Opportunities for Action in Consumer Markets

A Holistic Approach to Trade Spending

The Boston Consulting Group
A Holistic Approach to Trade Spending

Trade spending—the financial deals that manufacturers offer retailers to market their products—stands at an all-time high for consumer goods companies, despite their lack of satisfaction with its effectiveness.\(^1\) On average, more than 30 percent of the price that consumers pay for a product goes to retailers in the form of trade deals, with wide variation across categories. That gives retailers considerable leeway in discounting prices—cutting into manufacturers’ profits, not to mention their own. Such discounting can also undermine the brand premium if prices fall below what consumers are willing to pay.

In recent years, manufacturers have tried to bolster profits by reducing overhead, but those savings—along with productivity improvements—have been offset by the trade-spending increases retailers have won. Because such spending is among the fastest-growing costs for manufacturers, optimizing the entire trade-spending system will boost bottom- and top-line growth. Moreover, because the European currency has brought greater transparency to differences in consumer prices and trade deals across countries, now is a particularly opportune time to focus on this cost.

Where Does All the Money Go?

The rise in trade spending in Europe has been fueled primarily by retailer consolidation, the displacement

---

\(^1\) Because trade-spending practices vary from region to region, we are publishing a slightly different version of this article for North American readers, titled “Converting Trade Spending into Investment.”
of smaller, independent stores by larger formats, the
competition for shelf space from private labels, and
an advertising environment that has become increas-
ingly cluttered, making it harder to create direct con-
sumer demand. More and more of the spending is
aimed at push efforts (deep discounts, such as price
promotions, that push consumers to purchase a par-
ticular product) and less and less at pull efforts (ser-
vices and marketing, such as cooperative advertis-
ing, that pull consumers into the store to ask for the
product).

Push tactics not only cut into profits but also, if poorly
planned, encourage consumers to take care of their
future needs at discount prices—a behavior known as
“pantry loading.” Promotions that merely shift share
on a weekly basis fail to boost consumption and result
in lower margins for both the manufacturer and the
retailer. Sporadic discounts also drain back-office
resources. Stable prices and margins are important
not just because they allow for investments in R&D,
product improvements, and advertising, but also be-
cause they help establish a consistent brand image for
the consumer.

Many companies have tried to optimize one or anoth-
er aspect of their trade-spending system, but few have
taken a comprehensive approach to the entire “price
waterfall” as it flows from the consumer to the retailer
to the manufacturer. Rather than view trade spending
as central to the go-to-market process (the full range
of actions that promote a product’s success in the
marketplace), many companies focus on incrementally
modifying just one or two elements of the system
without taking into account the effect on the whole
program. Such an approach precludes long-lasting
improvements.
Advantages of a Holistic Framework

In its work with consumer companies, The Boston Consulting Group has been using a holistic framework that puts trade spending at the center of a broad go-to-market strategy and helps companies reassess its effectiveness. (See Exhibit 1.) We recognize trade spending as the linchpin connecting the manufacturer and the retailer to all the strategic elements involved in taking a product to market. These include:

- Channel and Trade Partner Strategy. Which channels and trade partners have priority? How do you manage different channels and formats? Which trade partners are open to brand-building activities and which are not?

Exhibit 1. Trade Spending Links All Parts of a Go-to-Market Strategy

Source: BCG analysis.
• **Brand Strategy.** How are your brands valued in the retailer’s brand portfolio? Which brands do you want to promote? How much of a premium—if any—is the consumer willing to pay for your brand?

• **Product Strategy.** How do you manage the product portfolio across channels and trade partners? How do you structure the product lineup to ensure that a consistent brand message and price-value equation can be communicated reliably by the sales staff to consumers?

• **Execution Effectiveness.** Does the sales force have the right incentives? Is the manufacturer clear on who is responsible for pricing and margins? Are all of the elements in the price waterfall transparent?

