

Overcoming Barriers to Efficient Assortment

By Dan Graham

The logical extension of the SKU Rationalization process at the manufacturer or distributor level is the efficient assortment process that takes place at the retailer's shelves. After all, in the final analysis, both processes should be driven by the same factor – **consumer demand**. If there are not enough consumers who will buy a product, then there is no sustainable, long-term rationale for either the retailer to sell the item, the distributor to stock the item or the manufacturer to make the item.

A key phrase in the previous statement is "**long-term rationale**." There are often very compelling short-term reasons to manufacture, distribute and attempt to sell new products, although the reasons are often different for manufacturers and retailers. For example, issues such as plant capacity and competitive activity drive manufacturers. A retailer's decision-making process is often driven by the short-term need for profitability or sales volume. The important question to ask, however, is: do these short-term pressures ever truly justify the products they inject into the supply chain? If the answer is yes, then we must find ways to manage the efficient assortment process so these products can contribute to long-term profitability.

The inefficiencies in the new item introduction process have been well documented to the point that one of the key Efficient Consumer Response (ECR) initiatives is Efficient New Item Introduction. However, since changing the process has proven to be difficult, it is important to find a way for the opposing forces of efficient assortment and new item proliferation to co-exist in the most profitable way possible.

Several elements of the new item introduction process contribute to the difficulties inherent in

maintaining an efficient assortment. For one thing, manufacturers are often able to play on the retailer's need for short-term profitability by offering financial incentives, or "slotting," to gain distribution for items. For another, the vast majority of new items fail, and there is nothing efficient about the process of getting them back out of the supply chain. The practice of making decisions based on slotting and introducing items that have no chance for success are both counterproductive for the same reason: items are not introduced based on consumer need and demand. So why do these two activities continue?

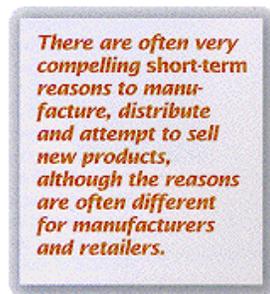
The Enduring Practice of Slotting

Category managers often struggle to maintain an efficient assortment due to repeated demands to produce immediate lump sum dollars to meet a financial reporting deadline or to "make the number." Slotting has become an important contributor to these short-term results. Given the considerable pressure to meet the financial community's expectations, retailers are not about to start rejecting the easy money offered by slotting unless they have a bullet-proof plan for replacing that income.

Of course, it can be very disheartening to complete an exhaustive efficient assortment process, making sure to get the SKU mix just right, only to be directed a week later to collect money by authorizing 15 new items that were previously rejected. Under such circumstances, it can be difficult for category managers to stay committed to a consumer-driven category management process, and very easy to adopt the attitude of "why bother." For the category manager, the issue becomes how to meet the short-term financial demands of the business while still practicing consumer-focused efficient assortment.

New Item Proliferation

The failure rate for new items remains surprisingly high, well above 80%. Yet new items continue to be introduced by the thousands, and continue to fail by



There are often very compelling short-term reasons to manufacture, distribute and attempt to sell new products, although the reasons are often different for manufacturers and retailers.

the thousands, wasting millions of dollars in the process.

One potential solution is for the category manager to simply refuse the vast majority of new items, only taking the obvious winners. The problem with such thinking is that separating the clear winners and losers is far from an exact science, and accurately predicting the potential of the items that fall in the middle is almost impossible. In addition, if category managers focused only on buying obvious winners, they would become far too conservative in their buying practices, missing the "sleeper" items that might generate significant sales. The profits that would be generated by these opportunities far outweigh the savings that might be realized by limiting the number of failures authorized. Once again, the key is in how to balance the onslaught of new items within the efficient assortment process.

Making It All Work Together

So far we've indicated that a category manager should continue to collect slotting as needed, should accept the majority of new items and should still practice consumer-focused efficient assortment. While they do conflict, if properly managed, all three practices can play a role in maximizing profitability.

...separating the clear winners and losers is far from an exact science, and accurately predicting the potential of the items that fall in the middle is almost impossible.

First, it must be accepted that it is not possible to achieve and maintain 100% item optimization. Even if slotting were eliminated, and only sure winners were accepted, today's "perfect" item mix would be outdated in a short time. The flood of new items never stops, and product life cycles are growing increasingly shorter. Item optimization is thus a continuous process, not a one-time event.

