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Retail

Advanced Category Management

How leading retailers are setting a new standard

By

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Many retailers have failed to recognize how weak their category management practices actually are. In the context of an increasingly tough retail environment, having weaknesses in such a core process is a serious handicap to a retailer's ability to be responsive to changing circumstances and to maintain sales growth and profitability. Oliver Wyman's in-depth interviews with 20 of the largest North American retailers reveal that a few are setting a new standard in category management, helping them to overcome these challenges. Creating a more effective category management system requires more disciplined and streamlined processes, a culture of analysis supported by the right tools, and an organizational model that supports category managers with the right expertise.

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Retailers vary widely in how they approach their core category management process, and in the outcomes that they see. In our work with many retailers over the years, we have observed that there are a few leaders that do things very differently to the average retailer, with much better results. Fascinated by the wide variation in category management practices, we have sought to analyze and quantify these differences and to answer the following questions:

- What are the most significant differences between the various approaches retailers use? Are these differences unique to the individual retailer or do they form part of a more general pattern?

- How important a role do these differences play in driving the success of the retailer?

- What can we learn from how the leading practitioners carry out category management?

- What are the implications for those firms that are not leaders? How should they set about upgrading their category management capabilities?

Survey Approach

In order to answer these questions, we interviewed the category managers of 20 of the largest North American retailers, including grocers, category killers, apparel chains, home improvement chains, department stores, and convenience stores. This survey is currently being extended to include large European retailers. It has four areas of focus:

- How retailers manage their overall category management processes, as well as how they manage each merchandising lever (i.e., the approach to pricing, promotions, assortment, etc.)

- The organizational, cultural, and behavioral context within which the category management process operates

- The degree to which the category management process is delivering high-quality and timely outcomes, and whether this is driving the overall success of the business

- The daily experience of the category managers and whether these processes enhance or diminish their job satisfaction

In September 2008, Oliver Wyman published a report (*Category Management Study, North American Retailers*—please contact us for a copy) which describes the detailed findings from our interviews. It covers many aspects of the category management process (data and systems, organizational structures and talent models, and process controls) as well as the approaches that different retailers take to managing each of the main merchandising levers (pricing, promotions and mark-downs, assortment and space allocation, private-label management, and supplier management).

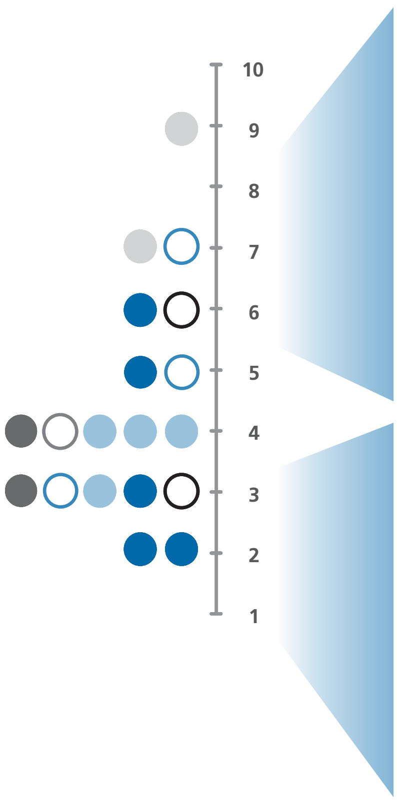
For each area, we describe the approach taken by a retailer with a relatively advanced capability and contrast it with the approach taken by a retailer with a more basic capability. We also score each of our interview subjects on a ten-point scale. This report brings to life the detailed differences in approach between the leaders and the rest. Exhibit 1 shows an example of the output from this phase of the study.

While the emphasis of our earlier report was on the detail of how each part of the process and each merchandising lever is managed, this white paper steps back to draw out the broader lessons. We will discuss some of the less obvious structural differences that allow a small number of retailers to stand out from the crowd.

