

ROI from Trade Promotion Management Systems:

A MATTER OF DEGREE

Executive Summary

Trade promotion spending by U.S. consumer packaged goods (CPG) companies exceeds \$80 billion per year¹ and is growing rapidly. Recent changes in accounting rules more specifically define disclosure of promotion spending, causing management to become much more aware of the scope of the spending.

Companies can begin to estimate savings from better promotion management by understanding their brand strength and management disciplines. Savings, of course, come from tighter promotion budget controls, but a majority of benefits accrue from sharing information across functions (supply chain, accounting, and so on.)

Few trade promotion software offerings effectively address this need for closed loop integrated information. Next generation software solutions can help CPG companies quickly realize spending savings and operational benefits.

Introduction: A Big Opportunity for All Companies

Size

If trade promotion spending in the CPG industry were a product category, it would be one of the hottest items in town. Experts such as AC Nielsen and Cannondale Associates consistently estimate that trade promotions (measured by short-term promotion payments to retailers) are an \$80-plus billion industry, growing at a rate of five to eight percent per year. The sheer scope of CPG promotion spending exceeds many substantial enterprises:

- Larger than all U.S. retail sales of over-the-counter drugs.

¹ Cannondale 2002 Annual Trade Promotion Study; industry studies.

- Larger than many of the top U.S. supermarket chains' annual sales.
- Growing much faster than overall retail industry sales.

Inefficiency

The latest CPG industry surveys show that nearly two-thirds of companies believe that the value received for promotion spending is only “fair” to “poor.” Eighty-five percent of CPG respondents feel that inefficient promotions are a “very important” issue. (Source: AC Nielsen Trade Promotion Practices Survey)

Visibility and Financial Results

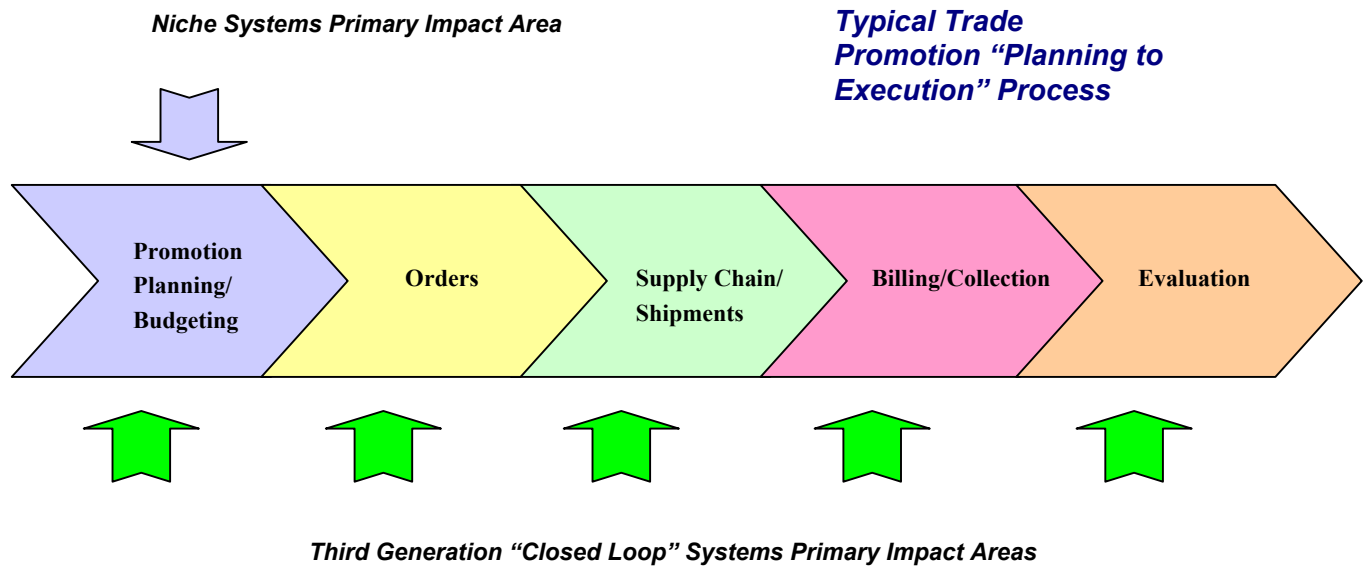
New rulings and disclosures demonstrate that trade promotion spending has an even more visible impact on company financial and operational results.

