

Profitable Category Management

Retailers take Competitive Category Management, Pricing Optimization, Efficient Assortment and Market Basket Analysis to New Levels of Profitability with ABC

Jack Haedicke, Arena CG

The Purpose of This Article

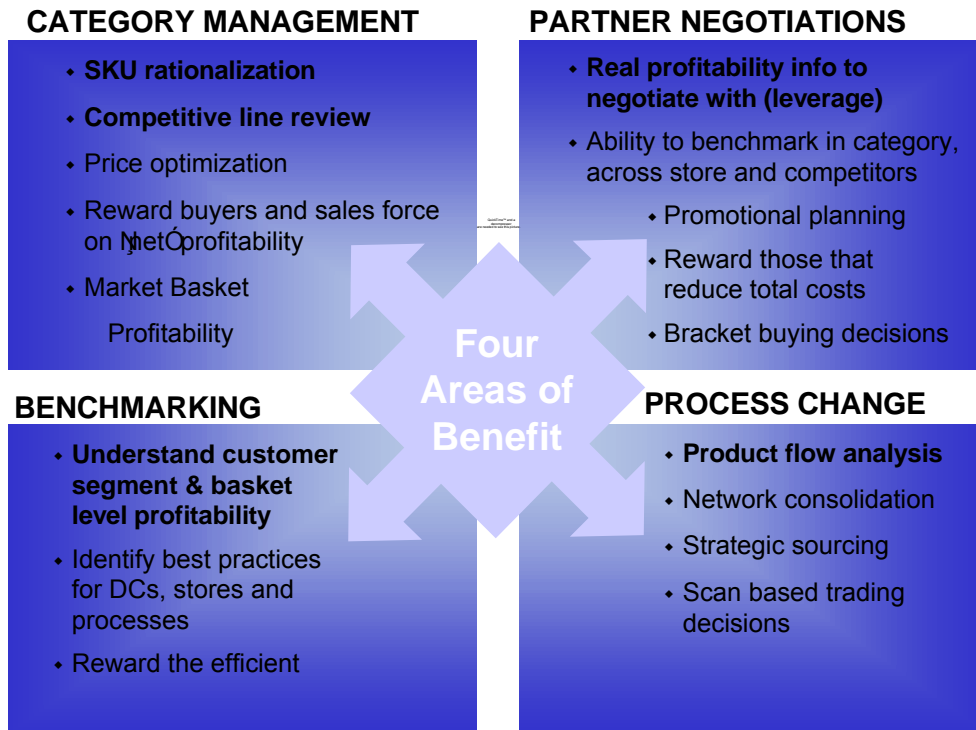
For years, Activity Based Costing (ABC) has been shown to benefit retailers in many areas — Cost Reductions, Partner Negotiations, Benchmarking and Process Changes — but Category Management is, perhaps, ABC’s highest calling for a retailer. Category Management defines how a retailer differentiates from other retailers, both with the items on the shelf and how they’re priced. It dictates what gets promoted. It’s the image presented to the consumer, and may even decide to which consumers it’s presented. It can even define how the retailer negotiates with vendors.

This article is intended to illustrate how ABC is employed as the key ***enabler*** of the Category Management process and, by association, Category Management’s key tactics of Competitive Category Management, Pricing Optimization, Efficient Assortment and Market Basket Profitability.

This article is not intended to discuss how ABC is implemented at a retailer or manufacturer. There are more than enough articles to describe that process. It is imperative, however, that whatever ABC system is implemented, it must be able to determine “net” profitability at the SKU (stock keeping unit, or item) level, be simple in structure and be designed by the users themselves.

And, while the retailer that is typically responsible for executing on Category Management strategies, the manufacturer or vendor will also benefit from a better understanding of how retailers choose to position products to build profitable revenue increases. It is, quite simply, in both the retailer’s and the manufacturer’s best interest to jointly work towards any solution that provides the greatest value to the consumer. ABC and Category Management provide the framework and language by which they can collaborate.

