



why promote?

Promotions have been a regular part of the Grocery retailing scene for many years now – maybe 30 or more years. When I was first involved in Grocery, nearly fifteen years ago, this question typically was dismissed as obvious. The theory that was put forward at that time was that a promotion was run so that the rate of sale after the promotion would be higher than that before - in other words one was led to believe that the objective was to gain a permanent increase in the rate of sale. Now that scan data is readily available (sales through the till) we realise that this is not something that can be guaranteed, indeed the vast majority of products appear to continue with precisely the same sales pattern as existed prior to the promotion. If it is in a growth cycle, that probably continues, if it is in decline, that also continues. Why then do we promote?

Consumer vs Price Promotions

The promotional scene varies somewhat around the world. The amount of activity, the average depth of the price discount, and the extent to which promotions are funded and organised by retailers or manufacturers varies significantly. In some countries promotions are always account specific - unique to that retail group. I am not sure that this practice is universal. The tools also vary somewhat, with coupons being a big part of the action in many countries, and outlawed by retailers in others. However amongst all this variety, two fundamental types of promotion exist – consumer and price promotions. Price Promotions are sometimes called Trade Promotions. Consumer Promotions are promotional events co-ordinated, planned and partly executed by marketing departments, often in concert with other marketing activities, and all are designed to achieve an articulated objective. Trade or Price promotions are short term price discounts designed to stimulate sales at retail. I do not have data for anywhere else in the world, but in Australia the price promotions would account for 90% to 95% of the activity, in other words far more price promotions are run than consumer promotions. In total probably 30% of consumer sales in Australia would be promotional sales, but this includes Consumer promotions. This appears to be significantly more than in the UK, where one retailer reported 10% of their sales as being promotional sales.

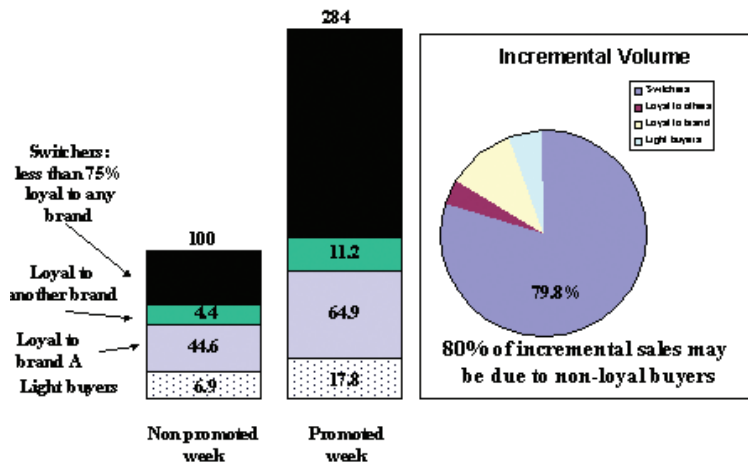
Consumer Promotions

As each of these has an articulated objective, there is clarity about why these promotions are executed. These might be to increase usage amongst a target group, to entice trial for a product that has not achieved full coverage in its market segment, or simply to introduce a new or revamped product. Whether they are successful is another matter, but that is not the point of this paper. As the objectives are clear, we need not concern ourselves with this type of promotion. In the rest of this paper we will concern ourselves with the price promotions.

Price Promotions

Price promotions are promotions that are run without specific marketing objectives. The first question one might ask is why do these exist? There are a number of reasons for that. Firstly it did not take long for manufacturers to discover that sales both ex-factory and to consumers can be boosted very significantly by offering discounts to the trade. The reason for this is really quite simple, many consumers are somewhat indifferent in their brand choices, and are certainly influenced to change their selection if a significant discount is offered. Others are simply happy to accelerate their purchases (pantry stock) and yet another class of product can be shown to increase consumption when discounted. The following graphic is an average of all grocery products, and although these figures come from AC Nielsen, the numbers have been confirmed by a number of studies.

