HARVARD | BUSINESS | SCHOOL
WORKING Knowledge

Precision Retailing

HBSWK Pub. Date: Feb 7, 2005

Can you apply profitability management to a retailer? Absolutely, says Jonathan Byrnes. Start by calculating the profitability and return on invested capital for every item in your store.

by Jonathan Byrnes

Can you apply profitability management to a retailer?

That was the question posed to me by a senior manager during a talk I gave to a group of executives in the Midwest a few months ago.

In the talk, I had described how to analyze the profitability of customers and products, and how to turbocharge a company's profits by increasing the portfolio of profitable business, turning around marginal business, and shedding deadweight business. (See "Who's Managing Profitability?")

This executive explained that industrial companies and distributors have salesforces, so they can select and manage their customers. Retailers, on the other hand, put products on their shelves and seem to have little control over who comes in the store and what they buy. What can a retailer do to manage profitability?

The answer is: plenty!

Recently, I worked with a major retailer to improve its profitability. In a relatively short time, we created a PC-based model that calculated the profitability and return on invested capital for every product in every store. We found the same profitability pattern that I have seen in over a dozen other industries: islands of high profits in a sea of marginal business. There were large opportunities for profitability improvement even in this well-run company.

Several months ago, I held a strategy session for the CIOs of major grocery chains. In conversations and correspondence afterwards, a number of participants offered a similar view of their industry.

Here's what one IT vendor executive wrote to me: "I suppose that if supermarket executives sat down, they would agree that probably 25 percent of the customers that walk in the door cost them money. All the profit comes from the 25 percent with the largest baskets—not necessarily the largest revenue.... Well over half of that profit comes from 10 percent or less of the base." (See "The Hunt for Profits.")

Retail profitability management
Here are five high-impact areas for profitability improvement in a retailer.

Assortment management More is not always better. This is true for two reasons.

First, overly broad assortments can be confusing for both sales associates and customers, especially for technical products. In many retail situations, over 60 percent of the customers enter the store with a generic need, such as a "radio to play at the beach," rather than a particular branded product.

Hence, there is a need in each category for a relatively tight selection of products that fill certain roles: key price points, traffic drivers, technical icons, fashion showpieces, and so on. Within this context, a retailer might choose to carry a somewhat broader assortment in a particular dimension to emphasize its positioning and strategy.

But beyond this, overly broad assortments can diminish sales, increase inventory costs, and cause inordinate markdowns. The exception is a specialty retailer competing in a narrow segment with sophisticated buyers.

Second, tight assortments are particularly critical to the success of smaller (sales volume) stores. A smaller store should not be simply a scaled-down version of a larger store. It must be assorted in a much smarter way. A large store is like a fast-flowing river: If you make a mistake in stocking a product that doesn't sell, or have too much of a product at the end of its lifecycle, the error flushes through the system relatively quickly.

But a smaller store is like a slow stream: If you make a product mistake, it's like throwing a big rock into the water. The shelves get clogged, and it takes a long time to free the shelves for a new, fast-moving product. This is the source of a disproportionate amount of profitability problems.

Customer service management Again, more is not always better. In last month's column, "Nail Customer Service," I explained the importance of substitution groups. A substitution group is a set of products that fulfills the same assortment role, like an entry-level price-point printer.

Because so many retail customers are indifferent to particular products within a substitution group, customer service levels (i.e., in-stock positions) should be gauged on the substitution group, not individual products, subject to certain minimum in-stock levels for shelf appearance. An exception would be a product on which customers have a strong brand preference.

Substitution groups are also important because they give a retailer an opportunity to execute a Dell-like strategy of managing demand, or "selling what they have," especially with short product lifecycle, high-end products. (See "Dell Manages Profitability, Not Inventory.")

Within a substitution group, a sales associate can steer customer purchases, when needed, toward products with excess stock and away from products with thin stock. This requires a strong link between the merchant group and the stores. But it only need take place perhaps 5-10 percent of the time, especially late in the lifecycle, to have a big positive impact on inventory and markdowns.

Overly broad assortments can diminish sales, increase inventory costs, and cause inordinate markdowns.

Retailers can also use merchandise presentation to steer customer purchases, especially toward high-profit products and those with excess stock levels. Products can be emphasized or deemphasized by repositioning the product on the aisle, or on shelf-end displays (endcaps).

For example, one prominent retailer analyzed which products would likely spike in sales at the start of the Iraq War. On the first night of the war, it repositioned these key products—guns, Bibles, and flags—in every one of its stores. Sales soared the next day.