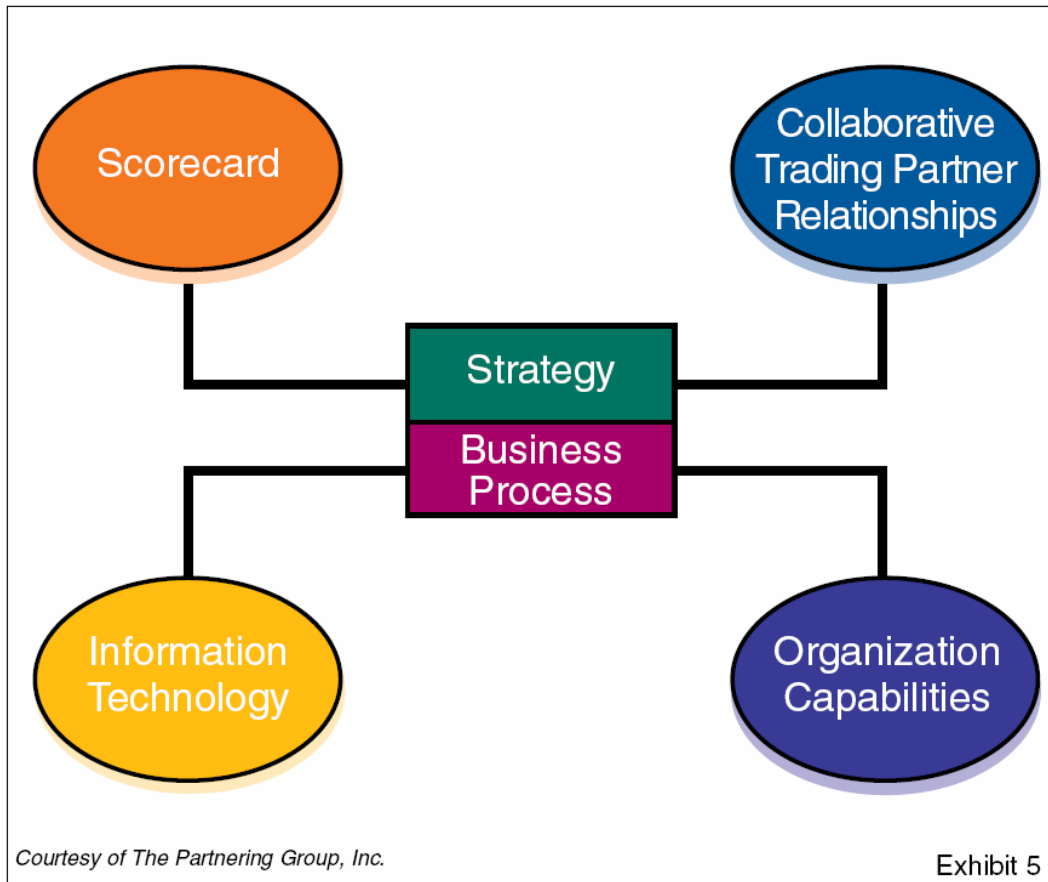
Item net profitability is a foundational capability which enables several short-term initiatives to generate quick returns



The Basics

Let's start with the basics. Category Management was an outgrowth of the Efficient Consumer Response initiative of the 1990's. The theory was that, since the retailer owned the consumer, and the manufacturer knew more about how to market their particular products (think coffee or laundry detergents) than any retailer ever could, their collaboration would work to provide increased profitable volume for both firms and better value for the consumer.

