

BALANCING SALES AND COSTS WITH THE OPTIMUM LEVEL OF ASSORTMENT DIFFERENTIATION

WHITE PAPER

Introduction

THERE ARE a number of trends currently faced by retailers that are putting them under a lot of pressure:

- 1. Consumers are more price-aware than ever.**
They're benefitting from better information. Price comparisons are ever easier to make. Pressures on household budgets are growing and that's driving increased competition in many markets, in particular from limited assortment discounters (LADs) in grocery (such as Aldi and LIDL), and from low-overhead e-commerce businesses in many general merchandise sectors.
- 2. Consumers have always valued personalized service,** wanting to be presented with their preferred assortment, and they like their dealings with their chosen retailers to be easy and stress free. But the more retailers fight for their business the more confidently consumers are demanding these things.
- 3. Consumer loyalty is getting harder to secure.**
Previous generations often identified strongly with a particular brand; for instance choosing to make a statement about their status through their choice of supermarket. However, today's consumers might choose to buy staples from a LAD (dried pasta, tinned tomatoes, bagged salad for instance) and

more specialized items (e.g. sourdough bread, pine kernels, monkfish) from a traditional grocery store.

In the grocery sector most retailers are working to raise their game to stop the rise of the LADs. Many grocers are responding with a drive towards 'customer centricity' – and leveraging their ability to craft assortments at individual-store level to best retain the loyalty of customers shopping in each particular outlet. However, as the same competitors are continuing to squeeze prices it's vital to remain cost effective at the same time.

The primary tactic when it comes to assortment management is to identify those parts of the assortment that can be kept as tight and centrally managed as possible with a minimum impact on sales. At the same time the categories where selection has the biggest impact on consumer perception and behavior are used to create customer focused assortment differentiation. The retailer's overall strategy remains paramount.

Finding the optimum balance between that tight core and customer-centric differentiation is a critical task. To make it clearer how this optimum can be arrived at we need to examine the benefits of a centralized assortment and of a customer focused store-specific assortment more closely.

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The benefits of a centralized assortment

CENTRALIZED ASSORTMENT – in other words carrying the same range of products in every store – is an important driver of sourcing and supply chain economics. A large retailer with more than a thousand stores yields much more power in its purchasing negotiations when it can leverage the options of either having the product in a thousand stores or none. This has been a major incentive to build central assortments.

Moreover, a dense centralized assortment is very effective at driving down supply chain costs. For example, having five variants of what is essentially the same product can more than double DC inventory due to the extra safety stock needed to ensure availability for distribution. More variety also means more warehouse picking locations, leads to lower volumes per product and thus increases supply chain handling and space costs. Variety means more capital is tied up in stock while supply chain operations are far less cost effective.

So operating a totally centralized assortment allows a retailer to seek the lowest possible cost base. Then if the retailer prices items at standard market levels the centralized assortment delivers the highest, fully-cost-loaded product margin. Cluster-level assortment, where stores are clustered by consumer demographic and demand characteristics and where the assortment is varied accordingly, falls in the midpoint of the cost/margin range, as per the picture below.

So it is clear that offering a central assortment,

modified potentially only by store size to increase assortment variety within larger stores, is the most cost effective mode of operating for a retailer. However, it is also a market in which the LADs are hard to beat—they operate tight ranges where SKUs are numbered in hundreds rather than thousands and buy and sell them in huge volumes.

Furthermore, most retailers want to understand and serve their customers better and offer them the products they really want – i.e. they want to build a more ‘customer centric’ assortment.

The benefit of customer centricity

THE BIGGEST CONCRETE benefits of a more customer-centric assortment are increased sales and sales margins. The increased sales are normally a consequence of consumers being more likely to buy products from a range that is matched directly to their tastes, requirements and needs. In the longer term an additional benefit is increased customer loyalty as they perceive stores to be more convenient and pleasant to shop in because of the carefully tailored assortment.