- The Financial Accounting Standards Board (FASB) ruled that most promotional payments must now be recognized as a reduction in net sales, rather than as a marketing expense. While this does not change net earnings, companies are exposing the precise amounts of promotion spending to explain the details of this transitional accounting.
- A \$1 billion household products company disclosed that it spent nearly \$150 million in trade promotion as it restated net sales due to the accounting rule. For this profitable company, trade promotion represents two times (2x) net earnings.
- A major pharmaceutical firm spent millions on year-end distributor promotional incentives so they could reach sales targets. Factories ran around the clock to meet shipments, and then were idled for eight weeks afterward, creating massive cost variances.
- A major food company lowered its earnings forecast “after discovering it was spending more on promotions than it realized.” The market reacted strongly, trouncing its stock price.

Complex Management Process

Few CPG companies have an orderly, information-rich process for budgeting, planning, executing, and evaluating trade promotion spending. Historically, many have used “home grown” systems to manage these large and detailed budgets and expenses. This gave rise to the first generation of standalone promotion management systems, often from bootstrapped niche software providers. Typically, first-generation or niche software products simply further automated the isolated processes in the sales or trade marketing department. In some cases, these products have been “upgraded” to second-generation, creating stronger yet still standalone systems.

Now third-generation systems have been developed that seamlessly integrate promotion information with a company's other financial data. For example, it is easy and affordable to install modules that integrate with payables and deductions information. These new closed-loop systems create value and profits by making trade promotion impacts more visible to operational areas.



Size of Benefit

Most companies spend several times net earnings on trade promotion, so it's easy to predict that even small improvements in trade spending will have a significant impact on net earnings. The size of the savings is simply a matter of degree based on the company's commitment to implement needed changes. However, some evaluation needs to take place to understand if the degree of savings for a particular company outweighs the cost of purchasing and implementing these new systems.

Just a five percent reduction in promotion spending potentially improves net earnings 10 percent or more.

Return on Investment (ROI) Overview

Return on investment is an estimate of the financial benefit on money spent on a particular alternative, such as an IT or IS project. Most CPG companies evaluate the details and returns of each promotional event with distributor customers. However, in this case, the evaluation is focused on the ROI expected from purchasing promotional management information technology.

In his paper *The Elusive Nature of Delivering Benefits from IT Investment*, Dr. Dan Remenyi of Henley College admits that measuring and managing IT benefits is a difficult challenge that has plagued the IT industry for many years. He concludes that there is no intrinsic value to IT investment; it is all *derived* value from the principal stakeholders. And in a 1997 study, Professor James Davenport agreed that *people* play the primary role in value creation from IT investment.

ROI from a trade promotion system will therefore depend upon the "human process" situation at each company. By analyzing the processes of the principal stakeholders, an evaluation can be made of the upside from investing in new systems that affect these human processes.

The Lake Group has developed a composite model of expected savings from improved promotion management. The model reflects 10 years of work with more than 30 CPG companies of all sizes. We also conducted a meta-analysis of available information related to CPG promotion management initiatives. Through our work with clients we have been able to validate the savings ranges included here.