To understand how a holistic approach to trade spending affects all aspects of the go-to-market strategy, consider the price waterfall illustrated in Exhibit 2. It shows the cascading effect of a typical trade-spending program, starting with the suggested consumer list price and flowing through the regular discounts, temporary discounts, and off-invoice discounts that go to the retailer. Because cost-to-serve is also part of a product’s total profitability, it too is represented, although it is neither an element of trade spending nor part of the retailer’s margin. A well-designed trade-spending program, however, can reduce that cost as well.

**Determining the Suggested Consumer List Price**

The best place to begin a comprehensive optimization of the trade-spending system is the suggested price
the consumer pays for the product. That price should drive all of the subsequent discounts to the retailer along the waterfall. Manufacturers should (but often don’t) determine the suggested list price according to the value of the product or brand from the consumer’s perspective—an approach that may lead to a different price than one derived from a pure “cost-plus” approach (cost to produce the product plus desired margin).

One advantage of a consumer-oriented approach to pricing is that it provides a clear picture of a prod-

2. In the United States and European Union, manufacturers are restricted from specifying resale prices to their customers and from requiring customers to pass on to consumers promotional or other discounts. Consequently, a manufacturer cannot monitor the discounting practices of a wholesaler or retailer with a view to enforcing its own discount policy.
uct’s profitability. A good example comes from a consumer electronics manufacturer we worked with. The company had always determined its suggested consumer list prices by coming as close as possible to the competitor’s price and then building in a margin for the retailer. When we helped this manufacturer institute consumer-oriented pricing (basing the suggested list price on the product’s consumer value proposition and allowing for an adequate trade margin), the company discovered that an entire subset of products had been unprofitable.

Because the former approach to pricing didn’t account for how consumers valued the product, the manufacturer had failed to recognize that some of the SKUs in its assortment wouldn’t sell as well as others. The retailer responded to the poor performance of those SKUs by lowering the price until consumers started buying them and then going back to the manufacturer for substantial promotional discounts, which the manufacturer gave but did not track systematically. Both the retailer and the manufacturer were dissatisfied with the margins those SKUs generated. Furthermore, the erratic pricing that resulted from significant discounting detracted from the brand’s overall image. After instituting consumer-oriented pricing, the manufacturer finally had the consumer data it needed to reevaluate unsuccessful products. It could then either remove those products from the assortment or change their specifications to make them profitable again.

Determining Regular Discounts

Regular discounts—those that are determined in annual agreements for every order, regardless of other deals—should provide the retailer with the base
margin it needs. The calculation the manufacturer uses to determine those discounts should reflect both the manufacturer’s strategic priorities and the economics of the channel and the trade partner. This exercise requires a close look at the format in which the retailer operates. Real estate costs for hypermarkets, for example, are considerably different from those for small independent retailers. Manufacturers should also consider the product’s role in the retailer’s portfolio, which is a function of the absolute margin (realized price, relative margin, and inventory turns) and the cost to sell (the cost of maintaining the retail space and sales staff, for example).

We instituted this approach with a food manufacturer that had been negotiating trade discounts with individual retailers without considering their economics or its own go-to-market strategy. First we segmented the company’s brands and products to determine the company’s ambitions for them. One segment, for

3. The use of discounts and bonuses is highly regulated in both the United States and the European Union, and it is important to seek legal review of your channel strategy. This article should be read with the following considerations in mind: U.S. law prohibits price discrimination among competing resellers, regardless of market share, and requires price differences to be justified by differences in the seller’s cost. In the European Union, a manufacturer with a significant market position, which might render it dominant, must exercise caution in devising its bonus schemes. In this regard, a manufacturer with a market share in excess of 40 percent in the European Union should be particularly wary. Discounts and bonuses offered by such a manufacturer must be based on demonstrable cost savings or efficiencies benefiting the manufacturer’s economics, as opposed to the customer’s economics; must be offered to all customers in a similar position (in other words, discounts should not be discriminatory); must not be in return for any exclusivity or fidelity requirement; and must be based on purchases over a short reference period (not normally in excess of a quarter). In addition, any scaling of volumes required for discounts must be proportionately tiered and linear.
example, consisted of “innovators”—new brands that generated traffic in the store. Retailers would receive comparatively lower regular discounts for those brands but higher off-invoice discounts to support advertising and other pull strategies. Another segment belonged to “defenders”—established brands that faced intense competition for shelf space. A high share of the trade spending on these products would go for regular discounts to make the margin sufficiently attractive to retailers.

