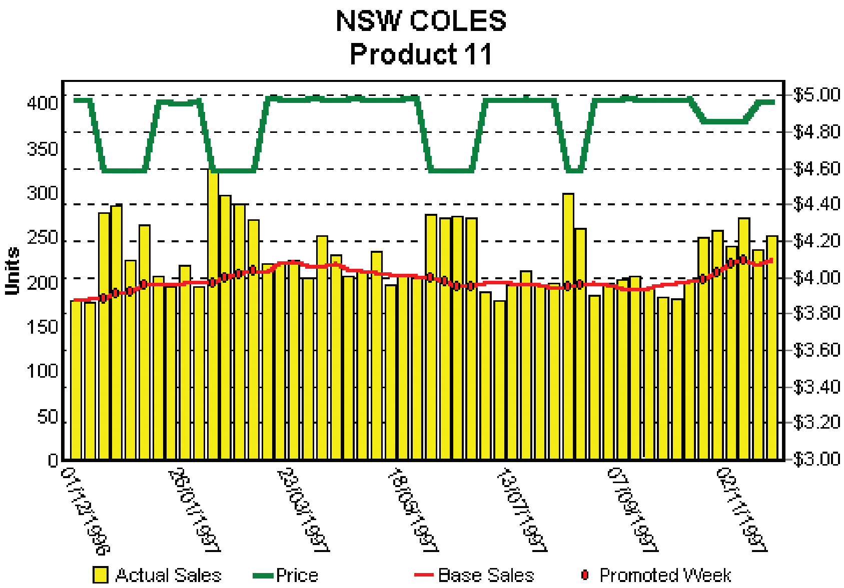
PROMAX

the mirage of promotional lift

The availability of retail scan data means that suppliers can now evaluate their promotions in terms of the additional sales that were sold through to the consumer. In this paper we will look at the issues surrounding this, and some of the problems.



Measuring if it was profitable

A typical promotion could show the following sales result. The weekly sales are shown as a bar graph, and the retail price per sku as a line graph. It is not unduly difficult to determine by inspection the incremental sales, which are shown above the red dots. It is not trivial to determine this incrementality automatically as has been done here. The red line is the estimated non promoted base rate of sale, hence the quantity above the red dot is the incremental sales. The red dot indicates that the week is a promoted week. This is based on the change in price.

If we are to determine whether a promotion was more profitable than doing nothing, some additional data is needed. In order to compare a promotion with doing nothing, we must make sure that the period of time is equivalent. It is not sufficient to simply compare say four weeks of the promotion with four weeks of base line sales as in any of the four week promotions in the chart above. This is because many retailers get a discount on what they buy – and this is frequently not the same as the quantity sold to the consumer in the two weeks. In Australia this is built into the system – retailers have extended buy periods that are 14 to 21 days longer than the promotion. To make matters worse they often insist on getting the discount on deliveries in the buy period as well as on orders placed at the end of the buy period which result in a delivery after the buy period has ended. Case deals may also be offered against scanned sales, and this may be as well as ex-factory case deals. Fortunately it is not that difficult to sort out the arithmetic.

Lets look at an example:

- 9500 cases purchased during a five week buy period
- Case deal of $4.80 per case offered
- Co-op required is $10,000
- List price of $50.00 per case
- Base rate of sale is 1000 per week
- Incremental sales are 2500 cases
- Factory standard cost of manufacturing is $25.00.

Now work out the incremental profit margin. The revenue on 2500 incremental cases is 2500x50.00=$125,000. The cost of manufacture of the incremental cases is 2500x25.00=$62,500 and the total case deals on all cases purchased are 9500x4.80=$45,600. The co-op is $10,000. Thus the incremental profit margin is incremental sales revenue less incremental factory cost less all case deals less co-op = ($125,000-$62,500-$45,600-$10,000)=$6,900. If this is positive, the promotion made more money than doing nothing. If negative, it made less money than doing nothing.

Sometimes people feel happier comparing the margin (contribution) earned by the promotion with that earned by doing nothing. This will give the same answer as that shown above, provided you do it correctly, but it is very easy to slip up on this comparison.

Step 1. Determine the period that the 9500 cases will cover. Since the incremental lift is 2500, the base sales are 7000, and these are equivalent to 7 weeks. (It is apparent that the retailer has invested or diverted some stock during this promotion.) Work out the do nothing contribution – 7000x(50-25)=$175,000.