It must also be acknowledged that slotting and new item proliferation do not appear to be going away anytime soon. Item optimization can co-exist with these practices if you plan to optimize only a portion of the item mix, and reserve the remainder for collecting income from slotting and testing new items. For example, 80% of the items may be optimized, with 10% of the remaining space available for generating slotting income and 10% available for other new items.

The percentages will vary depending on the level of activity in the category; however, it is important to keep the percentages balanced over time. Because of the number of new items that are introduced, if a category manager is not carefully monitoring the item mix, the percentage of space occupied by new items will grow rapidly. In order to keep that from happening, new item performance must be evaluated constantly. If the item does not perform within a reasonable time (3-6 months), it should be eliminated. If new items perform well, they become part of the permanent mix, and go through the periodic optimization process.



The way to limit the risk on new items is to carefully control the amount of inventory initially purchased. If an item proves to be a slow mover and is eventually discontinued, the cost of warehousing, handling, transportation and liquidating the remaining inventory can far outweigh any profit gained on the initial buy, including slotting. And the initial buy is often the only buy on items that fail. If that buy is not conservative, it can amount to many years of inventory. On the other hand, if the item proves to be a winner and sells well, it is generally easy to reorder replenishment inventory.

...if an optimization tool has the flexibility to accept the appropriate inputs, it can be used to optimize itemization throughout the supply chain.

Once a decision has been made on what items will go through the item optimization process, the approach for retailers and manufacturers is much the same. Once again, consumer behavior must be the key decision driver for both. If an item does not generate adequate sales volume, or address a unique consumer need (i.e., it is non-substitutable), it should not remain in distribution.

Some decision criteria such as ROI, profitability or volume thresholds will be similar for retailers and manufacturers, although different activity cost drivers may be used. However, if an optimization tool has the flexibility to accept the appropriate inputs, it can be used to optimize itemization throughout the supply chain. We have built such flexibility into the Dechert-Hampe SKU Optimization Tool Kit, and have been able to apply it successfully to analyze and maximize the performance of both retailer and manufacturer assortments (see article entitled "*SKU Rationalization for Improved Return on Assets*" and "*Sorting Out Efficient Assortment*").

Avoiding the Pitfalls of Item Optimization

There are some key pitfalls that retailers must be aware of in executing item optimization. For instance, the practice of ranking all items in a category and then simply "cutting off the tail" and eliminating the slow movers should be avoided at all costs. Items must first be sub-categorized at a level that consumers find substitutable. Once substitutable items are grouped

together, their performances can be compared and non-contributing items can be eliminated. Retailers must at the same time take into consideration unique items that have no substitute in consumers' eyes. Failure to properly group items and keep unique items can limit variety and damage category sales. When item optimization is properly executed, slow moving "me too" items are eliminated, return on investment increases, consumer perception of variety improves and sales increase.

Another key pitfall in executing item optimization is in expecting the same performance standards for all items in a category. Retailers must take into consideration the strategic role of the category when deciding what thresholds to set for judging item performance. For instance, an item that is heavily promoted and used to generate a price image will not generate the same margin as a routine item that is rarely promoted.

An item that appeals to only a subset of consumers may appear to be a slow mover when compared across an entire chain of stores, but it may perform very well in stores with similar consumers.

Item performance must also be judged at the right level. An item that appeals to only a subset of consumers may appear to be a slow mover when compared across an entire chain of stores, but it may perform very well in stores with similar consumers. By matching distribution to consumer demand, such targeted items can contribute significant sales and profit. For this reason, effective item optimization can only be completed by clustering similar stores together and then evaluating item performance.

Consumer behavior is where item optimization for retailers and SKU Rationalization for manufacturers meet. If over the long term, consumers will not buy a product, it should not be anywhere in the supply chain. It is not enough to only have consumer demand, however. The item must also be available to the consumers who demand it. Linking the processes of SKU Rationalization and Item Optimization allows manufacturers to target their items for distribution in retail stores where their target consumers shop. By ensuring availability to the right consumers, item

performance increases, ROTA is improved and total supply chain performance is optimized.

Prior to joining DHC, Dan Graham was Director, Category Management at the Von's Company, Inc. He specializes in Marketplace Management Consulting