The process was intended to work as illustrated below:



It all began with a Scorecard. The scorecard allowed both trading partners to collaborate on a given set of parameters that defined the success of any joint retailer and manufacturer initiative. That scorecard would constantly be updated using information technology capabilities and used to reward the organization and identify further opportunities for improvement. Out of this came a definition of roles and strategies for each category within the retail store. An example of such a matrix follows:

Category Roles	Category Strategies			
	Procurement	Distribution	Marketing	In-Store Service
DESTINATION	Acquisition Strategy – Best Quality/Reliability – Best Cost & Terms Transaction Strategy – All EDI & EFT	DC/Store Receiving – Auto Replenishment Transportation – DSD, Backhaul DC/Store Handling – Cross Dock – Sale-Ready Packaging	Attract Strategy – Traffic Building – Image Enhancing Build Loyalty Strategy – Transaction Building – Turf Protector Micromarketing	Full Service – (If Necessary) Differentiated – (From Competition)
ROUTINE	Acquisition Strategy – Best Quality/Reliability – Best Cost & Terms Transaction Strategy – Majority EDI & EFT	DC/Store Receiving – Auto Replenishment Transportation – DSD, Backhaul DC/Store Handling – Minimize Handling – Reduce Shrink	Build Loyalty Strategy – Transaction Building – Turf Protecting Cluster Marketing	Semi-Service – (If Necessary) Non-Differentiated – (From Competition)
OCCASIONAL /SEASONAL	Acquisition Strategy – Best Quality/Reliability – Best Cost & Terms Transaction Strategy – Some EDI & EFT	Transportation – Reduce Transit Time DC/Store Handling – Reduce Shrink – Sale-Ready Packaging	Attract Strategy – Traffic Building – Excitement Creating Cluster Marketing	Self-Service – (If Necessary) Non-Differentiated – (From Competition)
CONVENIENCE	Acquisition Strategy – Low Cost	DC/Store Receiving – Auto Replenishment DC/Store Handling – Minimize Handling – Reduce Shrink	Build Loyalty Strategy – Transaction Building Uniform Marketing	Self-Service Non-Differentiated – (From Competition)

Primary Category Strategy(s)

Courtesy of The Partnering Group, Inc. Exhibit 28

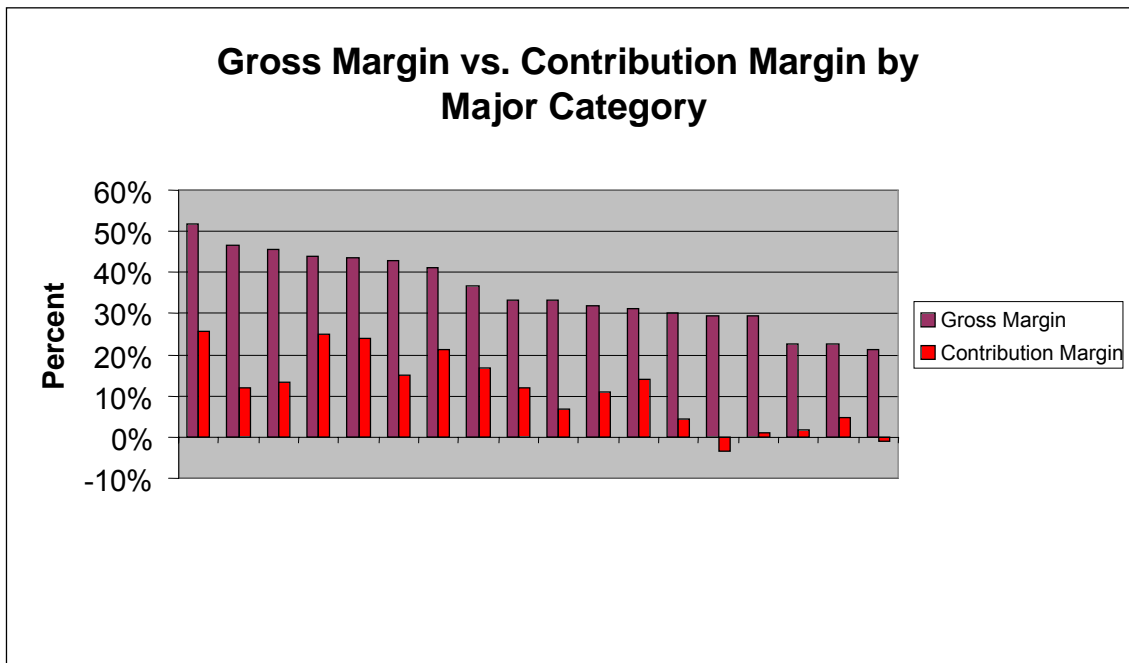
Each retailer would use a similar matrix to differentiate itself from the other based on how it chose to present itself to the market. It could be an “everyday low price” retailer or a “high-low;” the assortment could be broad or it could be narrow; the stores large or small. Whatever the strategy, the matrix helped define how an individual retailer would approach the consumer and served as a vehicle for communicating that strategy to internal employees and vendor partners.

