# A Practical Approach to Eliminating Slotting

By Dan Graham

SLOTTING CAN GENERATE SIGNIFICANT SHORT-TERM DOLLARS BUT CAN REDUCE MANUFACTURER AND RETAILER PROFITBILITY IN THE LONG RUN

Slotting has been identified as a major deterrent to the implementation of consumer focused category management, a fact that has been acknowledged by both manufacturers and retailers. Yet the practice continues, and may actually be increasing. If both retailers and manufacturers agree the practice is counter-productive, why does it continue? The answer is quite simple – slotting meets retailer's need for short-term profit.

For retailers, slotting actually plays a dual role. It continues to serve as a way to decide which products should be authorized for distribution. In today's world of me-too products and limited product testing, it is very difficult to tell the winners from losers, so the amount of slotting attached to an item is a convenient way to make decisions.

Even more importantly, however, the income generated by slotting has become an important profit center for retailers, and collecting slotting is often the way they "make the number." The end of the quarter "dash for cash" can often generate millions of dollars in lump sum money – and introduce hundreds of items into distribution that have no business being there.

But does collecting slotting really contribute to long term profitability? Certainly not as much as it would appear to upon initial examination. There is no question that authorizing questionable items to generate lump sum income can raise significant dollars. There is also a price to be paid for those decisions, however.

A retailer incurs a number of costs when injecting items into their supply chain, including set-up, receiving, handling, distribution, stocking, and inventory holding costs. These costs are usually badly underestimated, and can easily run as high as 30% of inventory value annually. The vast majority of the items bought only to collect slotting will then fail, so in addition there are costs to remove the item from the supply chain. When all of the costs are deducted from the income collected up front, the net gain may be very small, and there may actually be a loss.

And of course, authorizing items based on how much money can be collected couldn't be further from practicing Category Management. Category Management is about serving the wants and needs of consumers by providing them with the products they demand. That demand, of course, is in no way connected to the amount of money that a manufacturer paid to gain placement for an item. Actually, if a manufacturer has not done their homework and made sure there is a market for their new product, the more likely they are to attach significant slotting to their introductory offer, since they know that is the only way they will obtain distribution.

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There are a number of negative results when such items are authorized. First, they do not generate sales since consumers do not want them. As a result, they clutter the shelves, making it difficult for consumers to shop for products they do want. Slow movers can possibly cause out of stocks, since they take valuable space and holding power away from top selling items. Finally, such items can devastate category results, dragging down category management performance measures such as inventory turns and GMROI.

An even more compelling reason for retailers to stop focusing on generating income through slotting is the fact that such practices continue to make them non-competitive with other classes of trade. The simple fact is that retailers who collect slotting have a higher cost of goods over the long term. If they take all of their slotting income to the bottom line, without reflecting it in the cost of goods, they can be at the same margin as competition, and still be at a higher retail. The reality is they typically have higher margins, resulting in much higher retails This discrepancy in pricing has not been lost on consumers, who continue to flock to alternative classes of trade. Once again, the lack of consumer focus is harming category results.

Since there is acknowledgement that collecting slotting is not productive, the important question is how can it be stopped? First, it is important to realize that retail net profitability continues to hover between one and two percent. The amount of gross income collected from slotting is often larger than the net profit for a retail chain. Adding to that the fact that the net financial impact of eliminating slotting is uncertain at best, retailers cannot afford to simply stop collecting slotting immediately. However, also realizing that the long term impacts of slotting are negative, and are harming both category management and overall performance, devising a plan to eliminate the practice is appropriate.

An intelligent approach is to emulate the practices of a major, multi-category manufacturer who decided to completely revamp their trade-spending program, and sharply reduce spending levels. The potential impact was much the same – a temporary loss of volume due to reduced promotional sales, resulting in a reduction in income.

Their solution was simple, but very effective. Deal spending was reduced a product line at a time, and the restructuring was spread over a multi-year period. Each product line did suffer a temporary drop in volume, but since the impact was spread over time, the impact on overall results was minimal.