The ROI Model for Trade Promotion Management

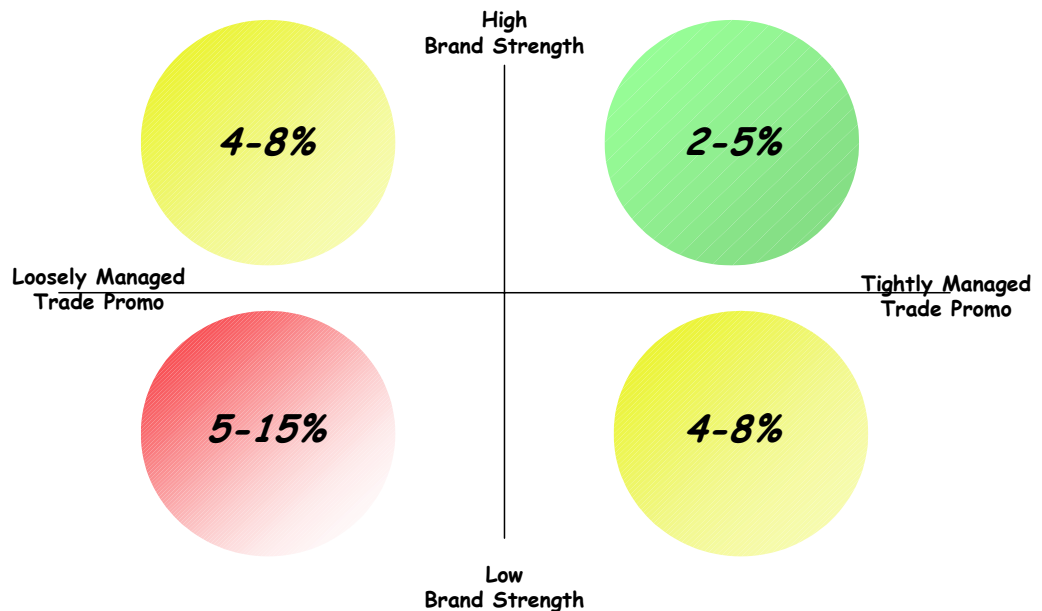


Figure 1. Percent of trade promotion budgets that may be saved through better promotional management and software tools

The ROI metrics model for promotion management shows dimensions of cost savings from better management of trade promotion funds. (In this case “management” includes the full spectrum of planning, executing, controlling, and evaluating spending.) It proposes that a CPG company’s ROI is a specific function of:

- Each company’s or brand’s competitive position in the market.
- The current level of discipline used in managing trade promotion funds.

Or in other words:

- How consumers understand and interact with the brand.
- How company managers plan and execute trade promotion activities.

These human factors dictate how quickly IT costs might be recouped and to what degree.

Dr. Jack Kasulis’ 1999 article “Managing Trade Promotions in the Context of Market Power” concludes that the relative power of manufacturer and retailer dictates the effectiveness of trade promotion spending. Typically, powerful brands are less dependent upon trade promotion spending as a driver of the business. On the other hand, weak brands (often ranked #3 or lower in the category or without a sustainable niche) may be overshooting their trade promotion spending

needs, given the fear of potential loss of powerful retail customers. The details of the ROI model dimensions follow here.

High Brand Strength

The strongest brands in a category are measured in several ways. Dr. David Aaker concludes that strong brands deliver a value proposition around three benefits to the end user: functional, emotional, and self-expressive.

One specific characteristic is that these consumer value-driven brands have high levels of sales without promotional activity compared to others; much of the volume is sold at everyday (full) price to the consumer. For example, Clorox liquid bleach dominates the bleach category with the highest share of category sales. The brand’s base or non-promoted volume is typically very high. Consumers will buy the product with relatively little price incentive. Brands in this position usually aren’t heavily promoted because those discounts would result in little real incremental volume with most of the consumer market. Strong brands will save less from better trade promotion management because by definition little trade promotion spending is occurring when expressed as a percent of volume.

One should be careful, however, in this analysis. A strong brand typically holds the number one share in a category. Trade promotion as a percent of sales is low, but because the absolute size of the brand is so large, there could be meaningful dollar savings from small improvements in the budget, for example:

Brand	\$ Sales (Millions)	Promotion as a Percent of Sales	\$ Promotion (Millions)
Brand #1	\$800	3	\$24
Brand #2	\$200	15	\$30
Brand #3	\$75	20	\$15

Figure 2. Spending scenarios for different brands in a category.

A five percent savings in promotion spending with Brand #1 still yields a \$1.2 million improvement. Although small in percentage terms, this amount might fund the addition of one more new product for the company, or in this theoretical example, improve before-tax profit by two percent.

Low Brand Strength

Low brand strength includes products with relatively little consumer loyalty or power in the marketplace. These are not necessarily “bad” or “weak” brands but simply brands with less negotiating leverage with the retailer than the #1 brand leader. There are many reasons for lower strength. Brands may exist in categories where the consumer sees products as being equal to one another with few distinguishing features or emotions. Examples might include the sugar or trash bag categories.

For products with limited to no consumer loyalty or strength, the relationship with the retailer or distribution channel is paramount. These brands exist at the pleasure of the retailer. The retailer is aware of this fact and expects meaningful discounts from incumbent low strength brands. If those discounts aren't forthcoming, there are multiple competitors with checkbooks in hand willing to purchase the space from the incumbent. The retailer knows that there will be minimal consumer dissatisfaction with exchanging the existing brand for another, and his or her overall category sales won't be negatively affected.

Lower strength brands, therefore, have the most to gain from better trade promotion management. A greater proportion of their marketing budgets go to greasing the channels of distribution. Indeed, these brands often have more complex spending schemes with volume rebates, purchasing contracts, co-op advertising, and other handcrafted promotional programs that prevent easy evaluation of results versus spending. Because of this complexity, low strength brands often deploy more personnel to manage trade deductions in accounts receivable departments.

