Paying for Performance
Trade Spending for Profitable Growth
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Paying for Performance

Trade Spending for Profitable Growth

Thomas Gaismaier, Betsy Heckenbach, and Nathan Lucht

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AT A GLANCE

Consumer products manufacturers continue to spend heavily on trade. To gain insights into benchmarks and best practices, BCG surveyed nine U.S. consumer-products companies. The findings point to a misalignment between spending and retailer performance that manufacturers must address to ensure solid returns.

A Misalignment Between Spending and Performance
The benchmarking confirmed that the growth of trade spending has outpaced the growth of both gross revenues and volume. Indeed, trade spending is consistently greater than other critical P&L line items. Moreover, we found that trade spending is widely dispersed, not only among channels but also among retailers within channels—with the best performers not always getting the highest rates.

Three Performance-Based Opportunities to Improve Returns
Manufacturers have three opportunities to improve the returns on trade investments: prioritizing trade-spending investments with “winning” retailers that will deliver profitable growth; analyzing returns and applying the insights to advance performance systematically at each retailer and event; and designing a trade structure and program to pay retailers for their performance, rather than on the basis of relationships or activities.
CONSUMER PRODUCTS MANUFACTURERS CONTINUE to spend heavily on trade—more than $60 billion per year in the U.S. and more than $500 billion per year globally. Trade spending—from price discounts to promotions to displays—has grown at an alarming rate for years. For example, it outpaced the growth rate of revenues by 3 percentage points and of volume by 7 percentage points from 2008 through 2010 at the manufacturers we surveyed. All the while, manufacturers have faced the persistent challenge of ensuring that these expenditures promote profitable growth.

Three external factors have fueled the escalation of trade spending: stronger retailers, slower demand growth, and rising commodity prices. The retailer landscape is shifting because of consolidation, the increasing sophistication of private-label products, and the emergence of e-commerce. Over the past decade, retailer margins have increased at the expense of consumer products manufacturers, in total shifting 5 percent of the available profit pool. In most categories and channels, the growth of consumer demand has slowed or stalled, increasing the need for “push” marketing. Retailers have also used trade concessions to “charge back” list price increases intended to offset rising commodity prices. And manufacturers have applied trade spending to mitigate the volume losses attributable to these price increases.

To make matters worse, many manufacturers lack the capabilities, processes, and tools to manage these escalating trade investments strategically. And they may have only limited understanding of which trade investments yield the highest returns. As we will discuss, leading manufacturers have adopted what we regard as best practice: designing programs that “pay for performance.”

To gain insights into benchmarks and best practices, The Boston Consulting Group recently surveyed nine U.S. consumer-products companies. We gathered data on gross revenues, unit volume, and trade spending over time. To understand design and execution choices, we interviewed leaders of sales, sales finance, and trade marketing, as well as leaders of trade strategy and execution. This allowed us to identify ten best practices for trade spending. Performance varied considerably among the benchmarked companies with respect to these practices. We found that all of the companies had opportunities to improve their performance in at least some of the best practices; no company had a “perfect” program. (See Exhibit 1.)

In this report, we provide an overview of the benchmarking and discuss three opportunities to improve the returns on trade investments: prioritizing investments...
with the “winners” that will deliver profitable growth; analyzing returns and applying the insights to advance performance systematically at each retailer and event; and designing a trade structure and program to pay retailers for their performance, rather than on the basis of relationships or activities. Last, we present a set of questions that manufacturers can use to assess their starting point in the multi-year effort to transition to a more effective trade program.

Because our benchmarking participants represented a wide variety of companies (based on category, size, and geographic scope), we believe the trends and insights discussed below are broadly applicable to consumer products manufacturers globally, although our benchmarking was limited to the U.S. market. In discussing the practices we observed, we are not analyzing or commenting on their compliance with applicable laws. Manufacturers should seek legal advice before implementing the practices outlined in this report.¹

### A Misalignment Between Spending and Performance

Trade spending is growing faster than gross revenues and volume; it is one of manufacturers’ largest expenses; and it is widely dispersed among channels and retailers. These findings from our benchmarking point to a misalignment between spending and performance that manufacturers must address to ensure solid returns from these increasingly large investments.

