GUIDE TO CREATING A

SKU RATIONALIZATION

STRATEGY THAT WORKS //

SKU rationalization may be a popular buzzword, but it is not something to be taken lightly. This report will delve into examples of strategies that have worked, and some that haven't. With a proper strategy, this process can be both beneficial for you as well as your customers.

QUANTUM RETAIL TECHNOLOGY

CREATING A SKU RATIONALIZATION STRATEGY THAT WORKS //

Right now is an extremely important time for retailers to optimize their assortments. This process can not only dramatically increase margin and sales, but can also help localize store-level assortments and increase the efficiency of your customer's shopping experience. When retailers offer too many choices, it can cause headaches for shoppers and supply chains alike, force unnecessary markdowns, require excessive inventory investments and ultimately will take a toll on margin.

However, going through this process can be a bit daunting and takes careful consideration on your part. Determining the proper breadth and depth of your assortment is not rocket science, but it is not something to take lightly. If you cut the wrong products, you could potentially lose some of your loyal customers if you are not careful.

But all retailers can benefit from going through the process to evaluate the performance of their products and stores. SKU reduction will help you create assortments that are easier to manage, more efficient and more profitable - this means less stock-outs of the products that are kept in the assortment (depth instead of breadth), tighter focus on product performance, and more flexibility in vendor-level considerations like tray size or pack size choices. Additionally, it can offer a better shopping experience for the customer who may otherwise be distracted by fringe products and the additional breadth allotted in the same space and make her more likely to find her preferred color in her size.

Carol Spieckerman, partner at New Market Builders Consulting Firm states, “It's happening across all of retail. Arguably, it's something that needed to happen." Brand extension - the practice of spinning off a new product category under an established brand name - was getting out of hand, Spieckerman said. “Retailers have found that by reducing the number of products, they can speed up shoppers' decision-making.” Wal-Mart, for example, found through its customer research, that the longer it takes to find an item, the greater the likelihood that item will be crossed off the shopper's list, Spieckerman said.

Steve Schildwachter, author of Ad Majorem states that in a recent interview with MediaPost, Stuart Taylor, VP of Customer Analytics for Nielsen, “highlighted the ease-of-shopping rationale, saying 60% of the retail chains they surveyed are doing it to reduce shopper confusion.” Research would seem to back him up. In comments to analysts last year, P&G’s then-CEO, A.G. Lafley, cited store tests where reduced assortment had no negative impact on sales or consumers’ sense of variety. In fact, he said, consumers believed they had *more* choices.

How is this process typically done?

Most retailers have some concept of store grade by merchandise category based on store sales performance or similar criteria. If grades are ranked from highest to lowest (e.g. A through G where A is the highest volume stores), then a product will be ranged to all grades between A and *x*. The choice of grade *x* is based on whether the product is core or is just meant to fill out the assortment - in which case it may only go to the top grades. When assessing overall product performance, a product should be removed from the assortment of grades where it is not meeting business expectations. Absent of a store grade concept, the same principal can apply to individual stores where the rate-of-sale of the product in the store can be used to determine whether it should still be assorted to that store.

What are the dangers of SKU rationalization?

If the decision to remove a product is made solely on that product's performance, you may be losing a product that helps drive the sales of associated products. Worse, you risk losing a key customer to competition and never regaining their business. It is important to know *who* is buying the products being removed and *what else* they buy.

Forgetting the market basket

In the latest edition of The Checkout, shoppers reported walking away from the shelf empty-handed due to price and limited product selection. The issue may be related to some retailers utilizing SKU rationalization methodologies that do not account for low-velocity items having "shopping basket gravity" – the pull some products have on other complementary products. Without a clear understanding of retailer-specific shopping patterns and basket drivers, the wrong SKUs may be cut leading shoppers to take their business for that entire category elsewhere.

Source: Shopper Culture

Lesson: Be careful about the products and product lines you cut. Look at transaction data to assess related products that were purchased with an item or line you are considering removing.

Cutting too much

Paula Rosenblum, Managing Partner at Retail Systems Research writes:

> First off – **our view of SKU rationalization: we believe is just the other side of the SKU proliferation pendulum**. I have often used the example of Tide. How many different scents of Tide do we really need? It starts to confuse me after a while.
>
> Sometimes, there is just too much stuff to choose from. Customers shut down, and leave. The assortment begs to be trimmed. But while Supervalu argues a more process-driven, science-based approach to SKU rationalization, others seem to just cut. **How many of us actually do market basket analysis when we decide to eliminate a SKU? How often do we actually ask the merchant how important an item is to the overall look of the merchandise assortment? How often do we find after the fact that we've just narrowed the assortment too much?**

Source: Retail Systems Research

Lesson: Avoid SKU proliferation, but do your research before you cut.

