

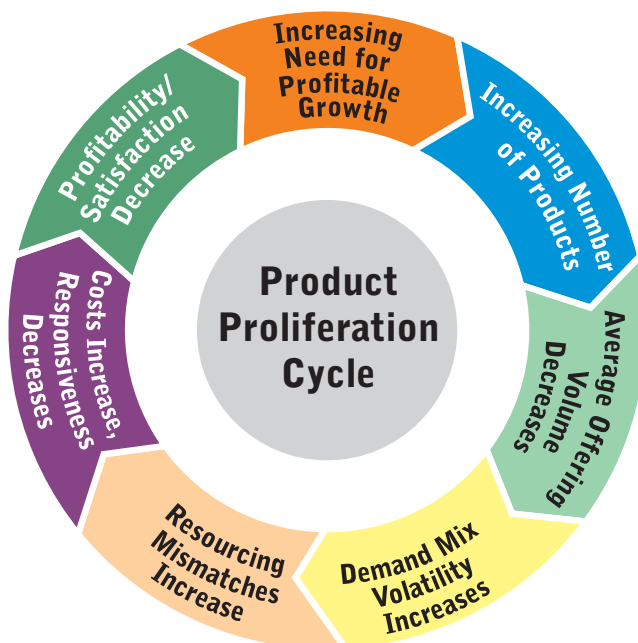


SKU Rationalization

Introduction

The primary reason for rationalizing stock keeping units (SKUs) in any business is the complications that arises from a burgeoning product portfolio. The quest for a long-lasting profit margin can induce a company to increase the number of products it offers, which results in a suboptimal product portfolio. This situation calls for a complete restructuring of the existing product line, which allows companies to identify irrelevant commodities. An increase in the complexity of the supply chain increases the overall cost per unit delivered.

Complexity Reduction: The Product Proliferation Cycle



Why Rationalize SKUs?

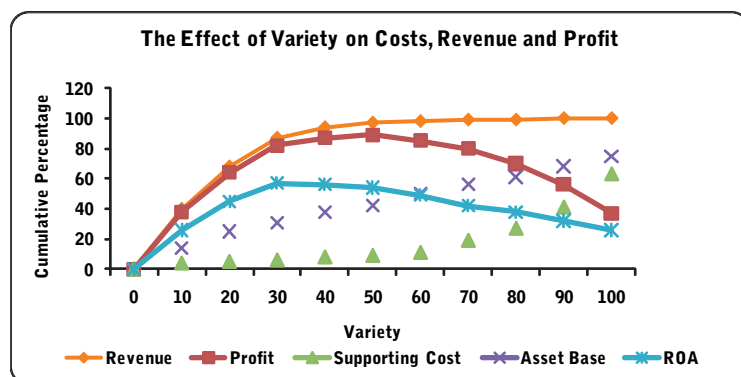
SKU rationalization is a process used to determine the benefit of adding, retaining, or deleting products. A company should identify the profitability of its products and the negative impact of maintaining a complex product line on its business. SKU rationalization helps companies identify the increase in the share of the profits earned with SKUs that add value. It also helps them reduce the impact of SKUs that increase costs.

The following parameters are affected by SKU rationalization:

- ▶ Overall Discount
- ▶ Logistics Cost
- ▶ Warehouse/Inventory Charges
- ▶ Yearly Planning Process

Some of the hidden cost drivers of a non-profitable product mix are:

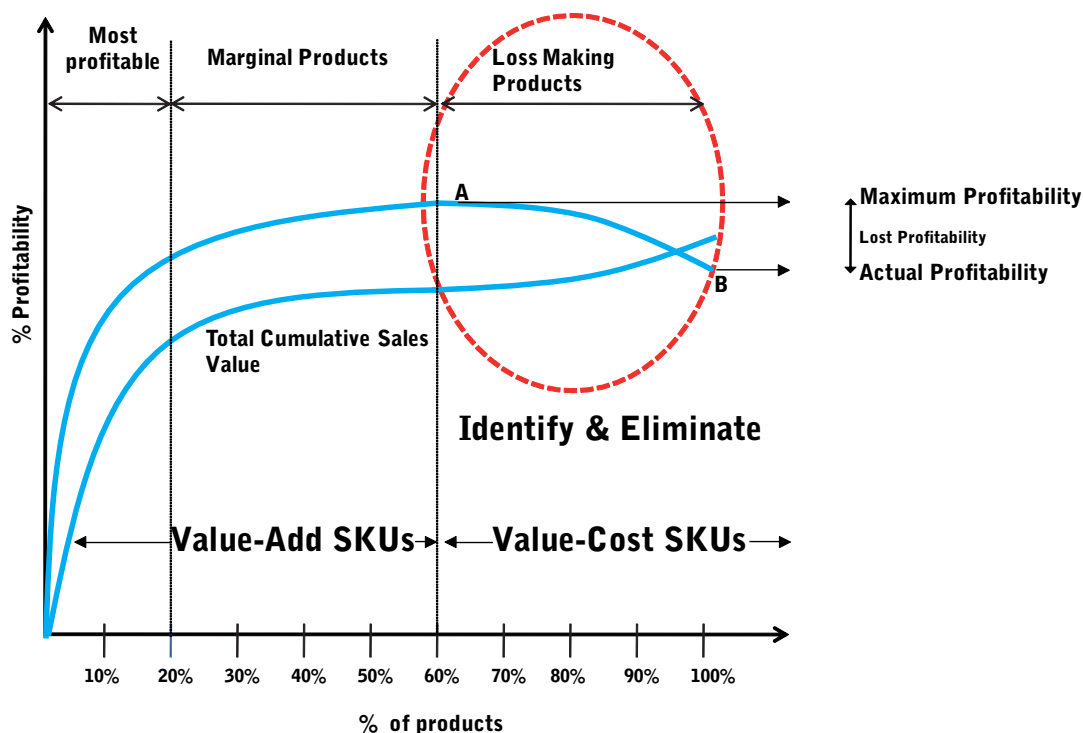
- ▶ Expedited Orders
- ▶ Irregular Changes in Inventory
- ▶ Typical Size of Orders Placed
- ▶ Invoice Checking
- ▶ Forecast Accuracy



