After years of product proliferation, many retailers are looking to eliminate duplicative items and boost profits. Successful SKU rationalisation relies on identifying the products that are important to customers, and understanding the full financial and organisational implications of narrowing the assortment.

Retailers in all sectors are launching assortment rationalisation initiatives, and with good reason: the thousands of products added in recent years have generated plenty of cost, complexity, and confusion, but their sales and profit benefits have been less clear. It has reached a point where SKU rationalisation can offer significant gains: justified reductions of up to 30% of the assortment can yield upwards of a hundred basis points of margin improvement while preserving or even growing sales.

SKU rationalisation is based on a simple idea: every product takes up valuable shelf space and generates additional operating costs, and so every product needs to justify its presence in the assortment. If an item is important to customers – they aren’t prepared to buy an alternative and may even switch stores to find it – clearly it must be retained. Certain products also play a vital strategic role (being essential to the promotions program, for instance); others may be somewhat duplicative but have high margins. Items that meet none of these criteria should be de-listed.

The logic is clear enough, but applying it can be difficult because the information needed for making SKU rationalisation decisions is unclear, complex, or scattered throughout the business. Furthermore, narrowing the assortment requires active participation – and perhaps a change in mindset – from the merchandising department, creating an additional set of organisational challenges.

In our experience, there are four requirements for making SKU rationalisation a success:

1. Identify the items that are truly important to customers
2. Acknowledge the strategic role of certain products
3. Understand the true costs of complexity, and ensure that suppliers cover these costs
4. Recognise and address the organisational challenges involved

This paper examines each of these in turn.
1. IDENTIFY THE ITEMS THAT ARE TRULY IMPORTANT TO CUSTOMERS

Customers value choice, but only up to the point where new items are no more than brands, varieties, or pack sizes almost identical to other products. Those items with unique appeal generate significant incremental revenue; those without it don’t. Cut duplicate products, and customers will buy others within the category.

In the context of SKU rationalisation, ‘which products are important to customers?’ boils down to something much more specific: ‘if I take out a particular item, what proportion of its sales will I claw back elsewhere?’ Removing products frees up shelf space and reduces inventory and store labour costs, so a small decline in category sales can still be profitable. However, a loss of 2–3% will almost always worsen operational gearing and customer satisfaction enough to make SKU rationalisation counterproductive. Preserving the overwhelming majority of sales is critical. Doing this requires a thorough understanding of the ‘switchability’ of one product for another.

Buyers and category managers often take an intuitive, judgment-based view of switchability to predict the impact of removing an item. They then combine this with other data – margins, supplier funding, space allocations, and competitor assortment surveys, for instance – to draw up a list of candidates for de-listing. In reality, differences in switchability between SKUs are often both large and difficult to guess. Without accurate measurements it is possible to make costly mistakes. We have seen situations where buyers relying on a qualitative and intuitive view of switchability expected a group of de-listed products to be 80% switchable. They turned out to be only 60% or 40% switchable, making the sales loss two or three times what was anticipated.

The safest approach is to calculate ‘brand switching matrices’ to accurately predict what proportion of a de-listed product’s sales will be clawed back, which other products will benefit, and what the profit impact will be. Exhibit 1 shows an example for orange juice.
### EXHIBIT 1: BRAND SWITCHING MATRIX: ORANGE JUICE

<table>
<thead>
<tr>
<th>SWITCHABILITY: HOW MUCH OF TODAY’S SALES WOULD SWITCH INTO OTHER BRANDS?</th>
<th>LEADING NATIONAL BRAND</th>
<th>PRIVATE LABEL</th>
<th>PREMIUM BRAND 1</th>
<th>PREMIUM BRAND 2</th>
<th>SECOND NATIONAL BRAND</th>
<th>REGIONAL BRAND 1</th>
<th>ECONOMY BRAND 1</th>
</tr>
</thead>
<tbody>
<tr>
<td>LEADING NATIONAL BRAND</td>
<td>21%</td>
<td>10%</td>
<td>27%</td>
<td>34%</td>
<td>29%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>PRIVATE LABEL</td>
<td>66%</td>
<td>69%</td>
<td>7%</td>
<td>10%</td>
<td>13%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>PREMIUM BRAND 1</td>
<td>79%</td>
<td>78%</td>
<td>3%</td>
<td>12%</td>
<td>7%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>PREMIUM BRAND 2</td>
<td>85%</td>
<td>75%</td>
<td>9%</td>
<td>13%</td>
<td>0%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>SECOND NATIONAL BRAND</td>
<td>85%</td>
<td>73%</td>
<td>5%</td>
<td>6%</td>
<td>16%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>REGIONAL BRAND 1</td>
<td>86%</td>
<td>48%</td>
<td>21%</td>
<td>8%</td>
<td>11%</td>
<td>12%</td>
<td>0%</td>
</tr>
<tr>
<td>ECONOMY BRAND 1</td>
<td>91%</td>
<td>85%</td>
<td>0%</td>
<td>7%</td>
<td>4%</td>
<td>4%</td>
<td>0%</td>
</tr>
</tbody>
</table>

1. The Leading National Brand is truly differentiated in customers’ eyes, with low switchability into other brands. Of the sales that would switch, 10% would go to Private Label, 27% to Premium Brand 1, etc.