Sources of incremental sales



What this clearly indicates that on average, the vast bulk of the additional sales gained are simply 'rented' market share. This average does vary quite significantly across categories, and up to 50% of the lift can be additional consumption, if the category favours that behaviour, but this is unusually high. While none of the research I have seen supports the extent of accelerated purchases that I believe occur, it is my firm belief, supported by a number of categories that I have studied, that accelerated purchases can also be a significant portion of the lift. Obviously this is absolutely dependent on the characteristics of the category, and the regularity and depth of price promotional activity. In the first instance it requires storable products, and generally frequent purchase, although significant investment purchases have been seen even with a six week purchase cycle.

Why Retailers Promote

The majority of grocery retailers around the world adopt a HI/LO price strategy. This means that they reduce the price of a fairly significant percentage of their range on some basis, either regularly or erratically. This means that consumers are exposed to a number of differing 'bargains' on every shopping trip. The purpose is to stimulate sales, and indeed research has shown that the promotion of 'traffic building' lines can increase the sales of other non-related lines by up to 10%. So retailers can use price promotions to increase both the number of customers they receive per day, as well as the average number of lines that are placed in a shopping trolley on each visit. There are also a number of retailers who do not adopt this strategy, or carry out very few price promotions of this type. These are so called EDLP (Every Day Low Price) chains. It is understandable that HI/LO retailers who must run promotions as part of their marketing mix should look to suppliers to assist in this practice. Indeed as the power of retailers has grown, it has become common practice for 'terms of trade' to dictate how much is to be spent on promotional activity. By 'terms of trade' we mean the commercial trading arrangements between supplier and retailer that govern how product will be supplied and paid for. It is quite obvious therefore why retailers would encourage or even insist that suppliers should promote their products. The question is why suppliers might encourage this process.

Why Suppliers promote

The graphic above indicates that the average lift on promotion for a grocery product is of the order of 184% – or more than double the non-promoted volume. This represents a significant increase in both volume and market share. It is well known that manufacturing costs are volume dependent, in the sense that as volumes increase, so costs per unit can decrease, and profit per unit increase. It is thus not surprising that a manufacturer might decide to obtain additional volume by price promoting. If his competitors did not adopt the same strategy, they would suffer a loss of market share. As a result, across the vast majority of grocery categories, all manufacturers tend to price promote. A key question to ask is whether non promoting would increase total dollar profitability, even though sales volume would decline. The market share garnered by price promoting has been termed 'rented market share', an apt term, since it is never owned, and one would be wise not to over invest in obtaining or retaining this share. The problem is, that in order to obtain a nominal amount of rented market share, the supplier must often discount all of his sales in a given week – meaning that the cost of the additional sales may well be exceedingly expensive. Some techniques like coupons go some way towards reducing the volume of sales over which discounts are given, but this is not the only promotional approach, and indeed coupons are not permitted in some countries. We will now turn to each of the more common reasons for promoting, from the supplier perspective, and analyse how one might set objectives and criteria to manage that decision.

