Why Isn't Category Management Living Up to Expectations?

By Dan Graham, Director, San Juan Capistrano

ACCORDING TO THE MAJORITY of manufacturers and retailers, Category Management has been accepted as one of the key competitive tools of the nineties. Today, over 75% of all food retailers say they practice some form of Category Management. Yet there appears to be a growing dissatisfaction with the results that have been achieved through Category Management. Why is Category Management not living up to expectations?

A number of the reasons for poor results have been widely discussed, including difficulties with data access and collection, ineffective decision systems and a lack of upper management commitment. Yet there is another serious roadblock to achieving improved results through Category Management: reward systems that encourage behavior that is detrimental to successful Category Management.

Legacy Reward Systems

It is necessary to change the behavior of the entire organization to truly implement Category Management. And a key way of changing and influencing behavior is the organization's reward system. Unfortunately, in many cases historical reward systems are still in place that actually reward behavior that hinders Category Management.

At most retailers, the Category Management departments that are in place today evolved out of traditional buying departments. The degree of evolution has varied from a simple change of titles to complete department restructuring, including a change of personnel to the type of individuals believed to be qualified to meet the challenges of Category Management. But while most retailers have changed the category manager's job functions, and possibly modified the category manager's incentive programs to reflect the goals of Category Management, they may not have made appropriate changes in the other areas that impact Category Management.

> *It is necessary to change the behavior of the entire organization to truly implement Category Management. And a key way of changing and influencing behavior is the organization's reward system.*

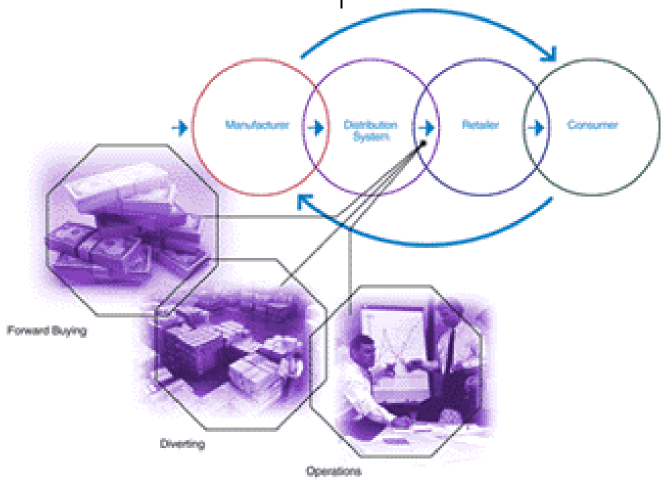
Before Category Management, there was often very limited reporting at the category level, and the buyers received a bonus based upon the company's overall performance and their division's performance. Today, however, it is increasingly common for category manager's compensation to be tied directly to the performance of their assigned categories. Typical critical areas of measurement are sales, gross margin dollars, market share and inventory turns. As a result, the category manager's bonuses often depend on achieving their budgeted category goals in the four areas above and GMROII (Gross Margin Return On Inventory Investment).

While the category manager position has been redefined, there are a number of additional job functions in the company that directly impact Category Management, yet the job descriptions and goals have often not been changed since the implementation of Category Management. Although it is true that most of these job functions report to or can be influenced by the category managers, as a practical matter, they just may not have the time to exert that influence.

According to a recent Grocery Marketing survey, the average retail category manager/buyer is responsible for just over 10 categories and 2,600 SKUs. They also feel that they do not have enough time to accomplish everything they have to do. When you realize that a category manager is responsible for all category activities, including pricing, selection, merchandising and promotion, it is not realistic to expect them to spend much time monitoring the activities of others that may impact the Category Management process.

Forward Buying

In most Category Management systems, there is a replenishment buyer who is responsible for maintaining warehouse inventory. The same position would have been in place prior to Category Management, and if their job function has not changed and they have not received any Category Management training, it is very likely that they are not focused on the correct issues when making ordering decisions.



In the past, their primary goals were likely to be 1) obtaining the lowest possible cost of goods and 2) maintaining high service levels and very low out-of-stocks. Buying additional inventory at the end of deal periods was seen as a good business practice and was considered to be a significant profit center. Their job performance was monitored by daily reports that measured out of stocks, warehouse service levels and missed buyout opportunities. Summarized versions of the reports were a key part of the performance appraisal process.

There are a number of conflicts between these goals and Category Management. The replenishment buyers are focused on the lowest cost of goods, and are encouraged to buyout on deals by the reporting process that identifies missed buys. While buying out on deals is not inherently bad, investment buying without all of the facts can be. If the true cost of holding inventory is not being properly evaluated, and it is typically understated, buyouts can actually be lowering profitability. The inappropriate buyouts also hurt the category manager's results on two key measures: inventory turns and GMROII. The same issue exists if there is an overemphasis on service levels without considering the cost of holding inventory. Turns and GMROII will again be lowered, since focusing exclusively on service levels will inevitably result in excess inventory.

While it is true that the replenishment buyers report to the category managers, the category managers simply do not have the time to supervise the daily reordering activities. A more appropriate and effective solution is to reward the replenishment buyers for focusing on achieving results that complement Category Management. The replenishment buyers should be trained in the basics of Category Management, given a system that accurately identifies the costs of holding inventory, and rewarded for helping the category managers reach their goal of maximizing return on investment.