From September 2011 through March 2012, we surveyed manufacturers in four broad category groups: food and beverages (five companies); household and personal care (two companies); wine, beer, and spirits (one company); and “other” (one

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**EXHIBIT 1 | All Benchmarked Companies Can Improve Performance in Some Best Practices**

<table>
<thead>
<tr>
<th>Trade-spending best practices</th>
<th>Benchmarked company</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 Build the category</td>
<td>1</td>
</tr>
<tr>
<td>2 &quot;Win with the winners&quot;</td>
<td>2</td>
</tr>
<tr>
<td>3 Pay for performance</td>
<td>3</td>
</tr>
<tr>
<td>4 Be simple, consistent, and transparent</td>
<td>4</td>
</tr>
<tr>
<td>5 Apply clear guardrails</td>
<td>5</td>
</tr>
<tr>
<td>6 Conduct systematic postevent analysis</td>
<td>6</td>
</tr>
<tr>
<td>7 Enforce retail compliance</td>
<td>7</td>
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<tr>
<td>8 Align sales force training and incentives</td>
<td>8</td>
</tr>
<tr>
<td>9 Define strategic customer plans</td>
<td>9</td>
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<tr>
<td>10 Use integrated tools and systems</td>
<td>10</td>
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</tbody>
</table>

company. We analyzed benchmarks on the basis of a company’s product categories. For example, if Company A had three categories of products—fresh food, frozen food, and beverages—each of the company’s categories represented a distinct benchmark. We refer to these as “company-category combinations.” We benchmarked a total of 28 such combinations.

The benchmarking confirmed that the growth of trade spending has outpaced the growth of both gross revenues and volume. Trade spending grew faster than gross revenues for 75 percent of the company-category combinations we examined. (See Exhibit 2.) It grew faster than volume for 90 percent of these benchmarks. And the difference can be significant: Trade-spending growth exceeded the growth of gross revenues by 5 percentage points or more for 30 percent of the benchmarks. It exceeded volume growth by that amount for 50 percent of the benchmarks.

Indeed, trade spending is consistently greater than other critical P&L line items, including advertising, R&D, and capital expenditures. At the manufacturers we studied, trade spending has represented an increasingly large percentage of consumer-focused spending over the past decade, as the growth rate of trade investments has far outpaced that of advertising and R&D. In shifting more and more resources to price promotions, for example, manufacturers are pursuing short-term volume improvements at the expense of long-term-growth prospects and brand equity.

**EXHIBIT 2 | Trade-Spending Growth Is Outpacing Revenue Growth**

Gross-revenue CAGR minus trade-spending CAGR, 2008–2010 (percentage points)

- Trade-spending growth < gross-revenue growth
- Trade-spending growth > gross-revenue growth

**Sources:** 2011–2012 BCG trade-spending benchmarking study, BCG analysis.

**Note:** The data capture total company operations, excluding Canadian operations.

1Represents 2010–2011 CAGRs.
2Represents 2009–2011 CAGRs.
Moreover, we found that trade spending is widely dispersed, not only among channels but also among manufacturers’ customers within channels. Within the same category and company, trade rates varied by up to 20 percentage points between channels and by up to 33 percentage points between customers. Our benchmarking also found that the “top three customers” did not always receive trade rates above the median in a given company-category combination. (See Exhibit 3.) In many cases, this dispersion results from a lack of tools, capabilities, and processes to manage trade strategically and drive profitable growth systematically.

