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Commercial spend in consumer products:
Ready for zero-based budgeting?

How profitability pressures and data analytics are changing commercial spend

Evolving consumer preferences. Rise of private label and niche brands. Influence of the digital marketplace. Volatile commodity prices. Growing transportation costs. These are just some of the disruptive trends that consumer packaged goods (CPG) manufacturers are facing.[1] These trends apply heavy pressure on manufacturers' profitability, putting the return on investment (ROI) of spend categories across the P&L under scrutiny. Commercial spend is no exception.

Commercial spend refers to costs that sales and marketing functions own. For most manufacturers, this area includes cost to discount (e.g., cash discounts), cost to promote (e.g., trade promotions), and cost to market (e.g., advertising). Although commercial spend constitutes roughly 15-20 percent of revenue for CPG manufacturers, it has historically been the last "safe haven" from explicit cost-reduction efforts.

Thanks to the proliferation of big data and advances in analytics that can provide reliable measures of performance, commercial spend is now an increasingly acceptable lever for spend effectiveness and margin improvement programs. In fact, according to a recent Deloitte survey, 63 percent of CPGs targeting cost reduction plan to address commercial costs.[2]

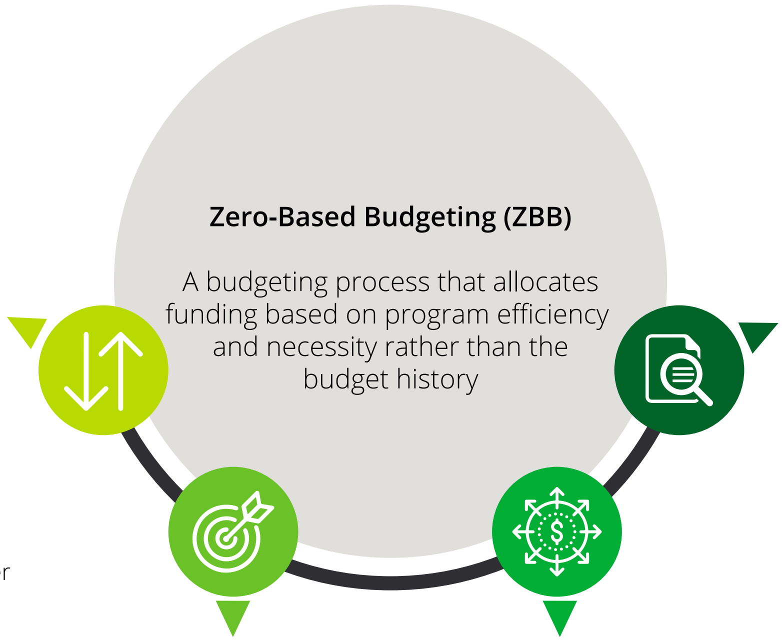
For nine out eleven of the largest US food manufacturers, percent of volume sold on promotion is down compared to one year ago (52 weeks ended September 10, 2016), signaling cuts in commercial spend. Seven of these eleven companies also show declines in net sales however, with all but one showing unit declines for the same period. This indicates that these cuts may be cutting the fuel for growth for these manufacturers[3] not just addressing unprofitable spend.

As CPGs are trying to make informed decisions about cutting commercial spend with negative ROI and increasing the effectiveness of this cost category, a recent Deloitte survey showed that 22 percent of CPGs have turned to zero-based budgeting (ZBB)[2]. ZBB, powered by advances in analytics, can offer a simple, repeatable way to manage commercial spend; it also, however, carries the risk of significant adverse impact on CPGs' P&L if certain parts of commercial spend are not treated with care.

What is ZBB and how does it work?