Losing customers

Steve Painter, Arkansas Democrat-Gazzette reports, in March, 2010 Bill Simon, executive vice president and chief operating officer for Walmart U.S., told retail analysts that the company was restoring about 300 products previously pulled from the company's shelves.

A Wal-Mart supercenter can have 100,000 or more SKUs. But Simon said the company found that removing certain slow-selling items had a disproportionate impact on sales.

He cited brown rice, not a big seller, as an example. The shopper who can't buy it at a Walmart store is likely to buy it - and the rest of her $80 shopping basket - at another store, Simon said. "We disappointed them by taking those [items] out, and we put them back in."

The vast majority of products Walmart pulled from its shelves, he said, were in fact, removed for the right reasons.

Source: All Business

Lesson: Retailers must assess what key items a few loyal shoppers may purchase. By removing one or two product lines from a category, rather than a specific item itself, retailers can avoid losing key customers.

How to avoid cutting items that top shoppers really want

Looking at transactional data (what items sold in the same transaction) or loyalty card information (which customers are associated with the sales of those items and what those customers have spent over the last year) are two means of addressing that question.

Retailers may also make choices about which products they plan to cut from their assortments by briefly discontinuing the product's replenishment. A good assessment of the choice can be made when a planner looks at how quickly the product stocked out and if any associated product sales slumped in the process. After this analysis, it should be fairly obvious whether or not the item should stay or be removed. Similar tests can be performed in a grouping of stores. Item performance can be analyzed in those stores and similar decisions can be made for like stores, especially those with similar item level performance and demographics.

When is a good time to rationalize SKUs?

For retailer's that have seasonality and have items brought in for each season, SKU rationalization should be done as part of pre-season planning. For long-living items, assortment decisions would be made at the start of the item's life that would then be tweaked after the item starts selling (but the bulk of the decisions would have been made upfront).

Which inventory should retailers focus on reducing?

SKU rationalization in many cases is more effective with longer-living merchandise because you can track an item's progress and make reasonable adjustments. With fast fashion, for example, it is more difficult (but not impossible) to base next season's SKU rationalization on the previous season when the previous season may have been impacted by the performance of particular styles.

When determining whether to add SKUs to or remove SKUs from an assortment, retailers should look at three major factors:

1. The relative value of each SKU in the assortment
2. The GMROI of the store itself (or cluster)
3. The local demand of each store – what shoppers are buying

The reductions or additions should be made in periodic intervals, perhaps weekly. This decision will look at these three factors and assess whether a planner should add one item to this cluster, remove two from another. It's not a once a year, twice a year process, it's constant. This is a big deal. Going through this process on a continuous basis will give visibility to product performance and the success of a reduced assortment.

Localization

It sounds like a no-brainer, but when supply chains become complex, retailers cannot keep up with store level demand and will send the same amounts of every product to similar store types. This is exactly why retailers need to perform SKU rationalization at the store level. Localization of store level assortments and order plans is proven to increase availability, full price sales and customer satisfaction. It is also proven to reduce overall inventory, wastage and markdowns which all erode margin.

Focusing on local store needs

Target is a great example of a store that personalizes its assortments for the local community. On July 25, 2010, the retailer opened its first Manhattan store, in Harlem. An obvious challenge from the get-go, Target aimed at appeasing the needs of that community with merchandise tailored to the neighborhood, including Spanish-language greeting cards, multicultural dolls, religious candles and renowned Southern food produced locally. It's a key step in the discounter's push into urban markets to fuel its growth.

Source: National Public Radio News

Retailer greed vs. consumer focus

When retailers neglect to focus on what shoppers are buying locally and think only in terms of cost savings across the chain, the effects can be detrimental. Schildwachter's observation is that retailers tend to focus less on consumer choices and more on which manufacturers will give them the best deals. Buyers know that if you tell four brands you are only going to accept two of them, you'll start a negotiation where at least one of the winners reduce prices.

The case for reducing confusion and streamlining store operations is a good one. If it's strictly financially-driven, however, it won't benefit anyone.

Product behavior

In order for retailers to target the right range of products on their shelves, they need an acute awareness of product behavior. There are dozens of product behaviors unique to every store. As well, product behaviors can be unique to customer segments. In order to analyze these behaviors, retailers should look at the performance of package size, brand, value, locality and demand as well as things like price points, life cycle, overstocks, under-stocks, amount of markdown, etc. What do these metrics tell you about your assortment of products? How do those metrics change across your stores? How do these products support your customer segmentation and brand strategies? Which stores have similar product behavior? What attributes do those products have in common? How often are you discounting those products? Retailers need to analyze their product behaviors in order to begin rationalizing their SKUs. But the complexity of this exercise can become time consuming when a supply chain is vast.