So when assortment differentiation is increased ‘intelligently’ the resulting dynamic is that sales and sales margins increase. By ‘intelligent assortment differentiation’ we mean adjusting the assortment offered in a store to meet the requirements of the consumers shopping in that store whereby the differentiation is data and insight driven, not the result of guesswork. The first step towards intelligent differentiation is clustering

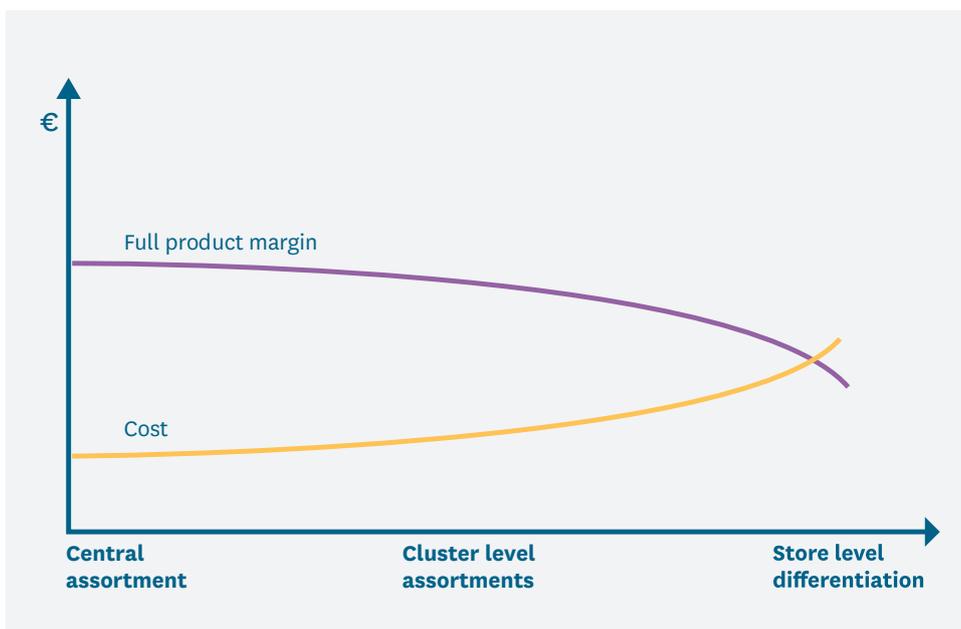


Figure 1.
Centralized assortment delivers the highest, fully-cost-loaded product margin

stores based on the similarities between the demand characteristics experienced by each – grouping stores based on how customers want to shop in them. This makes it possible to build assortments that fit each store very well, but by applying them to larger groups of stores with similar profiles it allows some of the efficiencies of scale associated with central assortment (i.e. parlaying volume for discounts from suppliers) Many retailers have increased sales by 2 to 4% through intelligent assortment differentiation without the need to build store-level assortments.

The effect on sales of different assortment options is illustrated below.

The optimal point of assortment differentiation

THE POINT WHERE profits are maximized is reached when the increasing costs of differentiation start to outweigh the impact of increased sales margins that would be achieved through further differentiation. The zone marked out in red indicates the degree of assortment differentiation, a sustainable position balancing low costs with great customer-focused service, which yields the most profit for the retailer.