Developed in the 1970s, ZBB focuses on improving ROI across a business by forcing justification of every expenditure every year. Pete Pyhrr, the Texas Instruments accounting manager who developed the approach, consulted for a variety of organizations and advised former president Jimmy Carter when he was governor of Georgia. Despite brief fame, ZBB never fully took hold. The practice only recently reemerged, thanks in large part to Brazilian private equity firm 3G Capital,[4] which has consistently applied ZBB principles, shaving costs and improving the performance of its portfolio companies.[5]

Figure 1: Explaining zero-based budgeting (ZBB)



Budgets are not connected to prior year spending

- Prevents "embedding" of existing spend in the cost base
- Allows spending levels to be set based on necessary activities of a function, rather than historical trends
- Requires more work to understand activities and cost structure

Spending increases or cuts are not simply spread evenly across budgets

- Eliminates common "sandbagging" practices in budgeting process
- Allows for more strategic allocation of planned spend
- Requires more work to analyze and prioritize activities and expenditures

Budgets are tied to specific activities and levels of service

- Better aligns spending targets with required activities of a function
- Replaces "do more with less" with "do the right things with the right amount"
- Requires fairly detailed knowledge of departmental activities and willingness to do less or discontinue activities

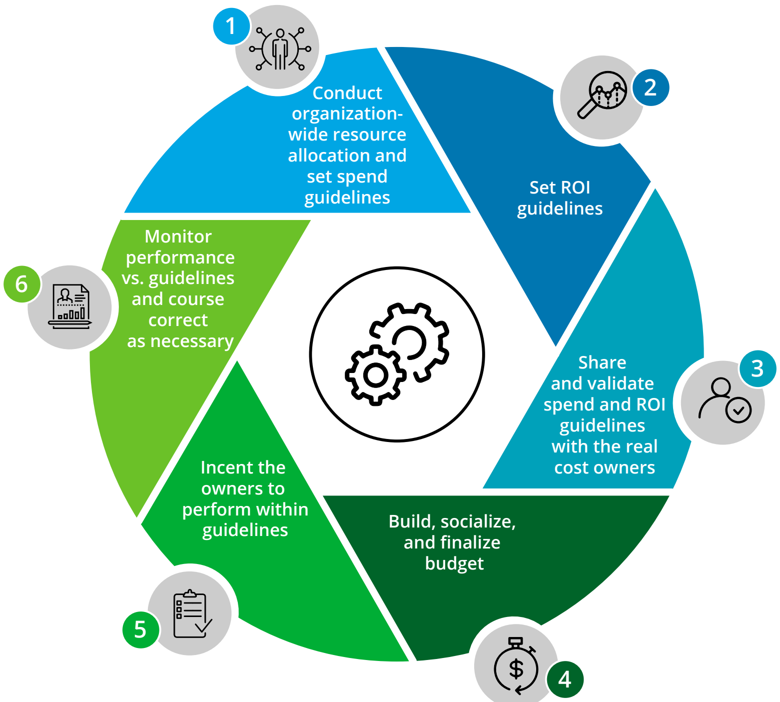
Funding is targeted more to activities that align with the strategy

- Allows for better alignment of expenditure with overall strategy and departmental missions
- Can reduce incidence of "we've always done that"
- Prioritizing activities across various functions can be challenging

More than a budgeting methodology, ZBB is a philosophy of cost justification and frequent monitoring that enables spend transparency at a granular level and gives companies the agility to adjust to market changes.

Incorporating a new philosophy into an organization can be difficult, so ZBB typically begins with defining savings or efficiency goals and mobilizing decision makers and teams to tackle specific cost areas. Teams collect data to evaluate drivers of specific spend activities. Businesses then evaluate how different cost levers impact productivity, cost avoidance, or other performance. ROI guidelines are set for each category and validated with cost owners.

Figure 2: The typical ZBB process



With the ROI guidelines set, budgets and implementation plans can be created for each specific category of spend. As budgets are implemented, the organization tracks impacts on performance, incenting performance within the established ROI guidelines. In each budgeting period, performance metrics are reevaluated and spend levels are reset, starting at zero (or an agreed-upon minimum level). Teams set budget levels for the period and track ROI for each spend category

To learn more about ZBB, we recommend reading **Zero-based budgeting: Zero or hero?**

Applying ZBB successfully to commercial spend

ZBB is most often used in spend categories without direct impact on customers pushing commercial spend out of the ZBB umbrella. While ZBB in commercial spend must be run differently, it now meets three key criteria that make it an excellent candidate for ZBB:

- **Sizeable:** Commercial spend typically accounts for 15-20 percent of gross sales of CPGs.
- **Measurable:** Calculating ROI for performance trade with acceptable accuracy is very manageable.
- **Fragmented:** Most of this spend is fragmented by class of trade, customer, category, etc., so various levels of returns are generated.