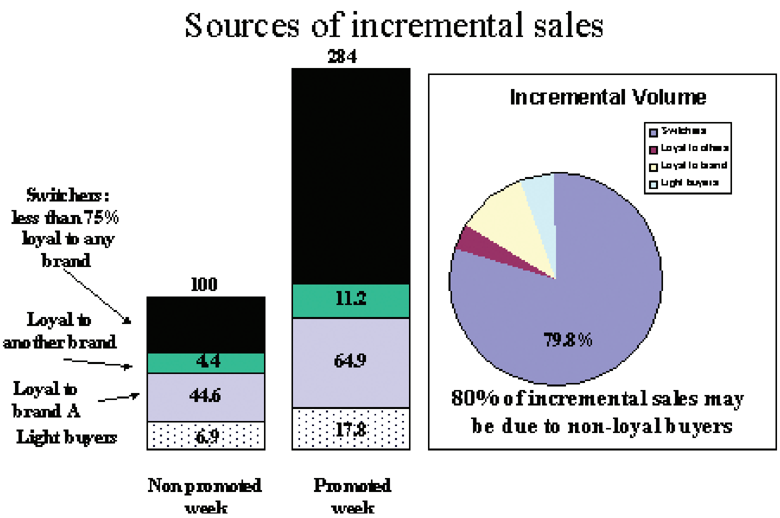
Step 2. Determine the contribution for this promotion. 9500x(50-25)=$237,500. Now deduct the promotional costs, in this case discounts and co-op. 9500x4.80=$45,600 plus $10,000. The promotional contribution is 237,500-45,600-10,000=$181,900.

Step 3. Determine the difference. $181,900-$175,00=$6,900. This is the same answer as calculated above, and this promotion earned more contribution than doing nothing.

Where did the incremental sales come from?

Here we have assumed the 2500 incremental cases are genuine additional sales. What can happen is that a portion of these may be accelerated purchases by consumers. In other words, a housewife who realised she would soon need to replenish may have decided to buy early. This is not a real gain at all. Alternatively, a housewife may simply decide to buy two or three instead of one, and if the rate of consumption is not changed, it will some time before she repurchases. Again this is not an incremental gain, but these issues are often overlooked, because they are hard to quantify. A further possibility is that a consumer who does not normally buy this product, has decided to buy. Ah Ha. You have spotted a real gain. But maybe not. The real question is whether this consumer is loyal to any brands.

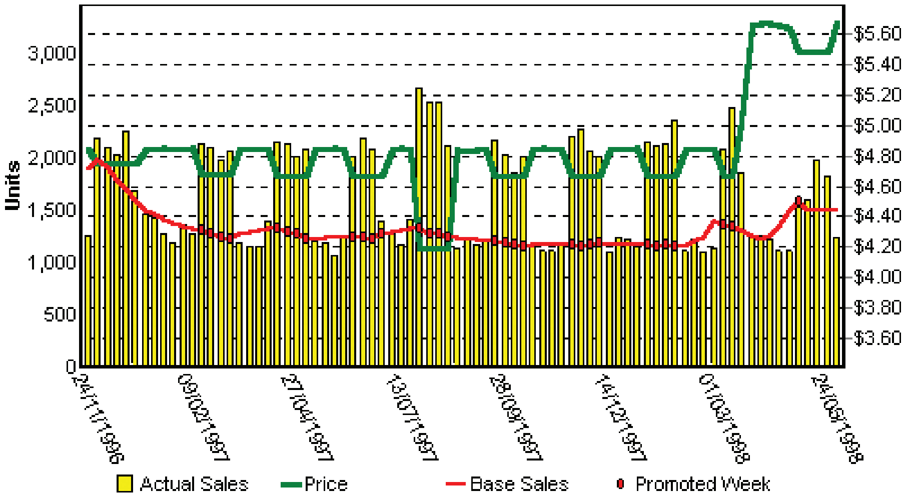
A significant proportion of consumers have learnt to buy on price, and are never loyal to any brand. This is simply due to our current love affair of price promotions – enticing consumers to switch. This means their sales are only of value if you gained additional contribution from the promotion. If your promotion makes less than normal sales, and the additional sales were primarily brand switchers – you have invested in consumers who cannot be owned – they are simply not worth investing in. The following data has been extracted from Analyzing Sales Promotion – Text & Cases: How to Profit from the New Power of Promotion Marketing. Second Edition by John C. Totten And Martin P. Block (1996) and was originally researched by A.C.Nielsen. This book is described on this web site. The data is apparently average USA data.