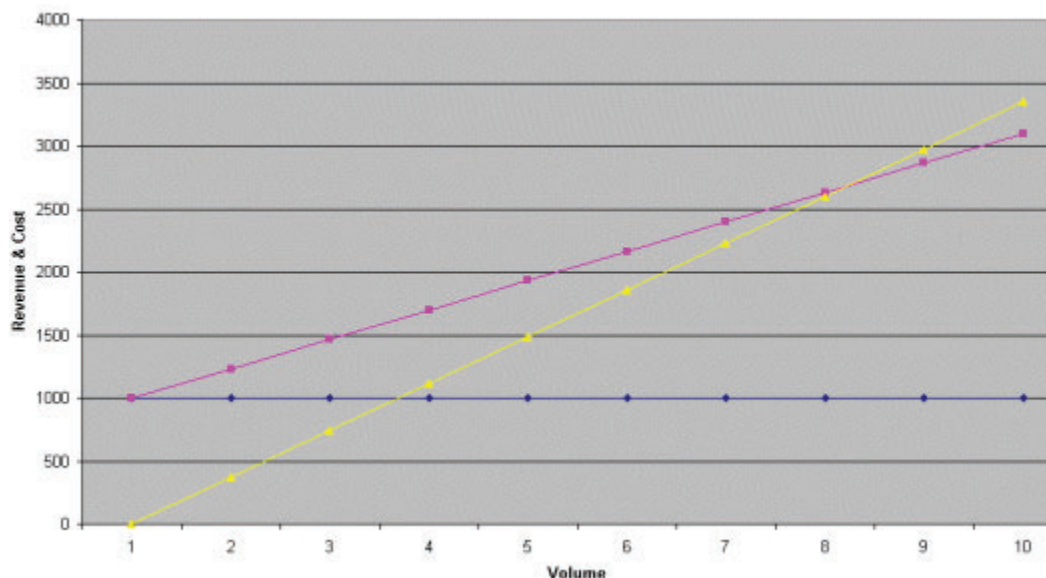
Reasons why Suppliers promote

The more common reasons why suppliers promote are:

To deliver a short term volume lift, knowing full well that this is only a temporary gain

This is probably the classic reason for price promoting. Generally a significant number of these promotions are built into the sales budget of both revenue and cost. What that means is that the volume lift is not incremental to the business - the lift is fully planned and budgeted. I have very often heard the story that this is necessary to maintain sufficient volume in the factory. That being the case, it is not a difficult cost accounting exercise to determine what the result would be without these price promotions. Many food industry products have relatively high variable costs, but this is of course not universal, and some have indeed very high fixed costs and low variable costs - bread being an example.

The following bitmap is a classic break-even chart. On the left hand axis is the revenue and cost dimension, and on the horizontal axis is the volume. As volume is increased, the costs and revenue increase till the break-even point is reached at about 80% of capacity. (Actually at 80% of budgeted volume.) The point to note is how close the revenue line is to the total cost line. This is the yellow and the purple lines. These are only close because the fixed cost component, here 30%, is relatively small. If it was much greater, the two lines would be separated by a greater amount.



While I have attempted to build a realistic model here, clearly one should build a model on accurate cost data in order to make the point I wish to make. The yellow line represents revenue. The blue is the fixed cost, and the purple is the total cost line. Where the yellow line crosses the purple is the break-even point, and the difference between these two lines to the right of this point represents the profit earned. The point that is generally the centre of attention is the break-even point, here about 80% of budgeted output. Obviously full profit (8% of revenue) is only earned at 100% of budgeted output, and at 80% no profit is earned. What is often overlooked, is that in this cost model, fixed costs are 30% of total costs at budgeted revenue (which is probably too high for many food suppliers). If a discount of 5% is given away, because the revenue line and the total cost line are relatively close together, a very large increase in volume is required to recover the lost contribution. In other words the break-even rapidly moves to the right, if the revenue line decreases by 5%, moving the break-even close to budgeted revenue.

The strategy that might well be realistic in a high fixed cost business like bread is totally inappropriate if fixed costs are low. In this situation the company is price sensitive, not volume sensitive. They would probably better control the bottom line by setting the price that is required in the marketplace, and forgoing market share. Of course that flies in the face of the conventional wisdom that says market share is the single most important factor in the determination of long run corporate profitability. In fact I would not dispute that point, but long run profitability delivered by market share is largely a function of long run economies of scale and learning curve effects, not price driven artificially inflated short run market share gains. The other point to make is that capacity in a factory is time based. If the factory runs at 50% capacity on Wednesday, that capacity is lost forever, and running a promotion the next week is not going to recover the capacity lost the week before, although it may well successfully conceal the lost capacity from the financial reports, which inevitably are averages. However if you are running at 50% of capacity consistently, one might well look very carefully at the economics of bringing capacity up to 80% via some promotional activity. The problem is that once you try to take a permanent lump of market share away from a competitor by price promoting, they will retaliate.



On the other hand if you grow your brand via consumer brand preference, price promoting on your competitor's part will only be a short run solution, and an expensive solution at that. Before leaving this particular point I would like to determine some appropriate financial criteria. With these budgeted promotions, the costs that have to be analysed are the long run average costs. While one might pay attention to how factory costs vary with volume, basically if these promotions do not make more average contribution than the sales from an equivalent non-promoted period, the promotions are not going to improve the bottom line. While incremental performance is certainly important, as it indicates the additional value gained, the average contribution is the more important, as that is what flows through to the bottom line. In another paper on this site I discuss the fact that optimum incremental performance does not occur at the same retail price point as optimum average performance, and that a focus on incremental performance to the exclusion of average performance will reduce overall contribution.