Most CPGs have shied away from including commercial spend in their ZBB programs for the following reasons, both of which have changed significantly in recent years:

- **Measurability:** For some commercial spend buckets, sales and marketing teams have a hard time deriving a justifiable ROI, especially in the short-term; hence, they may fear this spend will be reduced or eliminated if ZBB is applied.
- **Retailers' visibility**: Commercial spend constitutes a significant part of retailers' margins and therefore their visibility into this spend is high; commercial teams may fear any cuts into this spend may have adverse effects on their relationships with the retailers.

Breaking commercial spend into three commonly viewed categories provides a framework for assessing how to best leverage ZBB:

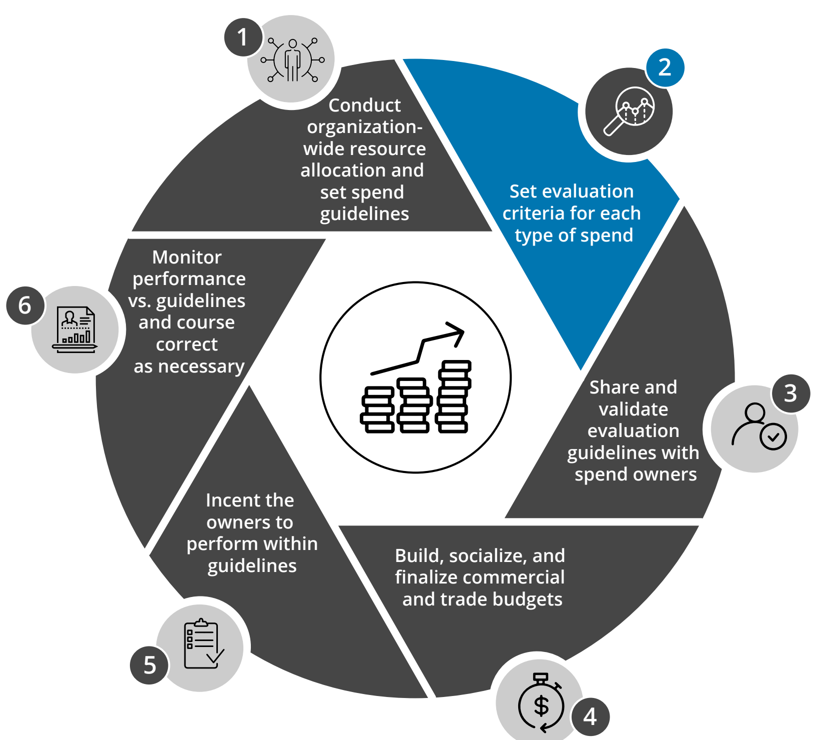
- **Gross-to-net discretionary spend:** Spend linked to non-performance trade, such as new item fees, cash discounts, and the like.
- **Marketing spend:** Spend dedicated to marketing campaigns (e.g. TV advertising, digital video).
- **Performance trade:** Spend linked to a distinct promotion or promotion calendar including every-day low price (EDLP); typically 85 percent of total commercial spend.

Advances in data and analytics reduced the measurability concern. As seen in figure 3, the extent to which key commercial spend categories can be measured and assessed has increased significantly.

Figure 3: Commercial spend categories and their measurement practices

Commercial spend categories	Past practices	Present common practices
A. Gross-to-net discretionary spend	Little visibility	Keep it as long as it is justifiable with an ROI
B. Marketing spend	Qualitative views on returns	Well-defined marketing campaign targets and incremental sales metrics (e.g., customer lifetime value measures, traffic-to-lead/lead-to-customer ratios)
C. Performance trade	No guidelines and limited metrics to measure trade	Regular review of performance ROI, lift, trade spend rate, contribution margin, and "estimated" retailer margin

Measurability concerns can be reduced further by tailoring the ZBB approach for commercial spend by making some modifications to the standard method. Rather than focusing on setting ROI guidelines alone, specific evaluation criteria and thresholds should be taken into consideration for each spend category. (See figure 4.)