Diverting

One of the most commonly mentioned roadblocks to building Category Management partnerships between retailers and manufacturers is diverting. Both sides seem willing to acknowledge that diverting is not a legitimate long-term strategic tool, and that it does nothing to build category sales or share, yet surprisingly diverting may actually be increasing. The previously mentioned Grocery Marketing survey reports that 59% of retailers said they purchased diverted product in 1994, an increase from 57% the year before.

> ***To be successful, Category Management cannot be the focus of only one part of an organization. All of the areas that impact the process must act in a way that enables, not hinders, Category Management.***

While there may be any number of reasons for an increase in diverting, misguided reward systems could again be an issue. Many retailers have separate departments that are in charge of buying and selling diverted product that were in place well before Category Management was implemented. Such a department often has a budgeted amount of product it must purchase which increases annually, with the bonus compensation of the members of the department tied to meeting the budget. While the category managers may have veto power over any outside purchases, remember that they barely have enough time to do their jobs, so approval may fall to the replenishment buyer. Diverter buys are typically approved if they are below the current direct cost by an arbitrary percentage, such as 4%.

This system is once again a remnant of the buying environment, and is inappropriate for Category Management in a number of ways. First of all, the diverter buyer is rewarded based upon the volume of product purchased. Such a system will obviously result in attempts to justify buying more diverted product, even when it may not be in the best interests of the organization. It is also not realistic to have the category managers approve all buys, which are typically presented many times a day and must be reacted to quickly. But deferring the approval to the replenishment buyer gets back to the same problem we had with buyouts: if they are focused on the lowest cost of goods, they will approve the buys without understanding all of the costs involved.

A threshold of a 4% cost savings is also too low. It is very likely that the promotional funds that are forfeited by not buying directly from the manufacturer would amount to more than 4% alone. All factors, including terms, pending deals and accrual rates for promotional funds should be considered before making a decision to buy diverted product. Buying diverted product without considering all of the tradeoffs can actually raise the final cost of goods and lower profitability. However, as long as the diverter group is judged solely on the volume of goods purchased, they will not be focused on making profitable decisions.

Under the current system, the diverter buyer is actually rewarded for making decisions that may be harmful to overall category performance. Buying diverted product also reduces the amount of promotional funding available for a category, which limits promotional activity and reduces sales. The system should be changed to reward the diverter buyer for making buying decisions that increase category profitability.

Operations

Store managers are often paid a bonus based upon their store's annual operating profit percentage. Since they typically have limited control over pricing and gross margins, they have two main areas of focus: controlling costs and reducing shrink. The largest controllable cost in a store is labor, so it is reduced at every opportunity. Pilferage is considered to be the main cause of shrink. The store managers may also control the display activity in their stores, and have the option of not ordering programs suggested by the category managers.

Unfortunately, both the emphasis on payroll control and shrink reduction can lead to decisions which hinder Category Management. Payroll that is too tightly controlled can lead to poor service, which can lead to sales declines. If store managers are not rewarded based on sales, a slight decline can have little or no effect on their bonus. A 2% decline in category sales can significantly impact a Category Management program.

A concern with payroll can also impact a store manager's decision on which promotional programs to support. Any program that requires substantial labor may be rejected, despite the fact that there may be the potential for substantial sales gains. Stores concerned with reducing labor often give the majority of their promotional space to DSD vendors, such as the beverage or chip companies, since they will build and maintain the displays. The fact that the margin on these DSD items is often low is not considered, since gross margin and sales are not part of the store manager's reward system. The lack of display activity for their categories can obviously have a serious impact on a category manager's results, however.

Similar problems are caused by an emphasis on shrink control. Since it is very difficult to actually stop pilferage, the solution is often to simply eliminate the opportunity. Items that are perceived to be high in shrink, such as batteries, film, pre-recorded video or some "high-retail" HBC items, are either not carried or locked up. Once again, the lost sales are not nearly as important to a store manager as the potential reduction in shrink. The lost sales can be significant, however. Items that have high pilferage rates also have high levels of consumer demand, which is of course the very thing that drives sales.

Once again, the store manager's reward system must be changed to encourage support of Category Management. Moving away from an emphasis on controlling shrink and payroll to a focus on balancing growing sales and profitability while controlling costs is necessary.

Summary

Buying out on deals, purchasing diverted product and carefully controlling costs are not always the wrong things to do, and in many cases may be the absolute right way to improve results. But each decision involves trade-offs, and if both sides of the equation are not considered, it is very likely that a bad decision will be made. Rewarding decisions that consider only part of the profitability equation encourages poor decision making.

> ***The store manager's emphasis on payroll control and shrink reduction can lead to decisions which hinder Category Management.[3]***

To be successful, Category Management cannot be the focus of only one part of an organization. All of the areas that impact the process must act in a way that enables, not hinders, Category Management. One of the first steps in making sure this happens in your organization is making sure you are rewarding behavior that leads to the results you desire.

Prior to joining DHC, Dan Graham was Director, Category Management at the Von's Company, Inc.
1 A version of this article appeared in the November 1997 issue of Supermarket Business.