Category Roles	Category	Category Strategies				
		Turf Protecting	Traffic Building	Image Enhancing	Transaction Building	Excitement Creating
DESTINATION To be the <i>primary</i> category provider and help define the retailer as the store of choice by delivering <i>consistent, superior</i> target consumer value.	Soft Drinks		Regular and Diet Colas		Specialty Flavors	New Age Beverages
ROUTINE To be one of the <i>preferred</i> category providers and help develop the retailer as the store of choice by delivering <i>consistent, competitive</i> target consumer value.	Pet Care	Dog Food			Pet Supplies	
OCCASIONAL/SEASONAL To be a <i>major</i> category provider, help <i>reinforce</i> the retailer as the store of choice by delivering <i>frequent, competitive</i> target consumer value.	Hard Surface Cleaners	All-Purpose Cleaners			Tub/Tile and Floor/Wax	
CONVENIENCE To be a category provider and help <i>reinforce</i> the retailer as the full service store of choice by delivering <i>good</i> target consumer value.	Shoe and Leather Care				Polishes and Protectant	

These principles were developed by Frank Grossi and “The Partnering Group,” in cooperation with the ECR Committee. They still stand as one of history’s greatest advances in collaboration between trading partners.

There was only one small problem: the Scorecard didn’t work well.

Most retailers then, and until only recently, determined their profitability primarily on a gross margin basis rather than using true net profitability at the SKU or item level. The following is an example from one retailer showing the difference between a gross margin and net profitability (contribution margin) as determined through ABC. Gross margin made everything look the same regardless of its supply chain costs, level of funding from the manufacturer, or inventory turn.



Obviously, not all categories are created equal. Gross margin is, at best, a poor indicator of a product’s capability to generate profits, and certainly no vehicle for communicating with a set of trading partners on your strategy for Category Management.

That’s the bad news.

And here’s the good news...

True net profitability at the SKU level, as shown above, is easily within reach for the majority of retailers. The barriers that existed to ABC at the SKU level in the 1990s no longer exist.¹ We now have the software, data processing power, experience and track record to make ABC happen, even in retail environments with hundreds of thousands of SKUs and thousands of stores.

Another bit of good news is that SKU net profitability through ABC is finally fulfilling its promise as the enabler of the Category Management process, and it is unlocking returns in the areas of Competitive Category Management, Price Optimization, Efficient Assortment and Market Basket Profitability.

Let’s discover the source of a few of those returns.