Then we examined the roles that the company’s brands were playing in retailers’ portfolios. That included calculating sales per square meter, sales growth, the size of the category, and the average price realized. The data were gathered for each distribution channel, which allowed the company to base trade terms on the product’s economics for the retailers in each of the channels.

An appliance manufacturer also adopted this approach to calculating regular discounts. The manufacturer’s trade spending had depended primarily on its sales reps’ negotiating skills—a practice that had resulted in erratic consumer prices across channels and some prices that stretched beyond a reasonable bandwidth. (A reasonable bandwidth would cover a narrow range of prices on either side of average, with larger, more efficient retail formats at the low end—given their favorable economics—and smaller independents at the upper end.) In following the new approach, the company grouped its customers into categories on the basis of sales channel and volume sold, and then adjusted trade spending accordingly.

The new system took into account the economics and margin requirements of the various channels, as well as the company’s desired bandwidth. As a result of these segmentations and adjustments, prices were sta-
obilized within the desired range to the advantage of all parties. The approach also preserved the purpose of trade spending as a payment for service, not as a fee to keep retailers in business.

**Making the Best Use of Temporary Discounts**

Temporary discounts are granted to retailers on an order-by-order basis. We often hear consumer goods companies say that if they could, they would eradicate them. We believe, however, that temporary discounts can be a powerful weapon for specific situations—to counter the effects of seasonality or short-term competitive moves, for instance. They can also correct temporary differences between regional markets and support promotions or products that need a temporary boost. Once again, companies must consult their product and brand strategy to determine their priorities.

Creating the right organizational processes to ensure the effective execution of trade deals is particularly important for temporary discounts. If a manufacturer manages the discounts through its central marketing function, it must set clearly defined rules for promotional effectiveness and monitor sales uplift and pantry loading. If it decentralizes temporary discounts by empowering sales reps and managers to determine who gets what, the company will need clear budgets and rules to avoid an imbalance in accounts. In either case, the company should track the discounts carefully with the appropriate information technology.

---

4. Any monitoring should not be used as a means of enforcing a passing on of the discount. See footnote 3.
Because of a lack of controls, the sales force for another appliance company we worked with had been misusing temporary discounts to meet day-to-day pricing requirements, often succumbing to its customers’ better negotiating skills. (In one country, for example, retailers demanded unusually high levels of “delivery damage” discounts.) The new trade-spending system the company established allowed for “smart” temporary discounts and removed the variable of poor negotiating skills by instituting a specific budget for each level of the sales force, calculated to give each sales rep enough room for negotiation on the basis of his or her trade-partner portfolio. The company also adapted its IT system for better control and linked successful use of discounts to sales reps’ compensation, which made it possible for reps to determine the right tradeoff between volume and margin.

Another company had handled its temporary discounts centrally but lacked a rigorous system for selecting the products to be promoted and for calculating the discount levels and trade support the retailer required. As a result, many of the promotions were destroying value because the increase in volume didn’t compensate for the price reduction. We helped the company set new guidelines to determine promotions and the optimal level of discounts, frequency, and support in the store. The terms given to retailers were linked externally to promotional effectiveness and internally to the compensation of account managers.

**Improving Performance with Off-Invoice Discounts**

Off-invoice discounts (rebates) are usually granted on a quarterly or an annual basis and should be paid out
to retailers as a reward for performance. Many companies have greatly increased their off-invoice spending in recent years. Most of the time, however, this spending is not linked to specific performance criteria. Ideally, such spending should be curtailed, but that’s not always easy to do.

