

### The impact of promotional buying on suppliers' gross margins

1. The following hypothetical (and simplified) example illustrates the impact of differences in promotional buying between supermarket chains on the gross margin analysis.

2. Suppose that in 1998, supplier X obtained gross margins of 28 and 30 per cent, respectively, from retailer A and retailer B. The difference represented retailer A's superior buying power—both multiples stocking similar ranges and having similar views on promotional opportunities.

3. Suppose that, in 2002, supplier X still obtains a gross margin of 28 per cent from retailer A, which has retained its buyer power. Suppose retailer B buys £10 million from supplier X and 95 per cent (£9.5 million) of its purchases are similar to retailer A (in range and promotions), with the supplier still getting a gross margin of 30 per cent on this volume (equivalent to  $0.3 \times £9.5\text{m} = £2.85\text{m}$ .)

4. The remaining 5 per cent (£0.5 million) of retailer B's purchases are additional 'buy one get one free'/deep discounting offers, which retailer A chooses not to feature. If supplier X normally has a margin of 30 per cent, its cost of sales is 70 per cent. If the supplier X lets retailer B have two items for the price of one,<sup>1</sup> its cost of sales is  $2 \times 70 = 140\%$ —ie its gross margin is  $-40$  per cent. Its gross margin on £0.5 million of such purchases =  $-0.4 \times £0.5\text{m} = -£0.2\text{m}$ .

5. Hence, in 2002, supplier X's overall gross margin on retailer B's sales equals  $£2.85\text{m} - £0.2\text{m} = £2.65\text{m}$ , on a total of £10 million sales—a gross margin of 26.5 per cent, apparently less than that obtained on sales to retailer A. However, this is no longer a true measure of the relative buying power of the multiples,<sup>1</sup> since retailer A could have taken advantage of the promotional offers, if it thought they were beneficial to its bottom line.

6. Moreover, supplier X has derived benefit from the promotions with retailer B which he has not obtained from retailer A. For example, suppose that, rather than the supplier bearing the entire discount, the supplier and the retailer share it. The suppliers' gross margin is now 6.7 per cent (Margin =  $1 - \text{cost of sales } (2 \times 70 \text{ for two})/\text{income } (150 \text{ for two})$ ). If sales increase by more than a factor of 4.5, the supplier will still make more profit (provided the sales are truly additional and there is no increase in overheads), as well as obtaining increased brand awareness for the product. At the gross margin level, the retailer will make a loss on the promotion. Unless the retailer normally has a very high margin on the product, the retailer may even make a loss at a marginal cash level, as the promotional goods may be sold for less than net purchase price from the supplier. However, the retailer may consider that the effect of potentially higher footfall in individual supermarkets compensates for this loss.

7. The above example is based on a typical supplier's gross margin. Margins of both suppliers and retailers vary considerably, depending on the category of the product in question, and the above calculation could be more or less favourable for the supplier, depending on the margin of the product in question. However, a key implication is that, due to the contribution of additional sales, the net cost of the promotion to the supplier will often be less than the headline invoice rebate the supplier pays to the retailer.

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<sup>1</sup>In practice, supplier X is may not sell promotional stock as cheaply as a two-for-one basis, but could effectively have done so if the supplier has to pay fees for gondola ends, administration and advertising retailer B's publications.