Key Findings

Four main themes emerge from the study: first, category managers report a wide sense of frustration with their present processes; second, retailers show widely varying capabilities in category management; third, the level of sophistication of any individual retailer is fairly consistent across all its

Exhibit 1 **Capability scorecard—Promotions example**



Relatively advanced example

- Promotional analysis is done by a separate group
  - Full understanding of customer effects of promotions, including lift, switching, stockpiling, traffic and perceptual impacts
  - Ability to forecast expected incremental sales and margin contributions
  - Scenario modeling for discount optimization
- Promotional strategy is viewed as part of the overall category strategy
  - The company's overall strategic direction is a key driver of the ad-planning process
  - Promotions are viewed as one element of a total customer value proposition
  - Vendor funding does not drive promotional decisions
- Planning is done well in advance, ensuring that buys are appropriate

Basic example

- Promotion performance economics are incomplete, based mainly on item sales uplift
- Critical effects of promotions, such as brand switching, impact on total footfall, and stockpiling, often go unmeasured
- Promotional decisions are not customer-driven
  - Heavy focus on repeats of previous promotions to ensure comparable sales spikes
  - Vendors often drive promotional programs by offering funding
- Promotional planning process is disorganized
  - Ad space allocated quarterly by category, but subject to constant shifts
  - Last-minute changes in strategy lead to accumulation of unneeded inventory

Legend

Mass merchant, Category killers, Apparel, Convenience, Grocery, Home improvement, Department

Source: Oliver Wyman Category Management Study

merchandising levers; fourth, greater sophistication drives greater profitability.

A Wide Sense of Frustration

In many of our interviews, category managers communicated a palpable sense of frustration. In particular, many found their category management processes time-consuming and tedious, placing too heavy an emphasis on template-filling and data gathering. There were three common complaints:

First, many category managers feel they get little guidance from senior management about how their categories fit with the overall business strategy. The guidance they do receive suffers from being poorly communicated, poorly linked into their key performance indicators (KPIs), and insufficiently actionable.

Second, the category management processes allow insufficient time for them to think strategically about their categories. The work involved in gathering data, filling in templates, and working through the process delays any strategizing until the very end of the process. Many managers, in fact, feel their category management processes actually interfere with their ability to think strategically about the businesses they run.

Third, category managers feel they do not have the sort of high-quality support they need to help them generate high-quality outcomes. In many cases, they rely on vendors to provide them with data—and often this data is of dubious quality and objectivity.

Widely Varying Capabilities

The companies we surveyed show a wide range of capabilities. For each element of category management, we think of these varying levels of capability as part of an overall "capability staircase", with the higher steps representing more sophisticated approaches.

Most of the retailers we surveyed are still on the lower levels of this staircase and have relatively weak category management capabilities (Exhibit 2). Only a very few stand out from the crowd. They have built a significant and hard-to-close advantage over competitors. They are setting a new standard in category management.

Later in this paper we will discuss what differentiates the leaders from the rest and what retailers can do to "climb the staircase" and build their own next-generation category management capabilities.

Correlation Across Levers

We also find that, in general, the retailers with higher levels of capability have higher levels of capability across the board. That is, they are towards the top of the staircase in all the different aspects of their category management processes. We see very few examples of retailers that have outstanding strengths, for example, in their pricing capabilities, and yet have a more basic approach to other levers. The leaders show an institutional capability that permeates all aspects of a company's approach to category management.

Later we will discuss the role that leadership expectations, culture, and organization structure play in creating the foundations on which to build strong capabilities across all the different elements of category management.