A more practical solution is to spend strategically. Off-invoice discounts can be a useful tool for rewarding performance, but they must be structured so that the desired behavior is clear and easy to measure. The best practice is to link performance objectives to some measure of shareholder value (growth, profitability, or cash-flow improvement). The objectives should also be consistent with trade-partner, brand, and product strategy. Although this is true for all elements of trade spending, it is most important for off-invoice discounts, which are designed as a reward for performance, not as a lump-sum payment to retailers. We have found that off-invoice discounts are easier to manage if their number is limited to one discount per performance objective.

A packaged goods company we worked with provides a clear example of the strategic benefits of off-invoice discounting. The company’s logistics costs were much higher than competitors’, partly because it had agreed to a 48-hour order-to-delivery guarantee for retailers. To correct the situation, the company announced a program that would reward the retailer with an off-invoice discount in exchange for a slightly longer order-to-delivery schedule. It was a win-win proposition for both parties. The new discount made up for the additional working-capital cost to the retailer. And the manufacturer was able to increase its direct deliveries (factory to retailer), thereby cutting warehouse logistics costs in half for relevant orders.

5. See footnote 3.
Another example, which also demonstrates the effectiveness of flawless execution, comes from a beverage manufacturer. The company’s off-invoice discounts didn’t reward well-managed shelf space, because the company felt that push efforts didn’t improve sales. But under a new trade-spending agreement, the manufacturer and retailer worked jointly to manage the shelf space, and both parties benefited. The retailer got a higher gross margin per square meter of space, and the manufacturer got increased sales volume.

A final example shows how a holistic approach to trade spending connects trade-partner strategy with brand strategy. The manufacturer had a high share of unconditional off-invoice discounts, which increased every year, with no additional performance improvement from the retailer. The company adopted a trade-spending system that linked off-invoice discounts to shareholder value. It offered trade partners in economically attractive channels (those with low cost-to-serve) a rebate for sales growth. That gave retailers an incentive to increase their business with the manufacturer, and the increase in these channels added to overall profitability. Another discount rewarded the retailer for providing more shelf space for specific brands, which improved brand mix as well as sales growth and supported the entire brand strategy.

Guidelines for Implementing a Holistic Policy

Trade-spending optimization is more like a marathon than a sprint. That said, it is well worth the effort. Here are the most important lessons we’ve learned.

while helping companies across a range of categories improve their trade spending:

• Before beginning to redesign your program, be clear about your goals. Do you want to lower total spending or increase the efficiency of your current levels by, for example, changing the product mix to improve margins?

• Altering the entire price waterfall across all business units and regions is a highly complex undertaking. Most companies do it in stages. Before you begin to implement a new trade-spending system, ensure compatibility across units or regions by clearly defining the overall blueprint. Then roll the program out by element, by country, and by region.

• Even when you implement a new system in stages, the effort will be massive and rigorously analytical. It will also require several iterations. You will need to run complex quantitative simulations, potentially involving many trade partners and products. Each simulation should reflect the impact on individual trade partners and products.

• The more you involve sales reps, the better. Improving trade spending should be a bottom-up effort that requires knowledge of trade partners’ histories, margins, negotiating behavior, and price-setting practices.

• The devil is in the details during the rollout. Senior management must be involved throughout the project for many quick but high-impact decisions. And don’t “go live” with a new trade-spending program until you are sure every piece of IT reprogramming code is in place.
• You may need to establish new processes and responsibilities, such as a pricing council to link trade spending to the other elements of the go-to-market strategy. Pricing—which affects marketing, sales, and finance, as well as production and logistics—needs to be managed cross-functionally.

• Remember that a holistic approach is also required during the rollout. If product strategy is affected by the new trade-spending system, changes to the product lineup need to be reflected as a separate milestone in the implementation.

Questions to Ask

Would our holistic approach to trade spending help you get more out of your arrangements with retailers? A number of questions will help you take a fresh look at how well your trade spending is working for you.