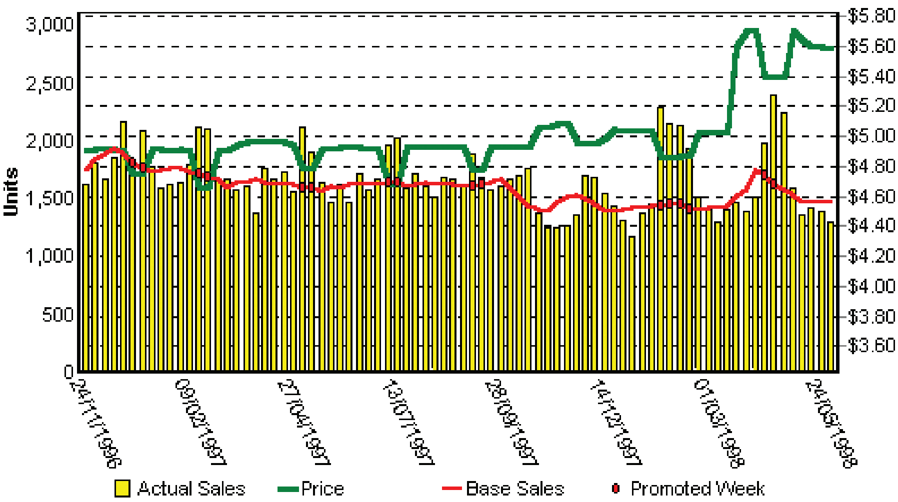
From this you can see that 80% of the additional sales on the average promotion are due to brand switchers. In the example above, this means that at best 500 of the 2500 cases were not bought by brand switchers. But they could still include pantry loading by loyal buyers. The quantity bought by pantry loaders can vary quite substantially. Pantry loading is generally encouraged if consumption increases. This is the classic motivation for potato crisps and soft drinks and confectionery. But laundry detergent, aerosol spray, kitchen wipes, aluminium foil, pet food, toilet paper and even coffee would probably not change the rate of consumption because it was discounted. However for every argument there is often a counter, and I was recently told that many coffee buyers are very infrequent purchasers. In this case one might expect some increase in consumption, but I think heavy coffee drinkers would not pay any attention to the price they paid when making the next cup. Incidentally even this example of heavy and light users is dubious. The data in the paper 80:20 it is not illustrates that you need about 18 light users to buy the same quantity of coffee as one heavy user. You are unlikely to increase your market share much by teaching light users to imbibe more heavily, but the temptation is great because there will be so many more light users. And it is only the heavy users who will pantry load (It is ironic that recent research proves that 41% of the incremental lift on coffee promotions is actually due to an increase in consumption. It seems, contrary to what I may have thought, a great many consumers are infrequent coffee drinkers, and once they are enticed to purchase, consume the contents, thus increasing consumption. It only goes to prove that nothing beats research.).

Can our actions in promoting cause consumers to behave differently?

This is an interesting point. Perhaps we confuse cause with effect. If we see large lift we believe a product is promotionally responsive, but it is just as likely that we have created promotionally responsive consumers. Have a look at the following scan data. This is real data, based on a product that is not a stomach related product, is a brand leader, and is an infrequently purchased product with a moderate to high ticket value - $4.00 to $5.00 per unit range.



You would conclude that it is promotionally responsive, and the promotional evaluation might turn out to be quite good, as there is a reasonable incremental lift. You may note the red line has not in fact determined that the first promotion is in fact a promotion, as the price drop is below the sensitivity. A similar problem occurs at the end of the data, where there is a price increase. However the following bitmap is the same product in another geographic region, but in the same supermarket chain, where incidentally it has a slightly higher brand share, against the same competitors.



Looking at this you might conclude the product is promotionally unresponsive. But the real difference is how the consumers have been conditioned. In the first situation the account manager believed his job was to have regular deep discount promotions, and he kept this pattern up for some years. He believed that his market share was a result of his 'blocking' tactics in running deep cut promotions. In the second, the account manager could not see what promotions could do for his business – he already had 70% plus of the market and consumers will not use any more of the product because it has been discounted. So his promotions were infrequent, unpredictable, and generally at a lessor discount. His approach did not lose him market share, quite the reverse!