Prioritizing Investments with the Winners

Manufacturers can boost returns from their trade spending by reallocating investments to the “winners”—the customers providing the largest profits or volume growth. Within the bounds of legal requirements, these superior performers should be rewarded with higher trade rates, while the weaker performers should receive relatively less. Customers that receive higher trade rates benefit from lower net prices; however, they should reinvest the trade funds to drive higher sales volumes—for example, through more or longer promotional events, lower prices for consumers, or more shelf space.

We have found that manufacturers use many different approaches to rank their customers. One of the most effective is designing a “trade formula” that allocates

**EXHIBIT 3 | The “Top Three Customers” Don’t Always Receive the Highest Trade Rates**

The Top Three Customers, Based on Gross-Revenue CAGR, 2008–2010

Trade spending/gross-revenue rate as compared with the median (percentage points, 2010)

40% of top three customers < median

Sources: 2011–2012 BCG trade-spending benchmarking study; BCG analysis.

Note: Data are based on the top 15 retailers measured by gross revenues for each company-category combination. Includes only benchmarks with warehouse distribution (26 of 28 benchmarks). Some data points overlap.

1Represents 2009–2010 gross-revenue CAGRs.
2Represents 2010–2011 gross-revenue CAGRs.
trade investments systematically and rigorously, without subjective judgments or negotiations, on the basis of metrics such as sales volume growth, share growth, distribution, or share of shelf. Applying a trade formula shifts trade funds to customers with strong profits and sustainable growth, and reduces investments in customers that perform poorly on both dimensions.

Analyzing Returns and Applying Insights

Beyond prioritizing investments with the winners, manufacturers must understand how to design and execute promotional plans to ensure the highest returns. Systematic and rigorous analyses of a customer’s performance provide insights that a manufacturer can apply to improve the returns from future events—creating a virtuous “closed loop” cycle of continuous improvement of trade investments. Four phases are common for this cycle.

**Event Execution.** All manufacturers develop event plans. In most cases, these take the form of an annual calendar based on the prior year’s calendar of events. Event execution typically focuses on designing features, displays, and merchandising. It is critical for manufacturers to also establish auditing capabilities and a compliance policy to help account teams ensure that customers are properly executing events.

**Postevent Analysis.** The depth, breadth, and rigor of postevent analyses vary widely among manufacturers. Best practice entails performing postevent analyses consistently for a majority of events at the largest customers using a standardized, comprehensive ROI formula. In calculating trade-spending ROI, the *investment* is the trade funding spent on the entire event, and the *return* is the variable contribution of this investment to the incremental volume sold. This return should be compared with the baseline profit—that is, the estimated profit in the absence of a promotional event. Advanced ROI definitions also take into account the extent to which a promotional event relating to a particular item results in reduced sales of the manufacturer’s other products (*cannibalization*) or leads consumers to stock up on the item (*forward buying*).

**Lessons and Insights.** Manufacturers should use the results of the postevent analyses to develop lessons and insights with respect to calendar design, promotion design, and execution. For example, a manufacturer may find that events lasting two weeks generate the highest ROI for one product, while three weeks is the optimal event duration for another product. These lessons and insights are commonly used to make immediate changes to upcoming events, to revise the retailer’s promotional plans for the current year (for example, by changing the timing of events), and to inform plans for the following year.

**Preevent Planning.** To ensure that trade investments are effective, the manufacturer should collaborate closely with customers on the tactical promotional plans for the year ahead—incorporating insights from analyses of events during the past one or two years at a specific customer and from postevent analyses relating to the same category at other customers. In so doing, the manufacturer combines its understanding of what works for the customer with a perspective on best practices.
Choosing the Right Program Model

To optimize returns over the long term, many of the benchmarked manufacturers have launched a transformation to include performance incentives in their programs. Although we have observed a wide range of specific program designs, they

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**TACTICS THAT DRIVE HIGHER RETURNS ON INVESTMENT**

We have observed a number of tactics for increasing the return on trade investments that have been effective for some manufacturers. The specific tactics that drive the highest ROI will vary by manufacturer and by category and retailer.