However in many countries the terms of trade with retailers dictate a very high level of promotional activity, and the supplier must spend a significant amount of money. Sometimes the terms of trade only covers co-operative advertising, and the case discounts are under the control of the supplier. In some cases the supplier has very little control of both elements, and then there is very little choice about these promotions – the costs are budgeted, and they will have to be run. The best that can be hoped for is that by careful execution that a tiny bit better result may be obtained. The best way to determine whether these promotions are effective is to look at a 12 month program, and compare bottom line contribution as a percentage of sales across retail accounts after apportioning all costs both fixed and variable. If one account is below standard, it is quite likely that the promotional program is out of line, either because of overspending or underspending. Generally it is the former not the latter.

Within this objective there are two different situations. There are a number of categories where a fairly significant increase in consumer consumption takes place once the shopper takes the product home. Some research has been done into this area, and turned up some interesting categories. Coffee for example significantly boosts consumption. Carbonated beverages and snacks like potato crisps have long been known to boost consumption, as well as many confectionery lines. Where there is an increase in consumption, the category is expanded, and provided this can be done at reasonable cost, everyone is a winner. In categories like margarine or detergents, there is no category gain, and it boils down to simple market share swapping amongst participants. To the extent that there are new entrants of differentiated products this may be another situation, but one which generally is handled as a consumer promotion.

In summary, this objective is probably the most common, and implies that the financial return to the company will be improved as a result of running the promotion. This should be measured as a bottom line dollar contribution gain. If this is not the case, then this promotional objective should be avoided.

To recover lost market share, due to aggressive competitor activity

From experience this is a situation that arises fairly regularly. An adequate response to a competitor indulging in an aggressive price driven promotional program for a number of his brands is clearly indicated. The question is whether matching the price activity is the best response. From observation of a few suppliers, some will match the price cuts, or even attempt to out-spend the competitor. Others will indulge in some activity, but limited to that which is considered the minimum one can get away with. Generally it would appear that any market share gains achieved by the competitor are likely to be lost as soon as the discounting stops. The only concern would be whether the gain in share delivers equivalent reduction in cost, so that the price reduction is sustainable. Again this would not appear to be the case generally. While on this point, it is worth pointing out that many traditionally designed cost accounting models are very biased, and a more modern approach, using activity based costing plus realistic overhead allocation, and an understanding of profit earned per unit of capacity consumed may indeed have led to your competitor realising that a lower price is sustainable, and your own cost accounting system may indicate you cannot afford to match his price, when in fact a better cost accounting system might indicate that you can. This is particularly true of products with a very high material cost, and relatively low conversion (value added) cost, in which situation traditional cost accounting systems are often woefully inadequate.

Criteria that are appropriate for evaluating these promotions must relate to the objective set. Clearly the primary objective is to recover some of the sales volume, at some level of cost. It is very unlikely that any of these promotions will be 'profitable' – it is much more a case of limiting the loss of contribution to that which the company can afford.

To reward brand loyal consumers

This seems a strange objective, but it is a simple result of the over-promotion that is so common. If you have a major share of the market, and have a number of competitors discounting regularly to try to tempt your loyal consumers, it is

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psychologically a good idea to “reward” them with a small discount every now and again. This way they do not feel that they never get to buy at a discount. Clearly the financial evaluation of this type of promotion may well indicate an investment has been made – i.e. a cost has been incurred. These are not run to deliver higher profits. You may induce loyal consumers to ‘pantry stock’, but if that is factored out, you are unlikely to show a positive financial return, and you should not be concerned about that. However it is important to set financial guidelines, and generally these should limit the frequency and size of the discount offered.