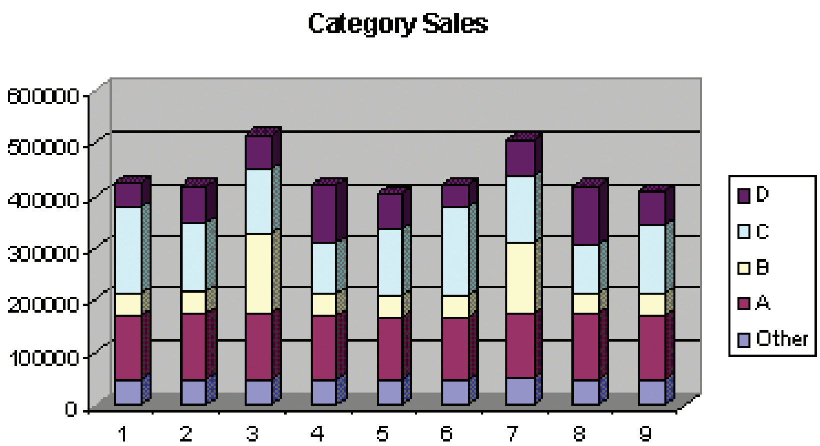
The message is very clear. The amount of lift above the base line can be a function of the consumer buying patterns that have been learnt. In other words in the first scan data example the product is no more promotionally responsive than in the second but consumers have learnt to time their purchases. In Australia we had many years of deep discounting of margarine. And 90% of consumer sales occurred on promotion. Even the margarine suppliers believed that they had to promote often with deep discounts. The retailers naturally insisted that this was the case. The retailers of course bought 100% of their purchases at a discount. One of the major suppliers was very surprised when consumer research indicated that 40% of the consumers were loyal to a brand, but never bought outside of a promotion. And when promotions were drastically reduced, it had no affect on their market share. But of course it would take years to build up the consumer loyalty that was so severely eroded by continuous discounting. What was amazing is the degree of brand loyalty left after all this discounting.

What about pack switching when I promote one size?

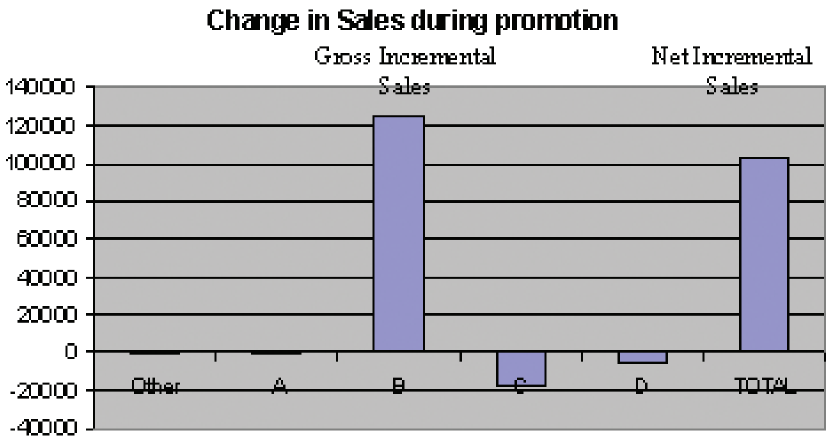
How can we measure brand or pack switching? It is possible to determine which brands decline below base sales, when a selected product is on promotion.If this is one of your own brands, you need to deduct the switched sales from the incrementality. Then you can recalculate the incremental gain, if there is any. There is a limit to the accuracy of these cross impacts, as sales inherently have a degree of variability - some more so than others. Nevertheless significant cross impacts can be readily detected. In a category with a lot of simultaneous promotional activity, it is extremely difficult to determine exactly what is switching with what. Certainly you can see the lifts and declines, but determining which cross impacts with what is more tricky.

Are some brands more affected by switching?

Absolutely!Have a look at this analysis I did some years ago, which measured who got the incremental volume over a nine week period in one category in a selected chain. The participants included a strong but somewhat price oriented house brand (D), two international brands (A and C) and a small local (B) Australian brand. The brand on promotion is generally easily spotted. The decline of other brands is also obvious, where there are significant cross impacts. The category only expands in two of the nine weeks, when supplier B is on promotion.



