule simultaneously, which makes it challenging to identify if sales increases are caused by heightened consumer demand or by aggressive promotions.)

A better way to measure category price elasticity is through a well-designed consumer research program that identifies how price and other category factors affect consumer purchasing decisions. This type of market analysis can project how category shoppers would respond to different levels of trade promotion across all brands, including private label. CPG companies can

use this insight to set promotions at the highest price point possible to still achieve the desired response.

Figure 3 shows a sample price elasticity calculation from conjoint analysis. In the following example, a brand effectively increases its price 25% by scaling back its trade spending. Consumers are not alienated by this change and sales volume only declines 4%, well short of the >25% decrease that would make the trade promotion change a money-loser. Using this formula, we determine that price elasticity is 0.16, demonstrating that the category is relatively inelastic. The results suggest that trade promotion is most likely destroying a category's profit margins.

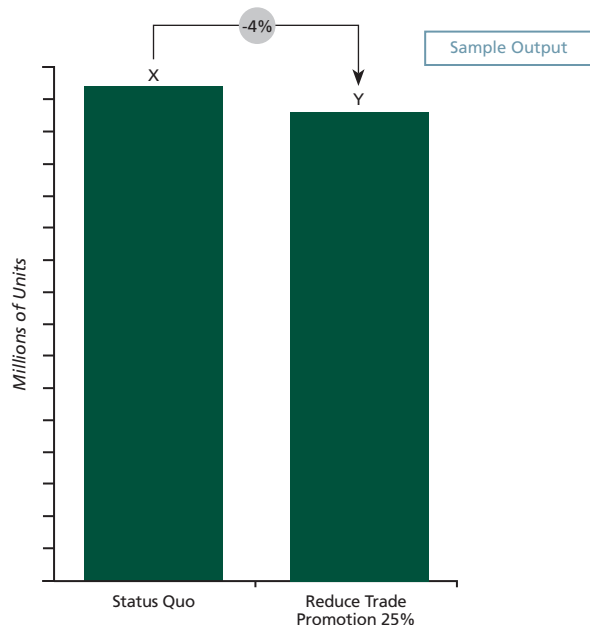
Given the low elasticity of the category, it is likely that consumers are simply responding to trade promotions such as buy-one-get-one-free (BOGOF) by taking the opportunity to "pantry fill" (i.e., pull future purchases forward) rather than truly consuming additional incremental units. Logically, CPG companies can shift marketing dollars away from ineffective trade promotions and invest in traditional advertising or other programs that can yield a higher return in this consumer segment.

Before significantly changing marketing programs, however, companies must consider all potential competitors, especially as everyday low price (EDLP) mass and club retailers continue to gain favor with shoppers, which may potentially shift consumer

Figure 3

Measuring the Effectiveness of a CPG Trade Promotion Program
Total Product Category (all brands)
Volume in Retailer X

$$\frac{\text{Volume Change}}{\text{Price Change}} = \frac{-4\%}{25\%} = -0.16$$



Source: L.E.K. Consulting

spending to other retailers or channels. A well-designed market research program that features conjoint analysis can also address this “channel switching” phenomenon. For example, a conjoint analysis can directly test if consumers are willing to shift their purchases from a favorite retailer that has de-emphasized trade promotions in a particular category and instead shop an EDLP channel, which has suddenly become more price competitive in their eyes.

Step 3: Evaluate Marketplace and Competitive Dynamics

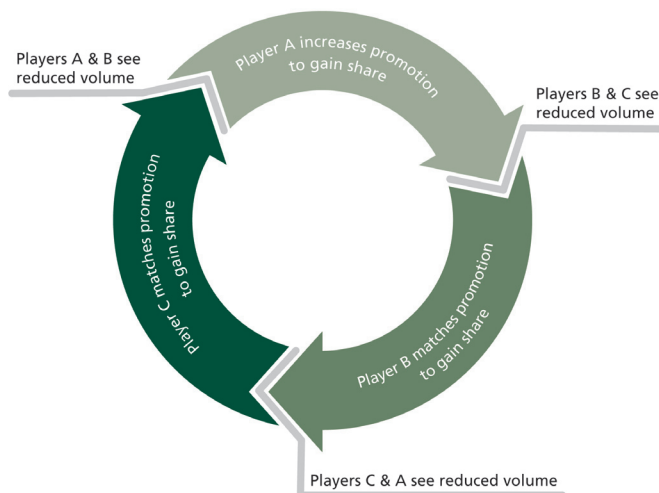
The objective of this step is to understand the perspectives of different marketplace participants and how a change in trade promotion by one player might impact the actions of other players. The typical pattern (illustrated in Figure 4) can be a vicious cycle:

- Company A increases trade promotion to take share from companies B and C

- Company B responds by launching a trade promotion campaign to regain share from A and take share from C
- Company C responds in kind to reclaim share from both A and B
- The cycle repeats

Figure 4

A Competitive Promotions Cycle Can Erode Market Value



We can observe this cycle very clearly today in categories such as cereal, nutritional supplements and frozen foods. In these categories, leading brands (including private label) will typically run trade promotions sequentially 3-4 weeks per month, essentially giving consumers a permanent ability to purchase products at promotional discounts.