**Optimize spending across the portfolio.** Promote premium brands rather than base brands; bundle negotiations of trade rates for selected brands or for the entire portfolio to create value for the customer while improving promotions for weaker brands.

**“De-average” activities.** Raise prices (and decrease trade spending) for products or category segments that have more inelastic pricing or higher market share; avoid “line promoting” (for example, promoting the full line of cereals), recognizing that some consumers will buy certain products regardless of a promotion.

**Identify the best time periods for promotions.** Align promotions with consumers’ receipt of food stamps or Social Security checks, or with holidays, seasons, or critical weeks for specific categories; don’t wait until the end of a period to chase volume by increasing trade spending.

**Avoid shallow discounts with limited merchandising support.** Limit the use of temporary price reductions of less than 15 percent without supporting advertising or in-store display activity.

**Compress retailer margins when providing deep discounts.** Ask customers to “coinvest” to drive sales and profits by recognizing that the high sales volume resulting from deep discounts will offset the lower margins.

**Optimize pricing and merchandising tactics on the basis of shopper behavior.** Collect and use available consumer data; for large product sizes, favor single offers over multi-item offers (for example, one for $4.99 versus two for $10), because lower prices are more attractive to consumers; favor front- or back-page ads over middle-page ads.

**“Unstack” the promotional calendar.** Limit promotion of multiple pack sizes and brands within the portfolio at the same time; avoid postholiday promotions; shorten the duration of events to two weeks or less.

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for the category. (See the sidebar “Tactics That Drive Higher Returns on Investment” for some practices we have observed to be effective.)
generally reflect one of three program models—pay for relationship, pay for activities, or pay for performance—each having distinct advantages and disadvantages. (See Exhibit 4.)

**Pay for Relationship.** Only one of the nine companies in our benchmarking study negotiates trade programs, budget allocations, and investment plans with each customer individually. It tailors them to each customer’s goals and context without applying a general framework.

**Pay for Activities.** Four of the benchmarked manufacturers develop promotional calendars for each customer. These calendars set out the activities to support (including frequency and timing), the expected volume from the activities, and the associated cost to fund the activities and customer-margin requirements. The necessary funding is then allocated using either a lump sum or an accrual rate. One challenge of this approach: two customers undertaking the same activities and achieving the same performance could receive different trade rates because the manufacturer might make different deals with each one on the basis of the customer’s margin requirements, for example, rather than its anticipated performance.

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**EXHIBIT 4 | Three Common Types of Trade Structures**

<table>
<thead>
<tr>
<th>Trade structure</th>
<th>Description</th>
<th>Evaluation</th>
</tr>
</thead>
</table>
| **Pay for relationship**           | Trade programs, budget allocations, and investment plans are negotiated with each customer:  
- Based on customer-specific goals and context; no explicit link to activities or performance | Can tailor plans on the basis of unique context or customer bases  
Relies on predicting how to drive results with each customer (many variables)  
Lack of transparency and comparability of models and structures across accounts |
| **Pay for activities**             | Trade investments based on account plans are negotiated with each customer, including:  
- Activity types, frequency and timing, and expected volume from and costs of activities  
Variations exist in the execution of account-planning and trade-investment decisions, for example,  
- Lump-sum payment by activity versus accrual based on calculated rate (per planned activities) | Activities typically chosen by proven success in the past (for example, ROI)  
Discretion to allocate funds where the manufacturer wants to invest the most  
Relies on predicting which allocation or plan will drive results (many variables)  
Subjective negotiations with customers often lead to inefficient allocation |
| **Pay for performance**            | Trade fund allocation to customers (“earn”) using a common rate structure:  
- Based on key performance metrics  
- Consistent across channels and accounts  
Trade investments (“spend”) jointly discussed during customer planning:  
- Investment amount based on common trade rate and anticipated volume | Objective factors drive differentiation; eliminates legacy behavior or negotiations  
Efficient allocation by measuring customers on metrics linked to profit  
Complexity for the sales force |

**Pay for Performance.** An increasing number of manufacturers, including four of the companies covered in our benchmarking study, established what we consider best practice: a pay-for-performance program. Pay-for-performance programs enable manufacturers to align trade spending with profitable growth, while maintaining compliance with “fair and equitable” legal requirements. The fundamental difference between pay for performance and the other two program models is the separation of “earn” (how trade funds are allocated to customers) from “spend” (how trade funds are invested).