One of the first areas a retailer should look at to assess product behavior and performance is at the local level. What are customers asking for at which store? How does this differ across stores? What categories perform best at each store? Which perform worst? Where am I losing margin within my stores? Are those categories under or over assorted? By answering these questions, you can narrow down your categories and products to focus on your biggest problem areas. There are tools today that can automatically do this for you – but if you will be analyzing your stores manually, you may only be able to focus on clusters, rather than individual store category performance. In either case, you should focus this exercise on your lowest performing stores first.

Where to begin

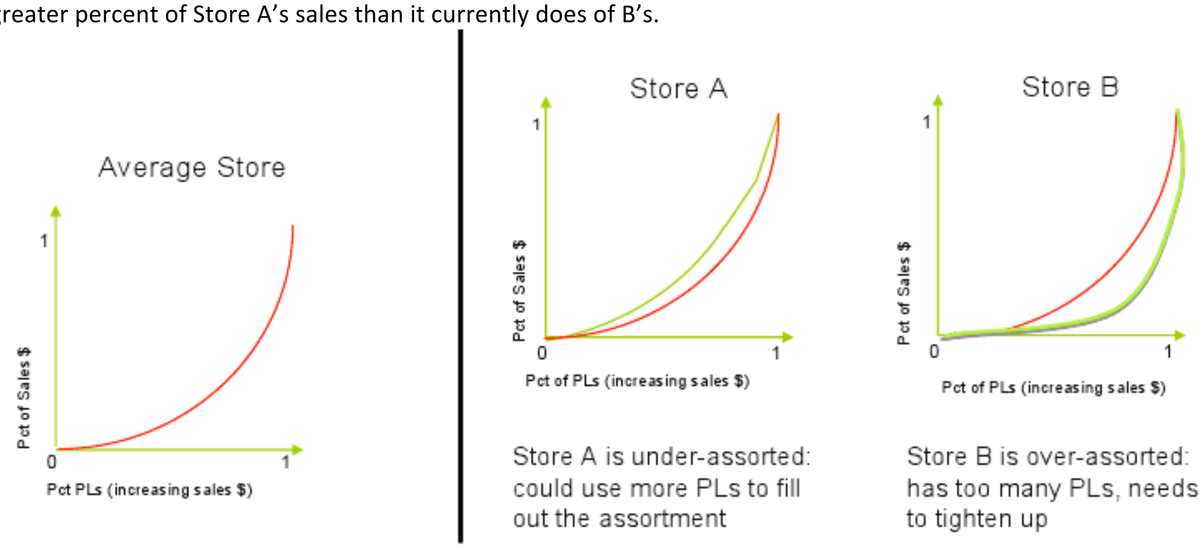
Your main question: What to send to which store for what reason?

The Top 3 things to consider when beginning the rationalization process:

1. The direct impact the SKU will have on the store's performance through it's sales contribution
2. The indirect impact the SKU will have (through halo/cannibalization, i.e. cross-item effects)
3. The hard-to-measure "image impact" - beyond actual dollars generated by the item or associated items, does the existence of the item in the store impact your customer's perception of your store

The science: Assessing sales disparity and GMROI

Suppose that for the average store, 20% of the sales come from 80% of the product lines (PLs). What happens as we move one (low sales $) product from B to A? Based on the disparity curves, that product will make up a greater percent of Store A's sales than it currently does of B's.