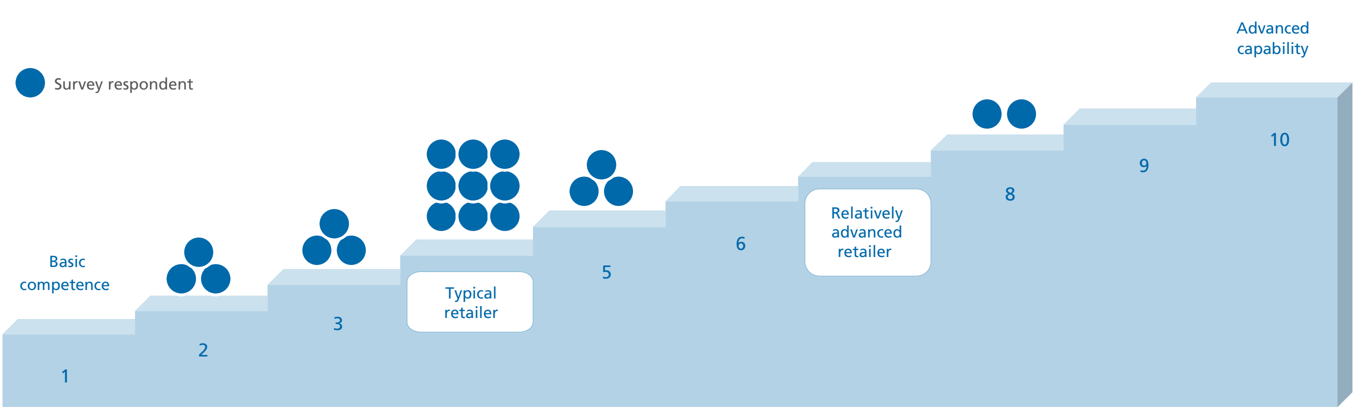
There are, of course, some exceptions. A few retailers do manage to reach a high standard on certain, but not all levers. Often, they are in the midst of upgrading their overall capabilities by improving one lever at a time. This lever-by-lever approach can be one way to successfully climb the staircase.

Higher Capabilities Drive Higher Profitability

As part of the study, we investigated the impact that a higher level of category management capability has on the overall performance of a retailer—clearly, the additional investment in building better capabilities only makes sense if it produces a greater return.

We use EBIT per square foot relative to each retailer's sector as our metric for performance.

Exhibit 2 **Overall category management capabilities—a staircase model**



Source: Oliver Wyman Category Management Study

This metric captures the company's ability to drive more traffic through its stores than competitors do, and to capture value from this traffic.

The power of a company's category management approach is far from being the only driver of performance. Nevertheless, there is a clear relationship between the capability scores and the performance of the retailers we analyzed (Exhibit 3).

These findings are validated by benchmarks from our past work with clients, which suggest that a comprehensive upgrade of all aspects of a retailer's category management processes can be worth between 250 and 650 basis points of profit improvement at constant sales; alternatively, the money can be reinvested to drive higher sales growth. As one would expect, better category management capabilities really do drive better economic performance.

Secrets of the Leaders

Three characteristics differentiate the leaders from the rest: They spend less time on their category management processes but are able to generate much better outcomes from the time they do spend on them. They place much more emphasis on using data and analysis to make better decisions. Finally, their superior capability does not exist in a vacuum, but derives from a different model of organizational and talent management.