2. By contrast, the Second National Brand has much lower loyalty – possibly indicating current sales are driven by deep discount promotions.

3. Regional Brand 1 has very low loyalty as 86% of customers would switch.
Past customer behaviour is the key to producing such matrices, and there are a variety of ways to perform the necessary calculations. Loyalty card and other transaction-level data, such as credit card-linked sequences of transactions, are invaluable. An alternative is to use out-of-stock data as a series of tiny ‘SKU rationalisation trials’.

This can be supplemented by modelling based upon customer decision trees and detailed item attributes to plug the gaps where there is insufficient data.

Measuring switchability will also identify those products which are so strongly differentiated that removing them from the assortment will cause some customers to make additional trips to competitors’ stores. Few products inspire this degree of loyalty, but removing any of them is a costly mistake. Even if they have very poor margins, it is essential to keep them on the shelves to avoid sales losses across the rest of the store.

If carefully executed, SKU rationalisation can in many cases retain all the sales of the category – Exhibit 2 shows an example where this was achieved.

2. ACKNOWLEDGE THE STRATEGIC ROLE OF CERTAIN PRODUCTS

Besides being differentiated or unique in customers’ eyes, there are other reasons why certain products may be essential to a category. One example is the need to maintain a competitive promotions program or pricing architecture, another is the desire to develop the private label as a brand in itself. Such considerations represent ‘exceptions to the rule’, and can justify keeping particular products on the shelves even if they are highly substitutable.

Many retailers drive significant volume through promotional activity, often relying heavily upon a small number of products, and funding from suppliers can make this a profitable strategy even if most of the volume represents cannibalisation of other products. In addition, promotions are the single strongest driver of short-term sales changes. Year-on-year sales targets reflect established patterns of promotional activity and SKU rationalisation without this in mind risks both seriously weakening the promotions program and greatly reducing sales volumes and overall competitiveness.

Pricing architecture imposes additional constraints. A retailer’s need to provide a competitive assortment across all price points may require keeping some unproductive SKUs – at least until better replacements can be found. The desire to prevent unprofitable volume mix changes within the category can have similar implications.
Private label products may justify special treatment. After all, private label represents one of the few significant and sustainable ways a retailer can truly differentiate itself from its competitors. Having complete control over these products is valuable in itself. De-listing them obviously hampers a retailer’s efforts to grow private label volume.

3. UNDERSTAND THE TRUE COSTS OF COMPLEXITY, AND ENSURE THAT SUPPLIERS COVER THESE COSTS

Complexity has a cost. It is always difficult to measure as it is spread across different parts of the business, but it can strongly influence assortment decisions. Before SKU rationalisation can take place it is vital to be aware of all the diffuse financial effects of carrying additional products.

Understanding the true economics starts from a robust view of each product’s gross margin. This is usually straightforward to calculate, but not always: it may be the net result of a complex blend of bought-in costs, listing fees, and volume discounts, for instance. In the case of heavily-promoted items, buyers need to predict what will happen to promotional funding if these items are de-listed. Some of it will be lost, but a significant proportion may be switched to support other promotional items.
Of course, gross margin represents only part of the picture. Most of the costs of complexity are borne by other areas of the business – or by customers. Additional products increase operating costs both in the store and further up the supply chain, since replenishment practices and delivery schedules are heavily influenced by the number of items carried. Slow-moving SKUs languish in warehouses and on the shelves, increasing the amount of inventory in the business, with unfavourable implications for working capital.

Duplicative range hurts customer service in two important ways. First, additional items make the store more difficult to shop, meaning it takes customers longer to find the items they want. Second, taking facings away from fast-moving products leads to more out-of-stocks. The implication in both cases is that additional items can actually reduce customer choice.

Once all these factors are taken into account, it is clear that the economics of adding SKUs are very different for the retailer than for suppliers – one justification for charging suppliers a fee for carrying a product in the first place. If a new product duplicates existing ones, it might be very profitable for its manufacturer, but for the retailer it will probably add more to costs than to sales revenue. Exhibit 3 shows a typical example in which adding to the SKU count merely rearranges sales in the category, rather than growing them.

This is why SKU proliferation has been driven by suppliers rather than retailers. SKU rationalisation attempts to redress the balance by eliminating redundancy and unnecessary cost. It represents a temporary – but massive – strengthening of a retailer’s bargaining position.