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Tightly Managed Trade Promotion

ROI from better trade promotion management must be viewed from each company's baseline situation and management environment. There are many indicators that may suggest a company's trade promotion management culture. (Figure 3). Tightly managed brands often spring from companies that call themselves "marketing driven." These companies have proportionately more spending and personnel deployed against brand management, market research, and consumer advertising. Executives at these companies might say that marketing drives the business strategy, while the sales department implements the strategy.

These brands often have narrow and defined promotional boundaries within which the sales organization can operate. Promotional dynamics have been studied exhaustively; incremental sales from different promotional types are well understood. There is little latitude by which the retailer can seek funding for an idea that is unlikely to succeed for the category or brand. Each dollar of promotional money is carefully tracked, sometimes even in manual systems.

Loosely Managed Trade Promotion

Most CPG firms do not rigorously manage their trade promotion spending. Given the enormous funds deployed for retail promotional activities, why would this be the case? There are three primary reasons:

- **Cost of doing business.** Executives feel that getting and maintaining brand distribution with retailers may have a fixed cost that can't be materially influenced. Provided this number stays within reason, and is similar to historic spending, the conclusion is that it is "just the cost of doing business."
- **Cost of evaluation outweighs actual costs.** Many companies feel that there is not enough time, money, or expertise available to evaluate the actual results of promotional activity. Cost of scanner data purchase with which to evaluate effectiveness is also, in itself, expensive. The more complex and customized the promotional scheme, the more difficult good evaluation becomes.

- **Sales driven.** Many brands have grown due to the opportunistic efforts of sales-driven executives. “Any order is a good order; you can’t make money with a customer you don’t have.” In these cases, volume gains are almost always made with trade promotion being the primary tool. Typically, the sales organizations in these companies become the de facto decision-makers for marketing strategy and promotion spending.

Indicators of Loosely Managed Trade Promotion Companies	Indicators of Tightly Managed Trade Promotion Companies
<ul style="list-style-type: none"> • Trade promotion data is captured manually or not at all. • Few persons deployed to evaluate market impact of major trade promotions. • Account sales managers free to construct their own promotion levels and dates. • Sales plans are driven from retailer requests rather than brand/marketing strategies. • Few new products survive at retail after six months. • Highest order weeks are at end of company fiscal quarters. • Operational shipment forecasts rarely accurate. • Finished goods inventory exceeds industry norms. • AR trade deductions increasing. • Trade deductions increasingly written off as not able to be collected. 	<ul style="list-style-type: none"> • Trade promotion five to 10 percent of gross sales. • Trade promotion data is captured automatically and shared with other company systems. • Trade promotion performance actively evaluated and included in sales managers’ performance reviews. • Much of trade spending is in the form of pay for performance. • Senior management dictates narrow range of promotion levels and specific dates. • Sales managers must get specific approval to promotions that are “off strategy.” • Sales plans are strictly a function of expressed marketing strategies. • Sales force measured on account profitability. • Customer order patterns consistent with consumption patterns. • Shipment forecasts reasonably accurate and improving. • Finished goods inventory below industry norms and decreasing.

Figure 3. List of indicators of tight versus loose management cultures

Example: Interpreting the Model

Infinite Foods Inc. is an \$800 million retail frozen entrée marketer. About 20 percent of sales is represented by private label manufacturing for large regional retailers. Infinite is the third-ranked brand in the category.

Infinite spends nearly 20 percent of sales on retail promotion activity, much of it in off-invoice amounts to get low price feature advertising. It has a large sales management organization with a significant entertainment budget. The marketing organization is small by comparison with a marketing budget consisting of trade shows and limited trade advertising.

In reviewing the chart, Infinite's CFO believes that they are in the lower left-hand quarter of the ROI chart. (Five to 15 percent savings.) The biggest savings opportunities from implementing a new system will be to:

- Capture spending plans before they are approved.
- Deliver promotional estimates to the production planning department.

The CFO and COO think that a 10 percent cost savings is realistic, which translates to a \$16 million earnings improvement.

$10\% \times 20\% \text{ promotion budget} \times \$800 \text{ million sales} = \16 million

In recent years, Infinite's EBT averages 10 percent, so the cost savings could boost earnings by 20 percent.