Customer management In retail, as in most businesses, a relatively small proportion of customers provide most of the profits. What can a retailer do? Identify them, hunt them down, drive them in, and get more of them.

First, use profit mapping to identify your most profitable customers (See "The Hunt for Profits"). Then, you can use direct mail and other highly-targeted means to drive them into your stores more often, and to increase the scope and frequency of their purchases. Loyalty programs are critical in this process. Once you secure your best customers, proactively find more like them.

Think about the implications for assortment management. Try this: Take a few representative stores and analyze the breadth of products your high-profit buyers purchase. Are they buying your entry-level products? Your on-sale products? Your traffic-drivers? Or, are they buying high-profit, higher-end products at predictable times, often early in the product lifecycle? If the latter, you can focus your assortment to maximize your sales to your power buyers, and stop losing money on unprofitable customers.

Dell keeps an extensive database of its best customers' buying behavior. The company knows when to prompt its best customers, and to what they will likely respond. This is a key element in its profitability management process.

Product flow management This area is a source of major potential profit gains in retail today, made famous by Wal-Mart's well-known cross-docking process. Retail product flow management is based on two important principles: supply chain differentiation and flow-through logistics.

In a well-differentiated supply chain, products are grouped into clusters corresponding to their demand characteristics, merchandising characteristics, and physical characteristics. Think about the differences among high-turnover products, seasonal products, and promotional products. Each of these clusters requires a different set of operating policies and a different supply chain. Each requires a different game plan for effective management.

Flow-through logistics is a process for minimizing inventory and handling. For example, relatively fast-moving products should flow from the vendors through the distribution centers to the stores in regular pulses with minimum cycle stock and handling. This process gives you major cost savings while maintaining service levels, but it requires a high degree of organizational coordination, both internally and with vendors. Other types of products require extremely crisp transitions (end-of-lifecycle or promotion) management.

Assortment management is crucial to streamlining product flow in two key ways. First, by compressing assortments, you build in the remaining products the volume and demand stability necessary for flow-through logistics. Second, substitution groups offer considerable opportunities to focus and stabilize demand. For example, in a substitution group with three vendors, you might offer all of the group's demand upside to one vendor in return for guaranteed capacity and flow-through logistics; the other two vendors would see extremely stable demand, which would facilitate flow-through logistics on their part.

Best-practice management By developing profit maps that show profitability and return on invested capital at the product-store level, you can construct detailed profit profiles that compare similar stores. In many retail chains today, stores are clustered geographically, a practice that is cost-efficient, but combines many dissimilar stores. Profit mapping enables you to cluster stores that are similar in size, demographics, competitive situation, and other key factors, and analyze their performance. This provides an invaluable complement to geographic-based store operations management.

Within a statistically-sound peer group, you can observe best practices and spread them quickly. The store managers, and store operations group, can systematically move the peer group of stores to its best-practice standards. Internal best-practice benchmarking is one of the fastest and most productive ways to improve performance. However, be sure that store manager compensation is based on absolute performance, not performance relative to the peer group, so the store managers do not have an incentive to compete with each other and hide their best practices.

Culture of profitability
The most effective way to create sustained high levels of profitability is to build a culture of profitability within your company. This is true for retailers as well as for all other companies.

- The merchants must understand the end-to-end net profitability, from vendor to shelf, and return on invested capital for all their products in every store.
- The supply chain and logistics managers must know their supply chain productivity, not just efficiency. Supply chain productivity is comprised of two factors: (1) the net margin of a product in a store as the numerator, and (2) the invested capital, chiefly inventory, supporting that product in that store, as the denominator.
- The store operations managers must see the net profitability and return on invested capital performance of all the products in all of their stores, as well as the comparison of their respective stores' performance to the best practice of their peer group of stores.

These three perspectives are aligned, although the details have to be tailored to each company's specific situation. Two more key elements must be instituted to create a culture of profitability.

First, the key managers in these functional groups must get together periodically to review the performance of their stores and products. Together, they control all the elements essential to profitability, and together, they must coordinate to develop joint initiatives to manage and improve profitability.

Second, all three groups must share the same performance metrics: net profitability and return on invested capital. Ultimately, putting in place this critical behavioral driver is the most important ingredient for bottom line success.

See you next month.

Jonathan Byrnes is a Senior Lecturer at MIT and President of Jonathan Byrnes & Co., a focused consulting company. He earned a doctorate from Harvard Business School in 1980 and can be reached at jlbyrnes@mit.edu.