To meet short term sales targets

This practice creeps in if top management are naive in their expectations. It is particularly common for companies who place a great deal of store on achieving the target monthly sales value. Many of these seem to be American multinationals. European multinationals seem to be far less concerned about monthly sales, but may suffer the same issue at year end. What happens is that the sales team offer a discount to their trading partners - the retailers, as an incentive to ‘investment buy’. While some effort may be made to ‘sell through’ and thus limit the inventory stocking effect, inevitably that is just what happens. The result is that the subsequent period effectively is shorter. If you achieve six weeks sales in a five week period, without an equivalent increase in consumption, you will have one week less trading in the following period. The same is true if in the last month of the financial period you achieve two months sales. The next financial year will be only eleven months trading. This is self evident to all who participate. Why then does it happen so frequently? There is a further complication that often happens. The retail buyers very soon notice this behaviour, and they hold back their orders waiting for the inevitable discount that will appear. From a control perspective the best thing is to capture these trade spend costs separately, and have top management understand the costs of meeting target results. If this is felt acceptable, then there is no problem. In many cases top management are unaware of the magnitude of the costs incurred. The evaluation of these promotions should be done against total volume sold and by reviewing the average cost of those sales.

In the vain hope that sales of a slow moving line will miraculously improve

Some undertrained account managers do not understand the source of incremental sales as shown in the graphic above. They still like to believe that after every price promotion another small percentage of loyal buyers will be found, and the volume will slowly grow. I like to say when running training courses on the subject, that I have never seen a single product grow as a result of price promotions, but that I have seen a good few brands destroyed. Naturally this overly confident statement is sometimes disputed with hard evidence to the contrary. However whenever the examples offered are studied, there is general concurrence that these are products that have not yet reached all the consumers in their target market. Equally it is often agreed that a consumer promotion might well have been more effective for these few situations. I continue to get away with the bold statement: ‘Price Promotions do not grow brands!’

However a price promotion will often cause a temporary boost in consumer sales such that the numbers that many buyers use – year to date, or period ranking, are sufficiently boosted to buy time to replace the product, or design a recovery strategy. This is a quite legitimate price promotional objective -and should be evaluated on total sales achieved to the consumer.

To clear stock

This can happen from time to time, and can be evaluated on achieving the objective at minimum cost. Effectively the product has lost value by being close to out of code, or in excessive quantity. The issue to be aware of is how to move the product without cannibalising other sales or upsetting either retail buyers or consumers. These are not really trade spend costs, but are often not accounted for separately.

To use up trading terms

This would seem an outrageous waste of both time and money. Surely one might think, a supplier can control how much money is to be spent, or at the very least re-negotiate the trading terms. This issue is getting more and more difficult by the day. In Australia we probably have the worst concentration of retail power in the world. We have two retailers accounting for nearly 70% of national grocery sales. It is certainly a fact in Australia that suppliers promote far more frequently than they might choose to, because of agreed trading terms with retailers. As yet none of our retailers are part of multinational retail groups, but already we see Kellogg in Europe bowing to retail pressure to abstain from manufacturing generic product for Aldi. One of our more astute multinational suppliers has reorganised responsibilities so that the Account manager who calls on our largest grocery retailer (Woolworths) is only looking at 10% of his sales budget. This has been done by combining sales into an Asia region. Under this scenario he can exert a reasonable amount of countervailing pressure. The vast number of the food industry suppliers in Australia have gone the other way, with Account Managers who only deal with Woolworths, and who have nowhere else to go but down (on their knees that is!). Evaluating these promotions should be done firstly to ensure minimum average cost. It may be necessary to



ignore sunk costs, and to minimise discretionary costs.

To get the buyer off your back

Again this is disappointing, but a fact of life where buyers are irrational and overly powerful. It is far better these days, where buyers are now looking to optimise categories, and are developing category strategies. However in years gone by, some buyers simply wanted everything promoted, irrespective of whether it was effective for either retailer or supplier.

A strategic barrier to entry

In a few categories like carbonated beverages, there is a fair degree of evidence that the major players can afford to buy all the promotional ends and keep their minor competitors very much at bay. This is not an opportunity available to many food categories, as it requires a high volume category, preferably one that expands consumption and is a frequently purchased item.

Written by
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This paper has been written to answer this very simple question. I would very much appreciate input from those who might disagree, agree, or simply add a different perspective.