To this end, each of the three commercial spend categories should be evaluated separately in determining the best way to apply ZBB principles.

A. Gross-to-net discretionary spend

Cash discounts and new item fees, part of gross-to-net discretionary spend, are examples of line items that should be viewed under the overall ZBB program. They should be measured against tailored evaluation criteria that consider the type of spend (e.g., cost-to-serve and payment terms for cash discounts, new item all-commodity volume (ACV), and time-to-shelf for new item fees).

These evaluation criteria should be used to evaluate investment decisions on a regular basis to provide increased structure, discipline, and direction for a variety of important commercial spend line items.

B. Marketing spend

Marketing spend should be evaluated with a strategic lens: It can be difficult to track specific ROI measurements consistently across tactics, particularly as new digital tactics continue to emerge at a rapid pace and spend can be rapidly re-deployed across a variety of marketing vehicles. For each marketing tactic, marketers should outline the outcome they are hoping to drive, then measure success (and be held accountable) against that observable outcome. Organizations should develop high-level marketing plans with specific budget guidelines based on the strategic intent of their marketing tactics and related opportunity size, and then set clear targets for the effectiveness of that spend, even if the goals are longer term in nature.

C. Performance trade

Performance trade should have an even more tailored approach and receive special treatment. This spend line item is the most visible to retailers and is typically second only to cost of goods sold in terms of its impact on the P&L. With that said, there is no diminished potential for ZBB in performance trade. On the contrary, this spend is becoming a better fit for ZBB as funds are being shifted into more measurable buckets, associated with funding activities for which outcomes can be measured.

Due to retailers' high visibility to performance trade spend and its significant impact on their P&L, ZBB concepts are often applied to performance trade through pay-for-performance trade programs. This can be accomplished by aligning spend to key metrics for the category and establishing a trade program that incents both retailers and CPGs to focus on those metrics. In these programs, CPGs should determine their own growth priorities and key performance indicators. They should use these to inform the weighting of metrics and thresholds in their trade programs. CPGs should also be as transparent as is practical with retailers, applying ZBB at the value chain level in collaboration with retailers.

In order for pay-for-performance programs to be effective, they should:

1. Link funding and discounts to retailer performance criteria and specific metrics to evaluate retailers' behaviors and category outcomes.
2. Provide all customers in "like" groups with an equal opportunity to obtain funding.
3. Be simple, easy to explain, and transparent to retailers without limiting ability to compete.
4. Create a common framework yet allow for flexibility in channels, countries, categories, or different routes to market.
5. Achieve differentiation among retailers, channels, and markets, aligned with segmentation and retailer performance.

Structuring the Program

Prior to establishing such a program, however, organizations should define their strategic and operational priorities. Leadership should identify the overall investment strategy, including metrics to differentiate trade and the extent to which investments can shift among media, categories, or customers. Funding parameters should be set, along with a vision for tracking performance.

On the operational side, commercial ZBB programs require dedicated oversight and planning. Leadership should establish a governance structure and build a team to manage the program. The team itself should define how and when to communicate to customers, as well as what additional support is required from across the business.

These programs can not only be a mechanism for reining in costs and improving ROI, but can also serve as a driving force in transforming a business into a more transparent, differentiated, and results-oriented organization.

The challenges of ZBB: Breaking down the barriers in commercial spend

While it can be powerful, ZBB often has challenges. Our experience has shown that, though complex and varied, there are specific steps organizations can take to address these challenges and implement successful ZBB programs.

Challenge #1: ZBB is resource intensive

ZBB is typically more resource intensive than traditional budgeting. The budget preparer must investigate and document uses and returns on spend, along with department activities; managers must perform regular reviews; staff must conduct relevant analyses and reports. With advances in predictive analytics, business-centric tools, and process automation, ZBB can become less time consuming for all involved.

Challenge #2: Risk of short-term thinking

Because ZBB begins the budgeting process at zero and requires justifying every expenditure, it can incent short-term thinking, for example, shifting resources to areas that would generate revenue or expand margins over the next calendar year. Organizations should establish ZBB timelines with regular reviews and milestones to highlight the long-term vision. Long-term brand-building activities, multi-year campaigns, and even long-cycle R&D inherently may be at risk when ZBB techniques are applied without a long-term lens.