What puzzled me was how little incrementality one of the international brands had achieved (A). They were not a client of mine, but over ten years I had learnt to respect them enormously, and indeed over that period they had grown their share continuously across a wide range of categories. Yet here initial evidence suggested their promotions were ineffective. This was to my mind mutually incompatible with what I knew of them – a very tightly run professional company. It threatened the very foundations of promotional evaluation as I understood it. If achieving incremental lift is not the name of the game – what is. I soon found my answer.



Take a look at the cross impact analysis above. This analysis was done from the perspective of the small Australian brand B, but when repeated from the perspective of Brand A, or indeed any suppliers's perspective it was obvious that their brands, i.e. A's,were almost totally unaffected by their competitors promotions. Sure their promotions did not get much lift, but then they appeared to own 100% of their consumers - there were no rented sales here - to repeat a phrase coined by P&G I believe. The term rented sales is an excellent one, as it very clearly indicates that you should not be investing in these consumers. Perhaps the single most important issue is building brands that are impervious to competitive promotions. **Instead of joining the rush to create and sustain brand switchers, how about building sales to consumers who don't want to buy anything else?**

What about excessive trade spend costs?

As discussed earlier, if a promotion whose incremental volume is likely to be mainly comprised of switchers is to be economically sensible, it has to cost less than the incremental contribution generated by the promotion. In most parts of the world this appears to be a simple issue. If it is not generating a positive incremental contribution, suppliers do not run the promotion. In Australia, this is quite another matter.

It probably makes absolutely no sense to those outside of Australia that we should be running over 90% of our promotions at a loss if the full costs are included in the analysis. But this is reality in Australia. For a discussion of how and why, take a look at another paper on this web site. The question I would like to try to answer here, is how can Australians cope with this situation and still make sensible economic decisions.

There are a number of options, each with advantages and disadvantages. The first option is to exclude some of the costs from the evaluation. Personally I do not favour this. Australian retailers, predictably, favour this, and if you present them with a promotional evaluation that shows a loss, they will shrug their shoulders and say: 'Nobody makes a profit out of promotions!' Alternatively they will say: 'You should not be including co-op, because it is a cost of business not a cost of promotions!'

How can we have got to the point where one can conclude that co-operative advertising is not a cost of the products it advertises and promotes? Quite simply. The co-op costs are now so high that everyone acknowledges they bear absolutely no relation to the economic value of the advertising, where there is actual media involved, or simply the economic value of any additional shelf space gained temporarily or temporary price tickets placed on shelf. Typically if co-op is measured against the sales revenue on a promotion, it is not unusual for the cost to be 15% to 35% of promoted sales revenue. How this happened is that it has been the accepted practice for many years in Australia that suppliers would commit to spending a fixed percentage of sales on co-op, and this percentage has been steadily jacked up from 2% to 6% of all sales during the last ten years. Coupled with this was a serious and longstanding misunderstanding by many sales people of what this percentage actually means. Because it was also common for the percentage to be automatically deducted, or at least paid monthly, sales people in general deluded themselves that this 4% on all sales was a cost of all sales. In a great number of cases they refused to attribute the total cost to the sales of the products actually on promotion. In this case the 4% could easily translate to 15% to 30%. And 6% is proportionately worse! I know this to be the case because for the last 12 years I have been having this very argument with account managers across Australian food and beverage suppliers.

Co-op is not the only cost that could be excluded from the analysis. It has in recent years been very common for retailers to investment buy - in other words buy more than they need, and to sell the balance at normal prices after the promotion. There is a direct relationship between the size of the promotional discount offered by the supplier and the quantity invested, so big case deals attract much bigger stock investments. This is because retailers can also calculate economic order quantities. Nevertheless the argument has been put to me by retailers that this is also a cost of business. And it is true that the margins earned via these activities are an essential component of retailer overall margins, and in that sense a normal retail business activity that is unrelated in a broad conceptual sense from running a promotion. But it is certainly a simple cause and effect relationship. Right at the moment many suppliers have negotiated trading terms that avoid investment buying by agreeing to pay, on some basis, the margin foregone directly to the retailer so that he does not have to go through the trouble of investment buying. Naturally this saves both supplier and retailer from the many costs associated with this practice.