1. What are your most pressing issues? The approach you take to trade-spending redesign will depend on where the current program hurts the most:

   • Net price differences across regions or countries?7
   
   • No control over temporary discounts?
   
   • No pay for performance?
   
   • Trade-spending increases as a percentage of sales?

7. Manufacturers in the European Union must ensure that they do not implement bonus schemes that have as their objective the partitioning of the national markets of the European Union; notably, they should not discriminate against customers that may export the products to, for example, higher-priced countries.
2. Does your trade-spending system reflect the interdependencies among all the elements of your go-to-market strategy? Or are you finding that optimizing one element creates difficulties in another?

3. Do you know the price consumers are willing to pay for your products? Or are your prices determined on a cost-plus basis or by benchmarking competitors?

4. Do your regular discounts reflect your trade partners’ support in selling your products, as well as their economics and the role your product or brand plays in their portfolios? Or are your discounts based mostly on past negotiations?

5. Do you use temporary discounts as a flexible tool? Or are they out of control?

6. Do your off-invoice discounts improve your performance and reward your trade partners’ performance? Or are they largely unconditional?

7. Is trade spending under the leadership of senior management? Is there one person or group who “owns” pricing and trade spending, and does that person know how much is spent by whom and for what purposes?

**A Win for Manufacturers and Retailers**

Manufacturers and retailers don’t have to be on opposite sides of the table when it comes to trade spending. Manufacturers want a program that rewards retailers for growth in shareholder value, is fair and easy to understand, benefits consumers, and encourages efficient spending. Retailers also want profitable category growth with top-line increases and gross-mar-
gin expansion. And they want to be rewarded for performance. Both manufacturers and retailers benefit when they share insights on merchandising and assortment. We are convinced that a holistic approach to trade spending that reflects the interdependencies among all elements of the go-to-market strategy will create an effective linchpin between retailers and manufacturers, for the benefit of all.

Rolf Bixner
Holger Gottstein
Just Schürmann

Rolf Bixner is a senior vice president and director in the Amsterdam office of The Boston Consulting Group. Holger Gottstein is a project leader and Just Schürmann a manager in the firm’s Munich office.

The authors wish to thank Christian Cerda, a manager in BCG’s London office, and Martin Stellmacher, a manager in the Munich office, for their contributions to this article.

You may contact the authors by e-mail at:
bixner.rolf@bcg.com
gottstein.holger@bcg.com
schuermann.just@bcg.com

To receive future publications in electronic form about this topic or others, please visit our subscription Web site at www.bcg.com/subscribe.

© The Boston Consulting Group, Inc. 2004. All rights reserved.
<table>
<thead>
<tr>
<th>The Boston Consulting Group</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amsterdam</td>
</tr>
<tr>
<td>Athens</td>
</tr>
<tr>
<td>Atlanta</td>
</tr>
<tr>
<td>Auckland</td>
</tr>
<tr>
<td>Bangkok</td>
</tr>
<tr>
<td>Barcelona</td>
</tr>
<tr>
<td>Beijing</td>
</tr>
<tr>
<td>Berlin</td>
</tr>
<tr>
<td>Boston</td>
</tr>
<tr>
<td>Brussels</td>
</tr>
<tr>
<td>Budapest</td>
</tr>
<tr>
<td>Buenos Aires</td>
</tr>
<tr>
<td>Chicago</td>
</tr>
<tr>
<td>Cologne</td>
</tr>
<tr>
<td>Copenhagen</td>
</tr>
<tr>
<td>Dallas</td>
</tr>
<tr>
<td>Düsseldorf</td>
</tr>
<tr>
<td>Frankfurt</td>
</tr>
<tr>
<td>Hamburg</td>
</tr>
<tr>
<td>Helsinki</td>
</tr>
<tr>
<td>Hong Kong</td>
</tr>
</tbody>
</table>

BCG
www.bcg.com