Challenge #3: Managing a cultural change

Transitioning an organization from traditional targeted cost cutting to ZBB involves a significant cultural shift. It is often difficult to move to a mindset of "no stone left unturned" and have legacy programs suddenly require justification. Leadership should establish tangible goals and balance resources spent with benefits achieved. The team leading the ZBB program needs to communicate and be transparent about what is required to make ZBB successful. Given that not all commercial spend can be easily measured in terms of its effectiveness, leadership must maintain a view of the qualitative returns on investment, particularly with regard to customer relationships and business partnerships.

Challenge #4: The art and science of ROI targets

Any changes in commercial spend will directly impact retailers. It is critical in the commercial space, more so than in other functions, to establish ROI and other evaluation criteria targets that are appropriately tailored to retailers, channels, and segments. Similarly, these targets should consider category dynamics, particularly for CPGs that operate in a wide variety of categories. Leadership should ensure that these targets are non-arbitrary and can be win-win for both the organization and its customers. It is incumbent on organizations to think holistically about investment returns and establish ROI standards based on relevant insights, segmenting spend areas into different ROI tiers when necessary.

Challenge #5: Customer buy-in

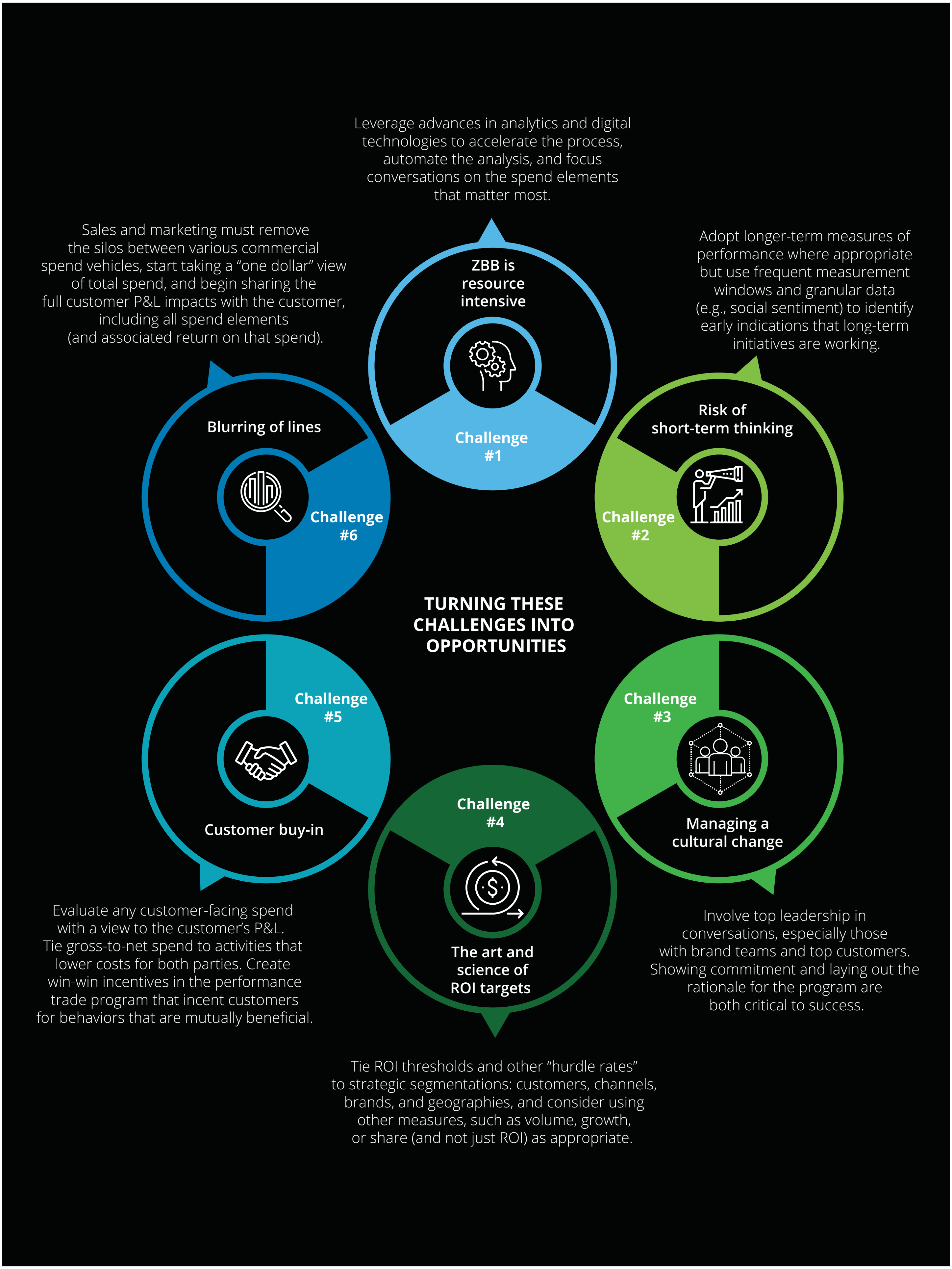
Channel partners and retailers are often skeptical of ZBB because of the effort required and the impact it can have on their business. Organizations should be as transparent as possible with these groups and involve them in the decision-making process.