Another subtle cost also exists. In Australia it has been traditional to have a buy period that is longer than the sell period. In other words, if the consumer sees the discount for one week, the retailer may see the discount for up to three weeks longer, or total of four weeks. With the recent change in trading terms in Australia to eliminate investment buying, this issue should be irrelevant. However I doubt that this is the case. In many situations the supplier might still fund consumption by consumers in the three additional weeks of the buy period, simply because we are so used to accepting this practice. The question to be answered is: 'Is this another cost of business to leave off the promotional evaluation?'

I do not like the concept of leaving off costs since these are trade spend costs and we are inevitably trying to take rational economic decisions which maximise the profit contribution of the supplier.

Another option is to do the evaluation with all costs included. The problem with this is that a 'good' promotion may well be one that delivers a negative incremental contribution, or a cost to sales of the incremental sales that exceeds the margin on those additional sales. If however we set the expectation that this is acceptable, it is a manageable situation. This is particularly the case if we use as a benchmark promotional cost as a percentage of incremental revenue – in other words, a promotion costing $60,000 which generates $30,000 of incremental sales has a cost % of200%. If we set the benchmark of 250% as being acceptable, this is a good promotion.(Not that I am by any means suggesting that 250% is a reasonable hurdle rate!) Personally I find that incremental contribution % is more useful than incremental dollars as a measurement criterion. We just have to ignore the fact that the margin is bound to be below 60%, and hence this promotion is losing money. This is the option I prefer, as it is pragmatic and simple. There is however a third option.

It is quite possible to decide that the maximum amount of co-op that would ever make sense to spend on a promotion is say 5%. We can arrive at this figure based on the fact that very very few FMCG companies spend more than 5% of sales on advertising, and do a perfectly adequate job at this level. Clearly there is no way we should cooperate (and split expenses) with a retailer and spend any more than this figure. With this or a similar figure in mind, one can next look at the total percentage of sales sold to the retailer at a discount. Typically in Australia this would be 60% to 100%. If we stick to 50% as it makes the arithmetic easy, 5% on a promotion means spending 2.5% on all sales. We can then take that 2.5% and apply it to the expected sales to arrive at the economic value of the co-op delivered by the retailer. Using the retailers current and highly inflated schedule of fees for different types of co-op activity as a base, we can scale down the cost to derive economic values for every promotional type. Typically in Australia if your co-op trading terms are 6% at present, the economic value would be 2.5*100/6 = 42% of current prices. You can then do your evaluations on 42% of current prices and set go/no go on the basis of the incremental contribution being positive where a promotion primarily gains switchers. This solution is elegant, but more complex. It certainly would make any trade spend system somewhat schizophrenic, as it tries to track both economic cost and real cost.

What can we do about it in the short term?

Well we can choose one of the three basic options. Ignore some costs, which means in the case of co-op one does not distinguish between the value of a gondola end and a shelf talker. Or one can set the benchmark such that making a loss is expected, or finally one can evaluate promotions based on a proportion of the costs to approximate the real delivered economic value in each promotion.

What can we do about it in the long term?

There is really only one solution. Suppliers should seek to renegotiate promotion related trading terms to get back to economic value. In doing so they cannot reduce trading terms overall, as the retail trade will still require the same levels and they will have to appear to give away terms for no return. In other words instead of 6% for co-op, they will have to give away 5% for nothing, and keep about1% for co-op. The key to this being effective long term is that the 1% should absolutely be totally discretionary – in other words the supplier should be under no obligation to spend to this level, and how much he does spend should be dependent on the value delivered by the retailer. It is also important that it never gets jacked up again, and it is also important it is paid on a going rate basis- in other words pay for each promotion as it happens. Agreements to pay a percentage on co-op and paying these amounts automatically are always going to be too big a temptation for a retailer to ask for more. Naturally this same arrangement will also have to be agreed with all retailers at the same time – probably the hardest part. This may be the killer, and it's a real pity the whole industry can't sit around the table and resolve this issue without drawing undue interest from the ACCC.

Under this scenario retailers will have to deliver economic value for their co-op charges, or they won't get the price discounts. And if they don't get the price discounts it will impact their price image. However as each of the major retailers is of a significant size, no supplier will be keen to walk away from promoting with a retailer – provided there is a return. Thus there will be a significant degree of power on both sides. So all retailers will have to deliver roughly equivalent value on promotion. That does not mean co-op charges will be the same, merely equivalent value.