The graph shows that as the number of SKUs increases, the revenue tends to increase marginally and then becomes constant at a certain level of variety. The decrease in the profit margin reflects the effect of increasing support and transaction costs. The return on asset (ROA) decreases when the number of SKUs increases.



The following graph depicts the dynamics of SKU rationalization.



- ▶ Value-Add SKUs: These products and services have a positive net margin.
- ▶ Value-Cost SKUs: These products and services have a negative net margin when all associated expenses are compared.
- ▶ Maximum Profitability (A): The maximum profit that can be achieved from value-add SKUs.
- ▶ Actual Profitability (B): The margin achieved without SKU rationalization.

Key Takeaway: The highlighted area in the graph is the region of concern. When increasing the product mix, the revenue of that product category increases, but the net profit margin decreases. Hence, identifying and eliminating irrelevant products is highly critical.

How to Rationalize SKUs ?

Rationalization

Identify separate information pool systems and consolidate them into a single system for easy tracking.

Analyze the cost drivers of each SKU.

Post Rationalization

Assort and manage the product directory, which requires frequent updates.

Create checkpoints within the organization. For example, a committee can be created that approves every additional SKU after reviewing the business case presented by the requestor.

Rejected products need to be re-evaluated for further action (such as merge, sell, milk, or kill).

Ongoing

Renegotiate the contract terms for non-profitable products.

Conduct market research and analyze financial data for the delisted product lines. This data can be reviewed to confirm the effectiveness of the rationalization process.

Strategic planning of the product portfolio boosts profit margins.

Freed resources can be reallocated to the remaining products.

SKU Rationalization Case Studies:

Some of the problems faced by major companies due to a complex product portfolio are listed below.

Problem	Solution	Result
<p>A major European food manufacturing giant had problems dealing with waste caused by their complex product mix. As a part of their annual cycle, they reviewed their product portfolio from a financial, commercial and supply chain perspective to identify the products/SKUs that generate above average levels of waste and add the least value.</p>	<p>Financial: The company's product portfolio was divided into several categories. The revenue and profit of each category was compared to the company's profit margin.</p> <p>Commercial: The company gathered market intelligence on the products and studied its customers' buying behavior.</p> <p>Supply Chain/Production: The company evaluated the in-built complexity of its products and factors that affected irrelevant goods, which can lead to obsolete stocks.</p>	<p>Similar product categories were combined to reduce waste. SKU rationalization improved the company's overall profitability and convinced the commercial team that SKU rationalization is the optimal approach to enhance profitability.</p> <p>The company's SKU portfolio reduced by 15% and waste reduced by 20%. As a result, its stock holdings and the complexity of its product portfolio reduced, which in turn increased its overall profitability.</p>
<p>A manufacturer of medical products with over \$190 million in revenue had a complex product line of approximately 380 different varieties of high-value SKUs. It was unable to quantify the effect of each variety on its revenue.</p>	<p>The company simplified its product line from 380 to 75 of the highest value-add SKUs. As a result, the company could:</p> <ul style="list-style-type: none"> i) Reduce its raw material expenses, ii) Decrease manufacturing expenses due to simplified scheduling, iii) Decrease distribution expenses by increasing the interchangeability of customer orders, and iv) Control maintenance expenses. 	<p>The company recorded a 14% increase in its net income annually, while maintaining the same sales level.</p>
<p>A transportation manufacturer had 34 varieties of a product that generated around \$150 million annually. Certain varieties had a major impact on sales compared to other varieties. Hence, the company needed to identify the reason behind this disparity.</p>	<p>The company launched a customer study that revealed that there was a split in its sales. One group of SKUs required fewer parts and provided 80% of the company's sales; the other group required more parts and only provided 20% of sales. The second group also had higher inventory levels, as it required more parts.</p> <p>The company's customers were not concerned about the varieties in the 20% group and were willing to substitute them with varieties in the 80% group.</p>	<p>By letting go of \$3 million in revenue (2% of the total) due to lost sales, the company gained \$9 million in working capital from reduced inventory investment. It witnessed a \$5.5 million increase in the net profit as a result of its simplified product mix, supply, and engineering functions.</p>



Sources:
www.kginc.com
www.igd.com
www.keystonegroup.com
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