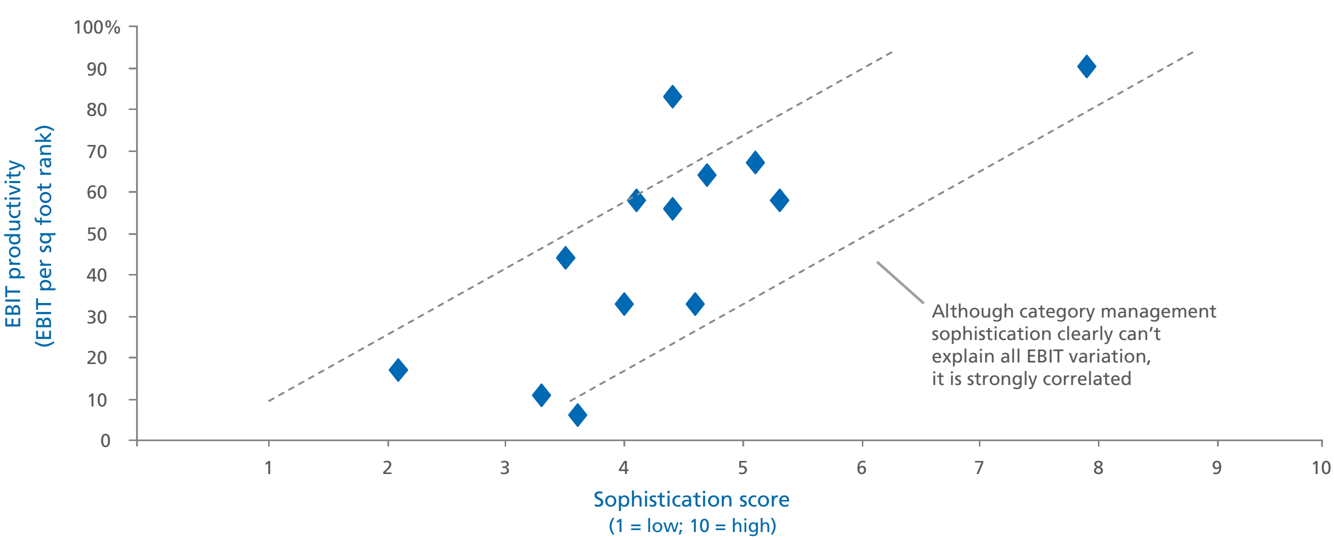
Less Time and Better Outcomes

Several characteristics ensure that the leaders' category management processes take less time and produce higher-quality outcomes:

More concise and focused: The leaders' category management processes are not multi-month affairs. Their processes are streamlined with less time spent on time-consuming and low-value data collection and template filling. This allows more time to be spent on forward-looking strategic planning.

A continuous process: Category management is not treated as an annual or biannual clean-up. It is an ongoing process, typically carried out every quarter, which involves constantly reviewing and refining the strategy. The outcomes of the process are measured and quickly fed back into the next iteration, so that there is continuous improvement. The category plan is a living document that is continuously updated, not left on a shelf for months at a time.

Exhibit 3 **Category management versus EBIT productivity**



Source: Oliver Wyman Category Management Study
Note: public data only available for 13 companies

Action-oriented: The outcome of the process is not a completed set of templates or reports. It is a set of actions that have implementation plans, KPIs, and measurement plans. Success and failure is defined up front, and the results feed back into the next iteration of the category plan. Category managers have the authority to execute their plans and are held accountable for their success.

A natural extension of company strategy: The goals of each category are spelled out as part of the company strategy. Category managers understand what is expected of them. Goals are specific, going beyond generic category roles, and include hard KPIs that are used to measure the fit with the company's strategy. Category plans are directly and explicitly linked in to the budgeting and forecasting processes.

Higher-Quality Decision-Making

The leaders have developed a "culture of analysis" in which there is an expectation that high-quality analysis will be used to support decision-making. These capabilities are built on three foundations:

Easy access to reliable data and analysis: The leaders have access to and make use of a wide range of different types of data, such as point-of-sale, customer, market, and competitor data. They link data together in an attempt to derive the fabled "single version of the truth", although this is not necessarily always achieved. Reports are distilled into their simplest and most actionable form and kept small in number. The emphasis is on producing genuine insight, not reams of numbers.

Better decision-support tools: Decision-support tools are used to support all significant merchandising decisions. They are customized to the needs of the individual organization and its processes and ensure that decision-making is both faster and more standardized.

Systems infrastructure as a source of competitive advantage: The leaders don't rely on "plain vanilla" or even "best-of-breed" systems, which in many cases are not good enough to reach the higher steps of the staircase. Instead, they invest in better systems as a source of competitive advantage.