Why should major retailers agree to this? Well they already recognise that the whole trading terms issue is a fiasco. Since it involves such big money, category buyers have to focus on getting their co-op budgets, when they should be focusing on new products, margins, stock turn and delivering what consumers want. Getting co-op back to being of marginal concern to a buyer is a very good idea. Under this scenario, buyers would value the shelf space they have available, and what it can deliver, rather than simply getting co-op. They would also not be keen to run promotions that do not deliver. If we can simplify trading terms, and earn the real profit at store level, everyone will win, consumers included. Major retailers are also concerned that the vast majority of account managers are totally disenchanted with promotions – as they see these as losing money. Many now tell me they really don't care how much co-op a buyer wants. It is all funny money. It is not in the retail interest for this view to prevail. It would be a lot better for all parties if those that wanted to promote, could afford to promote as much as they wanted and their promotions delivered at least a positive incremental margin, even if the incremental sales are all switchers.

It is some time since any supplier in Australia had totally discretionary promotional funds. In twelve years I only ever knew of one supplier who was a prolific promoter and who was in this situation. Naturally retailers detested this exception and took every opportunity to say so. He regularly had fights with major chains over this issue, but it was a very strongly held personal opinion, and he never changed his view. When the sales director was retrenched in a management reshuffle, the new sales director took only months to formalise written terms covering spend. And he was very proud of cleaning up the situation and improving retail relationships. What is even more sad to think is that he was paid to do this!

I have just learnt that one of our major chains has developed zero cost co-op trading terms. This is of course a variation on economic value co-op. These terms are only offered to suppliers who meet a number of conditions. Naturally existing co-op terms are turned into rebates. Then all case deal is by scan, so it also assumes the investment buy issues have already been settled. Finally the two parties must be developing joint business plans. This part is critical, as it enables the two to decide what sort of promotional events are appropriate and the frequency. Setting co-op to zero cost with all deals on scan certainly makes the promotional evaluation easy. Critical to this process is a very clear understanding of what objectives promotions are to meet, particularly since these have to be communicated to the chain. This sounds like a very big advance over the situation that has prevailed. Perhaps I am being unduly negative in still having a minor concern that an economic value is not being attached to the promotion. A supplier would always seek to have a gondola end with some sort of media if he has the choice, and with the cost being zero, I am a little concerned about this aspect. Still, it is overall a big improvement. And buyers would be able to ignore the co-op issue in making decisions, which is certainly a big advance.

Where does this take us?

Well it is obvious that you cannot simply assume that the incremental gain on a promotion is a reflection of additional business gained. It may well be due to accelerated purchases by loyal consumers, or worse, predominantly brand switchers, or even your own pack switchers. The real incrementality may be much less than the additional sales gained in any one week. The message is that you need to question every day – where does the lift really come from? And is it that important anyway? If that's not controversial, I don't know what is! When you see brands growing year on year, and note that their promotions do not lift significantly, you have to question these things.

There are of course many times when a supplier is looking to get additional volume, and does not care that this volume may be unsustainable. Obvious reasons include mopping up surplus capacity - factory capacity is only available in lumps. If you decide to add another shift, you have a lot of capacity to fill. Of course this is the classic rationale for exporting at marginal cost. Selling in your home market at marginal cost is an extremely dangerous strategy, as it undermines the base business. Other reasons include trying to lift volume in an account to maintain listing, or gain a better shelf position, or more facings. Under some of these conditions the objective will be one of breaking even or not losing marginal contribution. And this is when the issue of over-inflated trade spend costs becomes a practical issue.

Hopefully it should be obvious that promotions are a tactical device, which should be subordinate to the basic marketing strategy. In Australia to sheer weight of promotional activity has lent an authority to the process which is not warranted.

We should not be promoting just because we get good incremental gains. We should be promoting because it is part of the desired marketing communications mix, and if we do need to promote, then we should be looking for the best promotional vehicle and best incremental result. I still have a concern that there is a relationship between optimum incremental result and average trade spend which might mean that chasing maximum incremental contribution may increase trade spend. This point is explored in another paper on this site.

This issue gets more difficult every year, as in Australia the trading terms dictate that a very comprehensive program be run, and for many suppliers this is far more activity than they would choose. In the long run it is likely to destroy the brands and develop consumers who are brand indifferent. This is not in the best interest of suppliers, and also not in the best interest of retailers either, as it will leave price as the only meaningful point of difference between supermarkets.

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