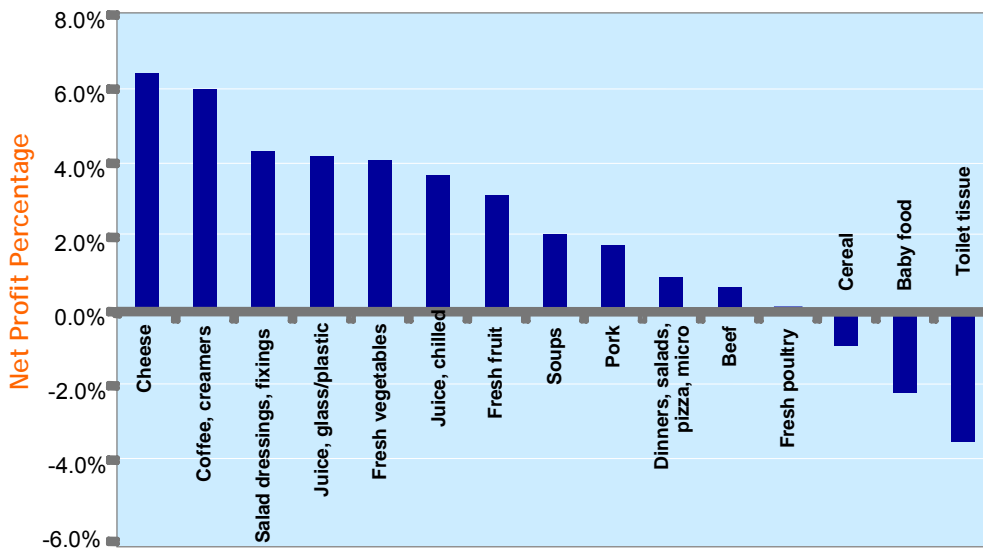
Competitive Category Management

At a baseball game, it’s often said that it’s hard to tell who the players are without a program. The same can be said of category strategies within a retailer.

¹ “The Birth, Death and Resurrection of Activity Based Costing,” The Arena Report, Haedicke, Fall 2003.

All retailers do some form of profitability analysis, and there is no shortage of opinions on what categories are most important and most profitable. However, the problem is that there is rarely agreement on what those categories are. In a properly constructed ABC system, net profitability at the SKU level is created by a cross-functional team involving the disciplines of Distribution, Merchandising, Operations, Information Systems, Industrial Engineering, and Finance. As such, the team represents the views of the key stakeholders of the business on key activities and cost drivers for the organization. One version of the truth is then created, and agreement, by definition, is the output of the design session.

Top 15 Categories Based on Total Revenue



This is no small accomplishment since, from my experience; more time is spent arguing about where a retailer makes its money than worrying about how to beat the retail competition down the street.

Once again, ABC net profitability doesn't make the decision for you, it enables the decision making process.

Price Optimization

Price optimization software has been receiving a lot of attention, as of late, and with good reason. Most price optimization software applications work by applying Bayesian inference, a methodology that mines transactional history to relate penny price changes on an SKU to changes in transactional volume. This is used to determine the optimal price point at which to create traffic within the store. The most advanced of these systems will even compare competitive pricing within a given market.

Here's the rub. What if you have chosen to maximize traffic on a category or set of SKUs that is, in reality, losing you money? However, you don't know that because you only measure profitability on a gross margin basis?

Intelligent Price Optimization can only be accomplished in a retailer that has true net profitability through Activity Based Costing as the enabler of the process.

Efficient Assortment

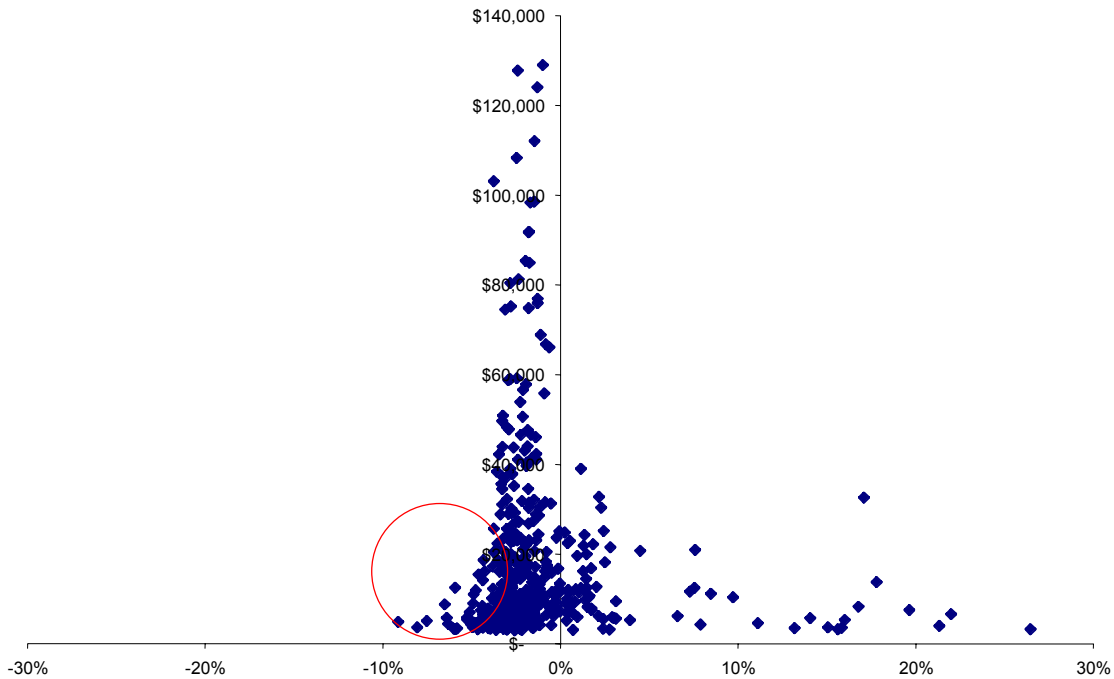
Potentially, one of the most fruitful areas of ABC net profitability is the area of Efficient Assortment or SKU Optimization. It's also devilishly complex because it blends both the science of ABC and the art of the merchant to determine the appropriate mix for any particular category. Therefore, this is a story best told by example.