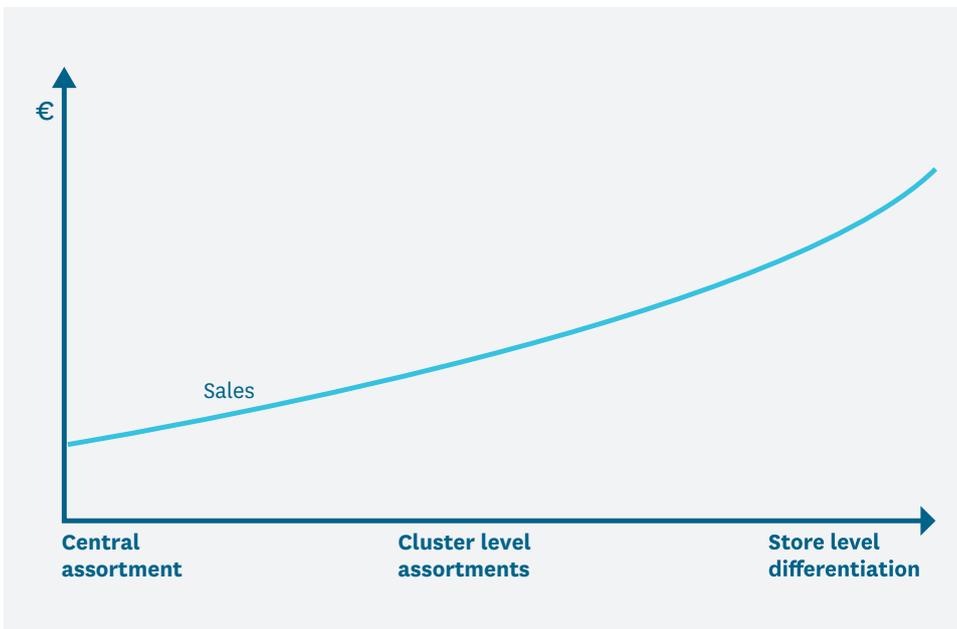


Figure 2.
The effect on sales of different assortment options is illustrated

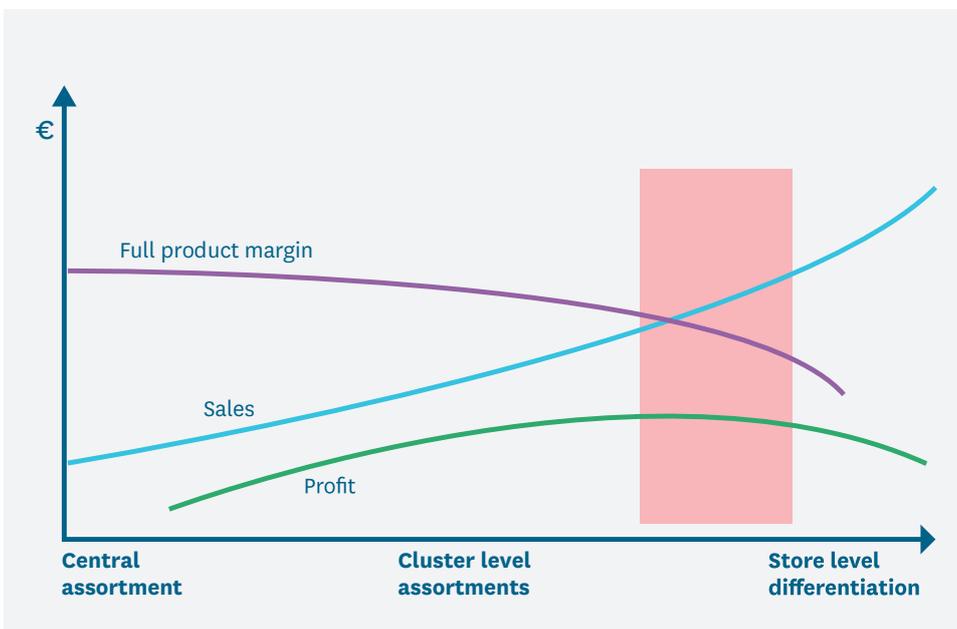


Figure 3.
The optimal point of assortment differentiation

The optimal differentiation level

THE OPTIMAL POINT of differentiation varies considerably from category to category and is mainly driven by three category characteristics:

- ▶ The category relevance to a store’s regular shoppers
- ▶ The strategic importance of the category to the retailer
- ▶ The ratio of costs in stores to costs elsewhere in the supply chain

Normally the more variation there is in consumer preferences within a particular category the more it pays to differentiate.

Another major factor is waste, as an assortment tailored more tightly to the demand of the store’s natural customers makes it easier to maintain high availability while minimizing spoilage. Keeping products that no-one wants to buy on the shelves just for the sake of availability always pushes up spoilage.