Retailers could certainly follow a similar approach. By eliminating slotting a category at a time, the reduction in immediate income would be minimal. If they then faithfully practice category management, the gains in sales and reductions in costs would more than offset the losses in income. But what happens to all of the money that they were collecting in slotting?

**FTC Survey: Slotting Allowances in the Retail Grocery Industry**

Most participating retailers and suppliers reported that in connection with a new product introduction, they negotiated over the amounts of such things as slotting allowances, advertising allowances, introductory allowances, marketing funds and funds for in-store displays, demonstrations, couponing and customer savings cards. Most also reported that if a retailer accepts a new product, the retailer will stock the product in its stores and the product will remain on the shelf for a "reasonable" amount of time, to give the product a chance to get established. But, several retailers and suppliers reported that payment of a slotting allowance did not, in fact, guarantee any particular shelf placement.

The reason retailers gave for requiring slotting allowances was to help defray the costs associated with new product introductions. These include costs for rearrangement in the warehouse system, modifying planograms, setting up computer and accounting systems, marking down old product to sell it off and evaluation of the new product proposal. New product introductions appear to be risky, with some sources reporting a failure rate of 70%. When a new product fails, the net revenue from sales of the new product may not be sufficient to recover the costs of introducing the new product. Slotting allowances reduce potential retailer losses on new products.

Most of the suppliers were skeptical that slotting allowances serve primarily to defray new product introductory costs. Their views on the purpose of slotting varied. Some economists and marketing researchers believe that slotting allowances can assist retailers in deciding on how to allocate scarce shelf space. Additionally, two economic theories suggest slotting fees can be used as a mechanism to lessen competition among retailers and among suppliers.

*Source: Slotting Allowances in the Retail Grocery Industry, Selected Case Studies in Five Product Categories, An FTC Staff Study, November 2003.*

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To remain competitive, it is certainly important for retailers to continue to collect their share of dollars that are available from manufacturers. There is also no question that the alternative classes of trade we mentioned earlier are receiving their share. They are just not receiving it in the form of slotting. Where they often receive it is in reduced cost of goods or increased promotional funds, which they then translate into reduced retail prices. So that is the transition that must take place – a shift of dollars from slotting into programs that increase consumer value.

The methodology for such a transition can be quite simple. When an item is introduced, both parties arrive at a case sales estimate for the first six months. The lump sum amount, that would have formerly been used for slotting, is then converted into an incremental, per case, off-invoice allowance. At the end of six months, the movement is reviewed. If the item has meet expectations, the off-invoice allowance is eliminated and the item becomes part of the regular category mix. If sales are not up to par, the item is discontinued or a plan is developed to increase sales, which would include continuing the off-invoice incentive in addition to other sales building programs.

There are a number of advantages with this approach. Most importantly, there is an incentive for the retailer to sell product. The more cases that are sold, the larger the total introductory allowance will be. This is far different than collecting slotting, where the amount is fixed even if there are not any sales or additional orders. And when retailers are focused on selling product, the consumer also wins.

The supply chain also benefits. When a large slotting payment is made, there is often a requirement to place a sizeable initial order to justify slotting payments. This need is eliminated with a move to per case allowances, a benefit to both retailers and manufacturers.

Retailers are not sitting on large inventories hoping the item will sell, and facing the prospect of having a warehouse full of obsolete product if the item fails. Manufacturers are not hoping to justify their expenditure with one large order that may amount to many months supply, leaving them with unpredictable demand for the item, and the prospect that the warehouse inventory may come back to haunt them. In addition, any incremental promotional spending by the manufacturer is likely to produce orders, and not just deplete warehouse inventory.

Finally, it is a practical approach to implementing change, allowing retailers to gradually move to a more competitive position without severely impacting their financial performance. And the plain truth is, traditional retailers really have only one choice – change or continue to be devastated by the more efficient and consumer focused competition. V

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