The value-destroying cycle is difficult to break due to competitive dynamics. In the mass cosmetics category, which we believe is an inelastic category, we have seen initial challenges when a player decides to reduce its trade promotion investment. Cosmetics brands and retailers who were first-movers to scale back trade promotions initially lost share to those who maintained their trade promotions strategies. But as we’ve seen across many categories, once a leading brand augments its marketing strategy, smaller industry players frequently follow suit. Because trade promotion programs in inelastic market segments are often losing propositions, many category competitors quickly refocus their sales and marketing dollars elsewhere.

Companies that lead a category in reducing their trade promotion programs should also consider simultaneously amplifying their advertising or other marketing campaigns to increase brand awareness. This approach can also minimize any negative impact on the bottom line caused by changes to their trade promotion programs.

Step 4: Assess Trade Promotion Options

Having completed steps 1-3, we now understand the baseline of trade promotion today, the motivations of different players in the marketplace, and how consumers might respond to changes in trade promotion. This understanding sets up our options for optimizing trade spend effectiveness. Generically, a CPG company with multiple product lines / brands has several options:

- **Maintain the status quo:** follow path of least resistance at the risk of leaving money on the table
- **Reallocate trade spend:** redirect trade investments from low/negative impact areas to high-growth opportunities
- **Pursue a different model:** work with channel partners to redefine how the category works

The right answer will undoubtedly differ by category. However, the fact base identified in steps 1-3 provides the foundation to define and assess the alternative options available to a brand, and to ultimately identify potential win-win scenarios for both CPG companies and retailers that increase total value for the category.

Case Example

A global CPG company in a consumable category found in food, drug, mass and club channels was facing significant market pressures from its competitors' trade promotion programs. The question was whether the brand could shift away from the BOGOF dynamic that had become an established category element. Using its market research process, L.E.K. conducted a diagnostic of the opportunity for the brand (and its retail channel) to potentially generate substantially higher margin dollars by driving a wholesale conversion of BOGOFs to BOGO50s (buy-one-get-one-50% off).

L.E.K. demonstrated that the category was price inelastic (price elasticity < 1.0) such that an across-the-board reduction in trade promotion would only cause a small reduction in volume. While the actual implementation will require careful planning and a concerted effort, the desired end-state is clear, and the CPG company can potentially realize significant top- and bottom-line benefits using its new trade spending strategy. In fact, the company has the potential for up to 15% improvements in contribution margin dollars at its key grocery and drug channels, while certain retail partners could potentially see 50%+ improvements (largely due to gains in private label share).

Conclusion

If you are a CPG company spending more than \$20 million² annually in trade promotion or a retailer in a heavy trade promotion environment, a review of your trade promotion plans may spotlight areas for improvement. Importantly, senior executives must establish metrics to track the success of individual promotions programs and understand the market dynamics that influence consumer decision making. Armed with this information, companies can then develop focused strategies to address competitive dynamics. For some categories, a strategic shift in promotion strategy may require companies to brace for short-term sales challenges in order to achieve long-term results. As our recent client work suggests, a seven-figure improvement in contribution margin dollars may be possible.

¹ AMR Research, *Trade Promotions: Are you Getting What You Pay for?* (2009)

² We cite the \$20 million annual trade promotion budget because even a modest 5% improvement in trade promotion effectiveness would yield \$1 million in incremental savings and substantially improve trade promotion program ROI. Clearly there is an opportunity for companies with varying trade promotion budgets to improve the overall results of their marketing programs.

L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and analytical rigor to help clients solve their most critical business problems. Founded more than 25 years ago, L.E.K. employs more than 900 professionals in 20 offices across Europe, the Americas and Asia-Pacific. L.E.K. advises and supports global companies that are leaders in their industries – including the largest private and public sector organizations, private equity firms and emerging entrepreneurial businesses. L.E.K. helps business leaders consistently make better decisions, deliver improved business performance and create greater shareholder returns.

For further information contact:**Boston**

28 State Street
16th Floor
Boston, MA 02109
Telephone: 617.951.9500
Facsimile: 617.951.9392

Los Angeles

1100 Glendon Avenue
21st Floor
Los Angeles, CA 90024
Telephone: 310.209.9800
Facsimile: 310.209.9125

Chicago

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

San Francisco

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

New York

650 Fifth Avenue
25th Floor
New York, NY 10019
Telephone: 212.582.2499
Facsimile: 212.582.8505

**International
Offices:**

*Auckland
Bangkok
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