Customers “earn” trade funds on the basis of a common rate structure applied to their performance in key metrics that are explicitly linked to the manufacturer’s profits. These metrics may include sales volume, sales volume growth, share of shelf, or historic share growth. In contrast to the other models, the rate is consistent across channels and accounts, so that two customers with identical performance would earn the same amount of trade funds.

While the “earn” component is consistent across channels and accounts, the “spend” component is specific to the customer. The account team and the customer determine trade investments during the joint business-planning process. They first estimate the trade funds that the customer can potentially earn, considering the established trade rate and the customer’s anticipated performance as measured by the applicable metric. The parties then develop a promotional plan for spending the trade funds, with the objective of investing them in activities with the highest returns. This allows the manufacturer and the customer to optimize trade investment choices for each planning cycle.

**Designing a Pay-for-Performance Program**

Through our benchmarking and experience working with manufacturers, we have seen a wide range of approaches to designing a pay-for-performance program, in both the “earn” and “spend” components.

**The “Earn” Component.** For allocating trade funds, best practice entails making choices and tradeoffs while adhering to three broad design principles: simplicity, consistency, and transparency.

- **Simplicity.** Programs with the simplest design are the easiest to communicate and manage, and they reduce the administrative burden on the sales teams. The simplest programs set the trade rate at the category or brand level, with no variations among customers or channels. When more complex approaches are used, the management of the programs becomes more challenging. For example, one manufacturer sets trade rates first by category and then by customer, using a customer segmentation model that assesses each account on the two broad dimensions of sales potential and efficiency. The manufacturer uses 25 quantifiable metrics to determine an account’s position in each dimension.

- **Consistency.** A common rate structure across customers eliminates subjectivity from negotiations and allows for joint planning discussions to focus on opportunities to deliver growth and performance—rather than a “better deal.”
• **Transparency.** A transparent and clear communication of the rate structure, performance goals, and metrics can help the sell-in process of a new trade-program design.

Notwithstanding these general design principles, the right approach to optimizing the program depends on the dynamics of the categories in which a company competes, the company’s broader goals, and the skills of the sales organization.

When making tradeoff decisions regarding simplicity versus complexity, consistency versus customization, and transparency versus opacity, many manufacturers address the following questions:

• How are funds split between base and discretionary? What is the right balance between the efficiency of a base accrual and the flexibility of a discretionary fund?

• At which product level are rates set—category, brand, pack type, or SKU? What are the differences in how products are promoted? What is the manufacturer’s ability to manage multiple rates?

• How different are rates among accounts and channels? Should rates be the same for all accounts or differentiated across channels or even within channels?

• Which metrics are used to differentiate rates? Should there be a “performance overlay” based on input metrics (for example, frequency of advertisements or number of SKUs offered) or output metrics (for example, share growth, gross-revenue growth, or efficiency of trade spending)?

• What information is shared with accounts?

**The “Spend” Component.** Manufacturers generally establish “guardrails” that define boundaries within which sales teams can make individual trade-investment decisions. The optimal set of guardrails depends on many company-specific factors, including the trade governance, organization structure, and culture. Common examples of setting guardrails include placing limitations on the amount that can be reallocated across categories or customers and on the extent to which funds can be carried over into the next year, as well as specifying consequences for over-spending. Some manufacturers also impose guardrails relating to the frequency and timing of promotional events, or require special approval to set prices below a predetermined floor.