Challenge #6: The blurring of different types of spend

With the digitization of the consumer's path to purchase, the lines between marketing spend and promotional spend are increasingly blurred. As consumers are more extensively influence by digital and as the share of revenue of eCommerce increases for CPGs, merchandising and promotional tactics can be delivered digitally as opposed to just in-store. Similarly, digital marketing and branding can increasingly be done in store or, in the case of eCommerce players, within the platform itself.

These six challenges often dissuade organizations from applying ZBB to commercial spend. ZBB does not have to be applied rigidly or without boundaries. Though the challenges do not come with quick fixes, organizations can use a variety of demonstrated methods to address them very effectively.

Leveraging the principles of ZBB alone, and doing so methodically and judiciously, can help organizations become more transparent, agile, and granular with their budgets. For commercial spend, ZBB can be used to be purposeful about investments and ensure that desired returns are being met.


Leverage advances in analytics and digital technologies to accelerate the process, automate the analysis, and focus conversations on the spend elements that matter most.
ZBB is resource intensive
Challenge #1
Adopt longer-term measures of performance where appropriate but use frequent measurement windows and granular data (e.g., social sentiment) to identify early indications that long-term initiatives are working.
Risk of short-term thinking
Challenge #2
Challenge #3
Managing a cultural change
Involve top leadership in conversations, especially those with brand teams and top customers. Showing commitment and laying out the rationale for the program are both critical to success.
Challenge #4
The art and science of ROI targets
Tie ROI thresholds and other "hurdle rates" to strategic segmentations: customers, channels, brands, and geographies, and consider using other measures, such as volume, growth, or share (and not just ROI) as appropriate.
Challenge #5
Customer buy-in
Evaluate any customer-facing spend with a view to the customer's P&L. Tie gross-to-net spend to activities that lower costs for both parties. Create win-win incentives in the performance trade program that incent customers for behaviors that are mutually beneficial.
Blurring of lines
Challenge #6
Sales and marketing must remove the silos between various commercial spend vehicles, start taking a "one dollar" view of total spend, and begin sharing the full customer P&L impacts with the customer, including all spend elements (and associated return on that spend).
TURNING THESE CHALLENGES INTO OPPORTUNITIES

Case studies of successful ZBB implementation in commercial spend

Leveraging commercial spend for growth: Transforming trade spend into a lever for customer performance

A $10B+ food and beverage manufacturer was struggling to use its trade investments as an engine for growth. Despite increased promotional activity, sales continued to decline and management feared that they had run out of options for improving customer performance.

In an effort to curtail sales losses, the company embarked upon an initiative to comprehensively assess its trade spend program and devised a plan to transform it into a lever for managing customer performance. A core group from the management team found that:

- Trade funding was based on historical rates and was in no way linked to growth priorities.
- Trade rates and other spending had either stayed the same or risen based on previous periods' spend.
- Nearly 15 percent of all commercial spend was allocated outside performance trade. (New-item funding was mostly based on slotting fees set by customers, without any agreed-upon metrics.)