$\$16 \text{ million savings} / (10\% \times \$800 \text{ million sales}) = 20\% \text{ improvement}$

Components of ROI Savings

In this context, ROI savings include certain cost areas that are improved due to having a better management system in place. Conservatively, funds invested in trade promotion systems will get a return from *reduced spending on trade promotion*. This view of return is the most easily measured and simple.

Greater returns are available from redeploying saved funds into opportunities with greater promise for returns. Examples include new product formulations, brand acquisitions, proprietary products or patents, trade spending in higher-opportunity markets, and so on. Typically, saved trade promotion funds can earn many times their value in new company investments. The model components, however, assume primarily cost savings. (The savings estimates are gleaned from the same research methodology noted earlier.)

Component	Impact Area	Percent of Total ROI Savings
Prediction of promotional event ROI.	Denial of spending; reduction of spending for “bad” events.	40
Reduced deductions; clean invoicing and accounts receivable.	Reduced paperwork handling, inquiries, and accounting staff.	30
Prediction of promotion event spike volume and timing.	Fewer spikes in manufacturing due to promotion; lower FG inventory; less direct labor; better raw material supplier negotiations.	20
Other business efficiencies.	Streamlined upfront planning, reduced time securing historical data, less troubleshooting, and fewer crisis meetings.	10

Figure 4. Components of ROI savings

Promotional departments can realize nearly 40 percent of the savings. One example is that closed loop systems allow modeling of a promotion’s impact before implementation.

However, other departments realize *more than half* of the total savings:

- Integration with order management and billing systems will increase invoice accuracy and decrease deductions.
- Integration with supply chain and order fulfillment ensures promotion event visibility in planning, fulfillment, and billing.
- Demand can be met efficiently, thus reducing hidden costs associated with volume surge, demand uncertainty, and out-of-stock inventories.

Most critical is that each savings area requires sharing trade promotion intelligence with other functional areas of the company. Companies choosing promotion management systems need to evaluate the capability to share data across platforms.

Summary and Actions

CPG organizations have recognized the trade promotion management challenge and invested in systems to address the issue. Despite these efforts, the real benefits have been elusive. Only now are more comprehensive and integrated systems available to help companies disseminate critical information to other functional areas. It is this next generation of information management that will be required to realize material savings.

Every company needs to better evaluate strategies to address spending that typically exceeds net earnings. Companies should:

1. Chart the information flow of critical promotion data. Is it in its own silo, or is it tracked back to enterprise systems?
2. Determine how field intelligence about promotion planning is captured. Is the internet being used as a tool for easy distribution of information with selling partners?
3. Begin to identify the rewards and benefits from making improvements. Use the ROI model to start estimating savings and earnings gained through a new IT initiative. Challenge line management to implement changes.

About The Lake Group

The Lake Group is a leading marketing and strategic planning consulting firm with headquarters in Portland, Oregon. Its experienced professionals deliver unique solutions to a wide range of clients in consumer packaged goods and business-to-business initiatives.

The Lake Group actively assists CPG firms with implementing process changes related to trade promotion management. We help evaluate organization capability and work alongside line management to ensure significant ROI is realized.

As President of TLG, David Lakey leads the organization's development and client service. He has more than 20 years experience in a variety of consumer packaged goods executive positions. He writes and speaks frequently to audiences of industry leaders. David has an MBA from the Weatherhead School of Management at Case Western Reserve University.

About PeopleSoft

A leading provider of eBusiness applications, PeopleSoft offers the most comprehensive closed loop solution for trade promotions. Integrated with supply chain and financial systems, PeopleSoft Promotions Management provides trade promotions forecasting, planning, tracking, reporting, execution, and analysis. In short: a comprehensive and flexible way to understand, manage, and focus your trade fund spending for optimum results.

PeopleSoft is the world's leading provider of application software for the real-time enterprise. PeopleSoft pure internet software enables organizations to reduce costs and increase productivity by directly connecting customers, suppliers, partners and employees to business processes on-line, in real time. PeopleSoft's integrated, best-in-class applications include Customer Relationship

Management, Supply Chain Management, Human Capital Management, Financial Management and Application Integration. Today more than 4,900 organizations in 140 countries run on PeopleSoft software.

Further Information

For additional information on how The Lake Group can assist you in the area of marketing and promotional strategy, visit www.lake-group.com or call 503 244 6315.

For information on PeopleSoft's closed loop promotions management solution, please visit us at www.peoplesoft.com/go/closedloop or call 888 773 8277.