Let's take the example of a high-low operator that has identified the cereal category to play the role of "loss-leader" within the store. What this means is that the retailer is willing to lose money on this category as long as it generates the right kind of consumer traffic and the consumer's overall market basket is profitable. A retailer just wants to be able to manage the bleeding of a loss-leader category intelligently.

The one thing Category Management teaches us is that, as compared to a Destination Category where a retailer will want to carry every brand/SKU variation possible, loss-leaders are often categories where they want just enough variety to pull the customer in the door. Assuming that's true, it's important for retailers to determine which SKUs to eliminate and which to keep in the loss-leader category.

As mentioned earlier, if the retailer is measuring profitability simply on gross margin, there is no easy way to discriminate between SKUs that lose a little and those that lose a lot. ABC enables retailers to differentiate between the two as shown on the scatter chart below.

Item Profitability - All Cereal SKUs with Warehouse Sales > \$3,000



This type of ABC-based analysis simplifies the process of accurately identifying profitable and unprofitable SKUs. First, identify the least profitable 10% of SKUs and consider eliminating them. Obviously, it's not quite as straightforward as simply identifying the least profitable SKUs and eliminating them. A retailer must rely on his marketing sense. For example, if Post Raisin Brand was part of the 10% of unprofitable SKUs slated for elimination, would a good merchant remove it? It's doubtful. However, this methodology is highly likely to unearth some surprises regarding SKUs that should be eliminated.

There are a variety of methodologies that can be employed once the net profitability scorecard is in place. They all involve some variation of looking at net profitability, rating the SKU for strategic importance, considering the newness of the item and determining whether its share is increasing or declining. The "art" employed by merchants in making these decisions is what differentiates one retailer from the next.

Once again, the key is to be able to identify the true net profitability of the SKUs through ABC in order to make informed decisions.