Management decided the program needed to be overhauled to drive sales growth. Using industry-leading benchmarks as a guide, the company designed a funding program that tied all elements of commercial spend to customer performance. In essence, funding rates were linked to specific performance thresholds, communicated to customers, and reviewed on a regular basis.

Through these changes, as well as increased recording and analysis of customer profitability, this manufacturer realized more than $300M worth of profit improvement. In shifting trade spend and other funding based on a strategy to "win with the winners," the company not only increased profitability but also strengthened the business relationships it had with its most important customers and was able to shift funding to the brands and products most aligned with future growth in its categories.

Realigning trade investment: Deciding on metrics to measure

Facing mounting pressure to improve profitability and rationalize commercial spend, a $3B+ consumer products company initiated a project to assess its trade spend and evaluate the extent to which returns were being measured and achieved.

At the outset of this initiative, the company defined three broad categories in which it wanted to boost performance with its trade spend across customers: volume, distribution, and retail execution. Specific performance criteria were developed that could be measured at the individual customer level, which would help meet overarching targets for these three categories. In addition to criteria such as sales dollars and number of weeks for promotions, the company included "share of shelf" as a new performance criterion on which to measure customer performance. Despite complexity in measuring "share of shelf," this new metric reinforced a focus on distribution and represented a unique way to measure trade spend ROI.

In addition to establishing specific goals and performance criteria, the company wanted to create full visibility to the size and usage of its commercial spend. This involved developing a consensus around commercial spend based on certain performance criteria thresholds and ensuring that commercial spend was tied to merchandisers' P&Ls. Customers were also grouped into specific segments, each with their own trade rates and ROI targets.

These changes marked a significant departure from how commercial spend had been managed in the past. The company had to develop a robust communications package for its customers and institute a system for regularly analyzing customer performance and appropriately adjusting commercial spend. As it was implemented, this approach led to a trade spend reduction of more than five percent, but in many negotiations with retailers, it also led to improved visibility on shelf, a broader assortment, and improved promotional execution.

Conclusion: Key questions you need to ask before embarking on this journey

In order to see if ZBB could help bring the most "bang for the buck" from commercial spend, CPGs should ask the following questions:

Figure 5: ZBB solution fit framework

Focus area	Key questions
Setting guidelines	Do we have the right targets and guidelines in place for commercial spend?
Incenting the right behaviors	Does our commercial investment funding incent the right behaviors, both internally and externally?
	Is our trade funding in line with the retailers' performance?
Communicating to retailers	Do retailers know what we are looking for?
	Is our funding transparent?
Monitoring performance	Do we monitor the performance of our commercial spend with specific metrics?
	Are there processes in place to review and course correct, if necessary?

If the answer to any of these questions is no, a ZBB approach to commercial spend management could help improve overall spend performance and reduce costs. A well-developed and implemented program would offer increased agility to adjust spend, greater transparency in the budgeting process, and a higher degree of granularity in the organization's ability to assess the return on commercial spend.

Endnotes

[1] For one account of these trends, please see our article: "Consumer Products Trends: Navigating 2020." http://dupress. deloitte.com/dup-us-en/industry/consumer-products/trends-2020.html. 25 June 2015.

[2] Deloitte, *Thriving in uncertainty | Deloitte's fourth biennial cost survey: Cost improvement practices and trends in the Fortune 1000,* http://www2.deloitte.com/us/en/pages/operations/articles/global-cost-survey.html

[3] Credit Suisse, "Food Sales Tracking Update," 20 September 2016.

[4] David Kesmodel, "Meet the Father of Zero-Based Budgeting," The Wall Street Journal, March 26, 2015, http://www.wsj.com/articles/ meet-the-father-of-zero-based-budgeting-1427415074

[5] Daniel Roberts, "Here's what happens when 3G Capital buys your company," Fortune, March 25, 2015, http://fortune. Com/2015/03/25/3g-capital-heinz-kraft-buffett/

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