**EXHIBIT 3: MOST NEW ITEMS REARRANGE SALES WITHOUT GROWING THE CATEGORY**

HOUSEHOLD PRODUCTS
UNIT SALES PER WEEK (K)

<table>
<thead>
<tr>
<th>WEEK</th>
<th>Added to assortment</th>
<th>Removed</th>
</tr>
</thead>
<tbody>
<tr>
<td>10</td>
<td></td>
<td></td>
</tr>
<tr>
<td>20</td>
<td></td>
<td></td>
</tr>
<tr>
<td>30</td>
<td></td>
<td></td>
</tr>
<tr>
<td>40</td>
<td></td>
<td></td>
</tr>
<tr>
<td>50</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

This vendor’s launch of 15 new SKUs grew the vendor’s share but not the category.
Making an explicit link between the negotiations process and assortment decisions gives suppliers the chance to offer better costs to avoid having their products de-listed. The size of the opportunity for the retailer should not be underestimated: an aggressive round of cost re-negotiation can produce profit gains that outweigh all the other benefits of SKU rationalisation combined. Case Study: SKU rationalisation and cost negotiations shows some examples of what can be achieved.

4. RECOGNISE AND ADDRESS THE ORGANISATIONAL CHALLENGES INVOLVED

SKU rationalisation requires commitment and active participation from the buying team. It’s important to acknowledge the challenge involved: removing 20–30% of an assortment that may have been stable for years represents a drastic change, with significant associated risks. Attempts to narrow the assortment in a heavy-handed, ‘top-down’ fashion are therefore likely to end up being ineffective, not to mention demoralising.

When cutting down the assortment, buyers and category managers face disincentives beyond just hard work and disruption. The fact that their period-by-period targets are based on the existing assortment is a significant obstacle that needs to be overcome. Senior management must acknowledge that the buyers bear almost all the costs, while other parts of the business reap many of the rewards of SKU rationalisation. For example, category managers may often suffer a decline in sales, while store operations will realise many of the efficiency savings. If targets are not adjusted accordingly, it’s not realistic to expect more than a half-hearted response from the buying teams.

It’s also important to appreciate that you don’t know in advance how many brands or items you should be looking to cut – because the buyers don’t know how substitutable different products are. The ‘right’ amount of SKU reduction will be the end result of thousands of independent decisions: some categories might end up with a 30% reduction in SKU count, and others none at all. This makes handing down across-the-board targets to the buyers a risky business.
CASE STUDY: SKU RATIONALISATION AND COST NEGOTIATIONS

SKU rationalisation can enable a retailer to negotiate significantly lower costs from its suppliers. These examples from US grocery illustrate the size of the opportunity and some of the tactics that can be used.

In the yoghurt category, one of the leading brands made an initial offer of cost reductions. The brand was a strong one – but when the retailer carried out the financial analysis, it was clear that even the new terms didn’t justify retaining most of the supplier’s SKUs. The two sides went back to the negotiating table, and in the end the supplier reduced cost by almost 18% to keep its products on the shelves.

In contrast, in the Preserves category, two national brands were pitted against one another. After they had submitted first-round cost proposals, it was clear that one supplier would see its products de-listed, leaving the other as the only national brand. One competitor offered a 6% reduction in net costs and won exclusivity in the category, while the other’s products were removed.

Many other categories also yielded significant cost reductions, see Exhibit 4.

EXHIBIT 4: RESULTS OF CATEGORY NEGOTIATION ON COST OF GOODS SOLD

<table>
<thead>
<tr>
<th>CATEGORY</th>
<th>NET COGS REDUCTION</th>
</tr>
</thead>
<tbody>
<tr>
<td>Yoghurt</td>
<td>18%</td>
</tr>
<tr>
<td>Flour</td>
<td>15%</td>
</tr>
<tr>
<td>Cooking oil</td>
<td>7%</td>
</tr>
<tr>
<td>Preserves</td>
<td>6%</td>
</tr>
<tr>
<td>Salad dressing</td>
<td>6%</td>
</tr>
<tr>
<td>Cereal</td>
<td>5%</td>
</tr>
<tr>
<td>Batteries</td>
<td>4%</td>
</tr>
<tr>
<td>Cocoa</td>
<td>2%</td>
</tr>
</tbody>
</table>

If this sounds like a tough approach, it’s important to remember that suppliers whose products are truly differentiated have nothing to fear. They stand to gain from SKU rationalisation, since they will pick up sales when other, duplicative products are removed. In the end, the losers from this process will be those suppliers whose products don’t cover the true cost of the shelf space they occupy.
CLOSING REMARKS

SKU rationalisation represents a huge opportunity for a retailer. As we’ve described in this paper, getting it right begins with understanding which products are important to customers: eliminate even a handful of products with unique appeal, and the whole process risks being a disaster. On the other hand, even some duplicative products may be worth keeping due to their broader strategic role.

In addition, the true cost of complexity needs to be understood, and form the foundation of a round of aggressive cost negotiations with suppliers. And finally, due consideration needs to be given to the organisational challenges involved.

Successful SKU rationalisation takes smart analysis and hard bargaining, but it takes more besides. A holistic, comprehensive approach will produce the best possible overall result: higher profits, higher sales, more satisfied customers, a stronger long-term competitive position, and an engaged and motivated buying department.
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