Store-level assortments are normally relevant only for fresh product categories with a high risk of spoilage and for those categories where the retailer wants to be recognized for having an excellent assortment, i.e. as part of its differentiation strategy. The chain-level (central) assortment is most suitable for categories

like batteries, cards, toilet rolls etc. At the other end of the scale demand for ready meals, for instance, varies considerably from store to store influenced by location and demographics. The illustration below shows typical differentiation levels by category.

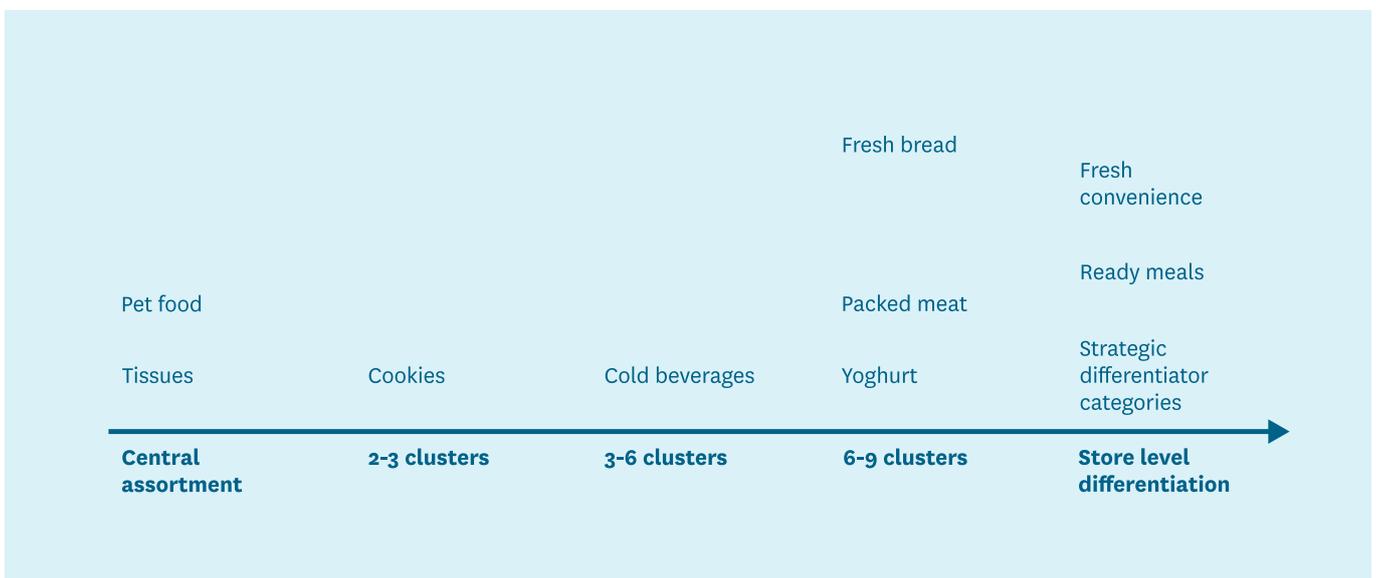
Conclusions

RETAILERS ARE CURRENTLY facing competing pressures: to provide more customer choice and to lower prices. From the point of view of assortment management, the best response is to identify the right assortment-differentiation level for each category offered by the retailer – and ensure the possibility of implementing it with intelligent clustering capabilities and ability to drive assortment differentiation from zero to store level.

At RELEX and Galleria we have years of experience building quick to implement solutions that create highly accurate assortment recommendations for every category. The assortments are built and tailored to the space and demand profiles of each store.

Assortment optimization can be so effective that a pilot, in selected stores, can clearly demonstrate its potential to improve footfall, customer loyalty and sales.

Figure 4.
The typical differentiation levels by product category





HOW TO PROCEED?

Contact me

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Let's meet!

An hour's meeting is enough to go through your company's current situation and to define the first steps!

RELEX SOLUTIONS IS ONE OF THE WORLD'S FASTEST-GROWING PROVIDERS of integrated retail and supply chain planning solutions. RELEX offers In-Memory-powered demand forecasting, inventory optimization and replenishment automation as well as consumer-focused automated category optimization, space and assortment planning.

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