A Different Organizational and Talent Model

The leaders put in place organizational structures that look very different to the standard models typical of the majority of retailers. They use a different hiring model and think about the category manager's role in a different manner. They have been successful in creating a learning organization that can deal with the complexity of the higher levels of the staircase. This makes continuous improvement possible.

Appropriate organization structures: The leaders have built centers of excellence for each of the major merchandising levers. These centers own the analytical approaches and the task of improving them over time. They advise the category managers as part of "virtual teams" that work together on building category plans.

Mixed talent models: The leaders don't rely on one source of talent for their category managers. They do bring people through the traditional retail route (from the stores and through the assistant buyer and buyer roles). However, they also look outside the organization to consumer packaged goods companies, direct MBA hires, and even ex-consultants and investment bankers. This combination of people with different backgrounds creates an environment that fosters a powerful combination of pragmatism and creative thinking.

What Should I Do About It?

This white paper may have stimulated some readers to ask themselves where their company's category management capabilities stand. Maybe they are starting to think about how a systematic plan to "climb the capability staircase" could help to drive higher sales growth and profitability. The idea of trying to develop an organization's capabilities can be a daunting one. The question for many will be where do they start?

They need, first of all, to be clear about *where* they are starting from. What are their current capabilities? How do they really compare to the leaders? How much time and energy goes into the process and how good are the outcomes? What is the case for change? How ready, willing, and able are their people to take on this challenge?

They also need a well-defined ambition. Are they looking to drive improved performance quickly? Are they trying to build better capabilities that can be a long-term growth engine? Are they trying to use improved category management as a way to help the company achieve a more fundamental repositioning of its entire customer offer? Do they want a growth story for investors that could encourage a re-rating? Or some combination of all of the above?

Finally, they need to decide on the right path for getting there. The truth is that there is no single way to approach the task of building their category management capabilities: There are as many paths as there are retailers. Some retailers will get there by walking up the staircase one step at a time; others may leap up three or four steps at a time. Nevertheless, there are commonalities among the different paths, and a few elements that will always need to be addressed:

Process and discipline: A disciplined process is a pre-requisite for any capability upgrade. Without discipline, there is no vector for improving capabilities. Category management improvements should also have clear links to the strategic planning process (so that category plans get built within the context of the overall company plan) as well as with the budget and forecasting processes (so that misalignments with the budget don't force category plans to be quickly abandoned).

Data, analysis, and tools: The value from a capability upgrade derives from making better use of data, adopting more sophisticated analytical approaches, and introducing tools that make the data and analysis more readily accessible. This will enable each of the thousands of decisions that category managers have to make daily to be made that much better and, if these improvements are well-designed, will also reduce the amount of time it takes to make each decision.

People and organization: Upgrading the company's processes and analytical sophistication may require making changes to the organization structure and talent model. The organization needs to be set up in a way that supports the new processes. The talent model needs to provide people who can thrive in a new and more demanding environment with increasing standards and evolving expectations.

The plan for a capability upgrade should seek to find the right approach to each of these three elements, balancing the construction of long-term capabilities and organizational structures with the need to quickly see financial results from the program.

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Oliver Wyman's survey shows that many retailers have relatively weak category management capabilities. These weaknesses cause plenty of frustration, especially for category managers. A few leading retailers stand out from the crowd, however. They not only exhibit a much higher level of capability but also show that building these capabilities becomes a significant driver of profitability.

The leaders differentiate themselves by putting in place more effective category management processes that require less time to operate and generate better outcomes. They build a culture of analysis and provide the tools and systems to support it. All of this is underpinned by an organizational and talent model that supports the retailer's ability to sustain higher levels of merchandising capability.

There is no single path to build stronger category management capabilities. Each retailer will have a different set of priorities and constraints. Nevertheless, the rewards are great. A sustained program to build category management capabilities can add significantly to sales and profit growth over the course of several years. ❖

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