**Capturing the Opportunity**

The BCG trade-spending benchmarking study confirmed that many manufacturers have a huge opportunity to fundamentally rethink how they invest in trade—a spending category that, as noted, totals more than $60 billion per year in the U.S. and more than $500 billion per year globally. On the basis of our experience working with consumer products manufacturers, it is possible not only to reverse the trend of growing trade spending but also to reduce trade-spending levels by 2 to 5 percent.
The transition to a pay-for-performance program is a multiyear effort and requires new capabilities in analytics, personnel, and systems. For example, new analyses for improved planning and execution of trade investments are needed, and IT systems must be upgraded to enable manufacturers to collect and analyze event data and rigorously measure and manage accrual funds.

Our benchmarking suggests that several manufacturers are taking steps to overcome the persistent challenges of trade spending. Although none of the manufacturers we studied had a “perfect” trade program, all were dedicating significant time and attention to improving their programs by adding performance-based elements, strengthening their analytical capabilities, and using new tools to enhance program management.

For an initial “health check,” a manufacturer should consider the following questions:

- Are we using trade investments effectively to build our brands and grow categories?
- Is trade spending allocated to “win with the winners”?
- Can we explain the variability in our trade allocations by channel, customer, and product?

### Exhibit 5 | A Trade-Spending Program’s Successful Transformation

<table>
<thead>
<tr>
<th>Situation: Trade spending is escalating rapidly and not driving profitable growth</th>
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<tbody>
<tr>
<td>A major nonfood manufacturer has experienced a rapid increase in trade spending over the past five years</td>
</tr>
<tr>
<td>• Trade growth as a proportion of sales is about 7%</td>
</tr>
<tr>
<td>• Trade as a proportion of marketing spending has increased from 57% to 70%</td>
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<tr>
<td>Spending increases are not driving growth or profit</td>
</tr>
<tr>
<td>• There is a high variability in trade effectiveness</td>
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<tr>
<td>• Event ROIs are lower than planned, many negative</td>
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<tr>
<td>• Trade is not aligned with business objectives</td>
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<table>
<thead>
<tr>
<th>Solution: New pay-for-performance trade program with four core elements</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Earning mechanisms</td>
</tr>
<tr>
<td>• Differential base rates depending on distribution—value, premium, and super premium packs</td>
</tr>
<tr>
<td>• Funding through a “live” accrual mechanism</td>
</tr>
<tr>
<td>2. Spending guardrails</td>
</tr>
<tr>
<td>• Funds can be spent across brands within a business unit</td>
</tr>
<tr>
<td>• Customers cannot overspend earned funds</td>
</tr>
<tr>
<td>3. Strategic and transition funding</td>
</tr>
<tr>
<td>• Strategic: capitalize on competitive opportunities</td>
</tr>
<tr>
<td>• Transition: mitigate volume and profit risks (phased out over two years)</td>
</tr>
<tr>
<td>4. Administrative rules</td>
</tr>
<tr>
<td>• Funds earned versus spent are reconciled quarterly to create a hybrid “live” accrual system</td>
</tr>
<tr>
<td>• Forward buying and diverting are not permitted</td>
</tr>
</tbody>
</table>

Source: BCG analysis.
• Do we know which events drive the highest ROI from trade spending?

• Do we require our customers to comply with execution plans relating to, for example, price, display, and frequency?

• Does our trade program “pay for performance”?

• Do we have integrated tools and systems that enable trade-spending planning and execution?

NOTE
1. It is important to seek legal review of your trade strategy. The use of discounts and bonuses is highly regulated in the U.S. as well as in other jurisdictions. This report should be read with the following considerations in mind: U.S. law prohibits a manufacturer from granting allowances or furnishing services to promote the resale of its products unless the allowances or services are made available to all competing customers on proportionally equal terms. Before implementing any of the practices discussed in this report, manufacturers should seek specific legal advice that takes into account the terms of the individual programs, the products subject to the programs, and the unique positions of the reselling customers to which the programs are made available.
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