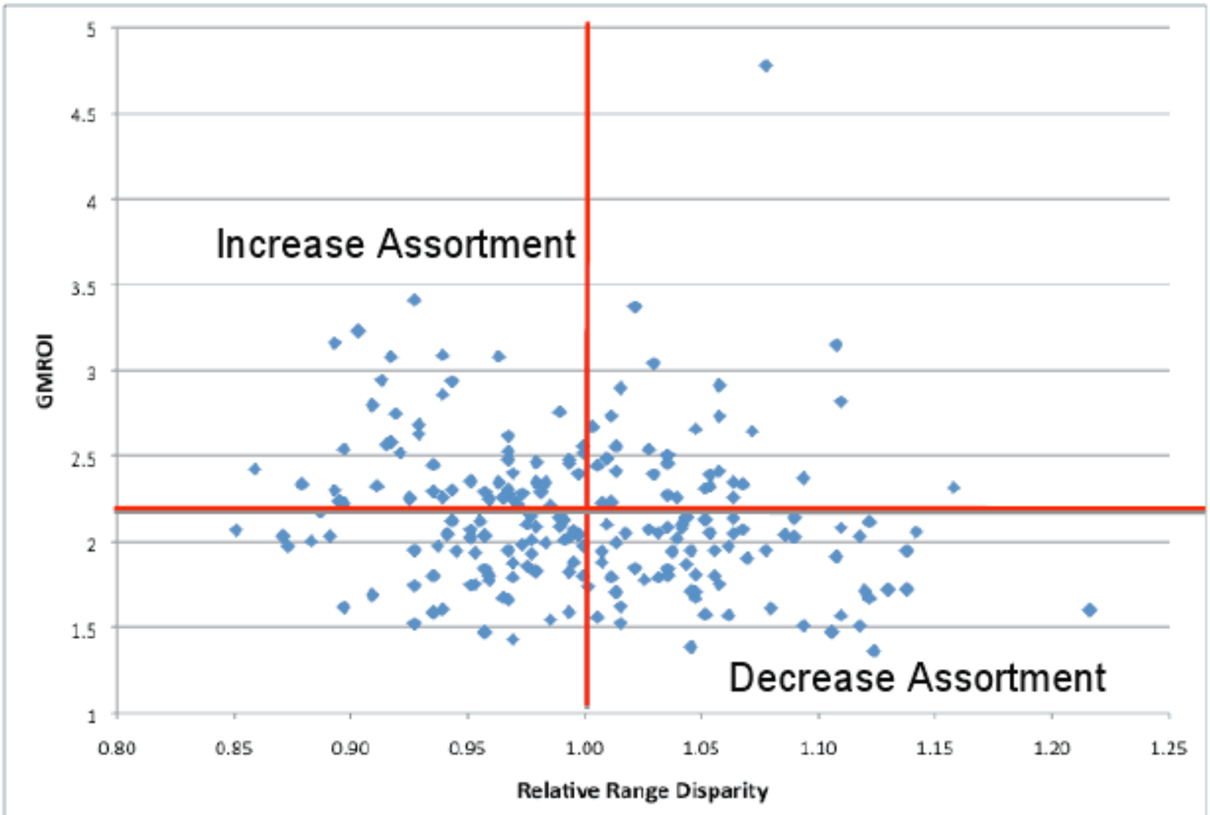
A low GMROI for a store does not imply a high disparity. It is possible that all products in the store are doing (equally) poorly, implying that we have low disparity. Likewise, a high disparity value does not necessarily imply low GMROI.

The cases of interest are where we have:

• High Disparity and low GMROI (opportunity to reduce assortment of low GMROI items)
• Low Disparity and high GMROI (opportunity to increase assortment in a location where items do well and have relatively equal contribution)

Disparity vs. GMROI Example:

The top left and bottom right quadrants represent areas of opportunity:



Alerts for Rationalizing

The relative disparity and profitability of a store for a merchandise/attribute area can be measured in terms of standard deviations from the mean.

- When the disparity is low and profits are high the assortment can be increased
- When the disparity is high and profit is low, the assortment should be decreased

What you should consider when looking for new capabilities

It is important to look for tools that will help you assess the profitability and success of each item at all of your stores. When retailers have a tool that can constantly and automatically monitor the success of their products and make recommendations on the breadth and depth of the assortment at each location, they will make the most of their time and quickly increase margin.

There are new technologies available today that can simplify this process and make it ongoing by creating a strategy for these attributes and applying it to all categories and stores.

In the complex task of SKU rationalization, planners and buyers need the assistance of smart technology that can give visibility to the performance of every product at every store. This kind of technology can quickly pay for itself as it optimizes your offering, reduces inventory and increases sales.

What to look for in assortment planning and SKU rationalization technology:

1. A system that continuously monitors business strategies, customer strategies, profitability, service levels and stock levels
2. Technology that utilizes the data it takes in to recommend the most profitable assortment for each store, across time while constantly taking customer demand into account
3. The ability to optimize SKU rationalization by recommending like-product attributes for new products
4. The ability to take in real-time data and automatically recommend inventory need based on local consumer behavior and store performance

Most software products focused on assortment give retailers the tools to assess item performance and to make removing or adding decisions. Quantum is going a step further by suggesting, by category/store, where ranges should be increased or decreased. The software will then quantify the specific assortment change recommended by suggesting *how many* items should be dropped or added to determine the final cluster assignment. The planner can then see the impact (a what-if) to sales/profitability/etc. when the SKU rationalization is changed. This gives retailers the tools to make intelligent decisions regarding the rationalization – while still leaving the choice in the retailer's hands.

When retailers optimize their product range based on local store demand, stock outs and customer behavior, they will quickly become more profitable and able to compete in today's retail market.

Learn more

Quantum Retail publishes a weekly blog, called "The Profit Lab" related to trends, news and best in class industry practices. To sign up click the link below.

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For more resources on assortment planning and SKU rationalization, visit:
http://quantumretail.com/solutions/assortment-range-planning/introduction/

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Our customers see valuable results in 8 to 12 weeks and our implementation approach gives your team access to the system from early on, so you can manage changes to your processes with ease. Quantum Retail continues to help all of its clients drive positive business value more rapidly than anything seen in retail.

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