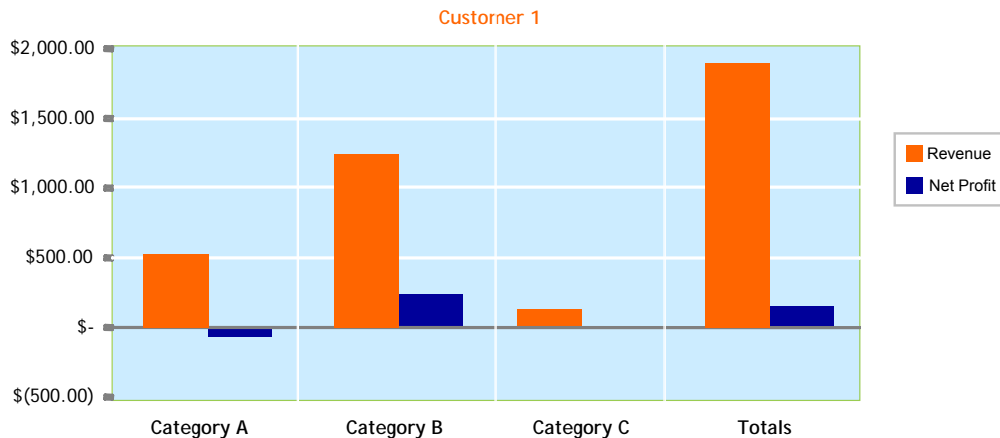
Market Basket Profitability

For years, we've argued about the best products to promote to create excitement, consumer draw and, ultimately, the most profitable market basket. Two things have

stood in the way of knowing this answer: what customers bought which items, and what the true profitability of those items was.

The rise of customer loyalty programs has put these answers within reach. Retailers can now track and retain the details of every transaction, most of them complete with information about who purchased what item and what else they bought. One of our retail customers is tracking over 75% of their purchases and retaining this valuable information within their database. With the highly scalable ABC technology that is now available, it's finally possible to combine the true net profitability of items within that transactional basket to determine overall profitability.

Building top line growth - Market Basket Profitability



Loss Leaders - Items and Categories

Proactive Consumer Promotions

ABC doesn't only reduce costs, it also builds top line growth and gross margin

Consider this: does promoting a \$.69 two-liter of Coca-Cola really draw in that mom from the high-end suburb with three kids under the age of ten who spends \$150.00 a week on groceries? And if so, what are the items she buys to go along with it, and is the overall basket a profitable one? Would promoting Kraft Lunchables have been a better solution? Or, as a home improvement retailer, would knowing that you lose money on mulch but make a large profit on shovels and wheelbarrows affect what home improvement projects you promote through consumer education programs? We can now answer those questions and better target the right products and promotions to bring in the customers that purchase a profitable mix of items from our stores.

For those of us who have spent the last decade or so extolling the virtues of cost reduction and bottom-line profitability through ABC, it is particularly exciting to see ABC being used as a vehicle to fuel top-line growth.

Summary

In summary, this is no longer the ABC of the 1990s.

Today we have reached a very exciting point where there is a convergence between the technologies used to implement ABC, the methodologies used to apply these technologies, and the expanding uses of ABC and Category Management in a retail environment. These implementations are no longer risky, leading edge projects, but mature applications that have been employed by many of the world's leading retailers.

At the risk of dating myself, I had the great pleasure of leading the ECR (Efficient Consumer Response) initiative for several years in the mid-1990s. Our job was to lead the modernization of retailers, manufacturers, brokers and wholesalers by employing the principles of ABC, CRP (Continuous Replenishment Process), EDI (Electronic Data Interchange), and Category Management. Retailers fell into two camps: 1) Those that participated with enthusiasm (Schnuck's, HEB, Wegman's and Kroger, amongst others) and who, almost without exception, continue to survive and thrive today; and 2) Those that, for whatever reasons, resisted the application of some very commonsense practices and, again, almost without exception, are failing, have folded or have been gobbled up by those with the will and vision to modernize their practices.

We're at that same inflection point again with ABC and Category Management.

When we look back in five years, which camp will we say that your firm fell into?

About the Author

Jack Haedicke

Jack Haedicke bears the distinction of having built more activity based costing (ABC) systems than any other single individual. As controller of manufacturing at Hughes Aircraft, he developed customer profitability models. He led the US efficient customer response (ECR) initiative while serving as director of cost accounting at Coca-Cola, and he later held the position of vice president of finance and supply chain at Kraft Foods. With consulting firm Arena CG, Haedicke has built customer profitability-focused activity based costing systems for Miller Brewing, Wegman's, Wal-Mart and Target.

Arena Consulting specializes on the interaction of cost accounting and supply chain in the areas of (ROI) Return on Investment, Pricing, CPFR (Collaborative Planning, Forecasting and Replenishment), ABC (Activity Based Costing), and Consolidation Warehousing.