

Retail Vendor Profitability

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How profitable are our products? How profitable are our stores? Analyzing supermarket profitability is quite different than in other businesses. Supplier profitability is more important than customer profitability. Margins in this industry are extremely thin and have to do a lot on how we negotiate with our suppliers. As important as price is to the negotiations, terms and conditions of delivery, payment and promotion expense are just as important.

The number of products available in the median average size supermarket hovers at around 22,000 with approximately 1,500 new products (or reformulations) entering the market every year. Yet, almost a quarter of the products in a typical supermarket sell fewer than one unit a month and just 8% of all personal-care and household products account for 85% of sales. What is needed is a tool to understand which products account for the bulk of supermarket profit and a method of analyzing suppliers to understand which suppliers are profitable for the organization.



The best tool to help understand the economics of retail supermarkets is Activity Based Costing (ABC). ABC provides information for profitability analysis by supplier, product groupings (family, category etc.) and by channel (stores, delivery, internet, etc). In addition, the ABC analysis provides activity and process information that will guide us in our best practice; supply chain and other initiatives.

When looking at Supermarket profitability we first need to change our conventional mind set. Traditionally, customer purchasing behaviors as well as product costs help determine profitability. In the case of Supermarkets, profit still comes from the price provided by our suppliers less the cost to serve them, less our operating expenses and customer serving costs

however we see our customers as one (General public) served through the different channels. Costs objects or main differentiators of profit are our suppliers, products grouped by family or category. Customer purchasing behavior (except for the channel used) has little bearing on store profitability.

Supplier Analysis

The ability to negotiate with our suppliers knowing the costs involved in dealing with them is very important. We need to identify the activities performed to deal with our suppliers. If supplier A and B offer the same product at a similar price, with supplier A using EDI, and guaranteeing delivery of product in 6 hours, while supplier B guarantees deliveries only twice

a week and doesn't use EDI it would seem logical to assume that supplier B will be more costly to deal with. Identifying the activities we perform because of our different suppliers, it's implication on cost as well as the measure we use are key for managing the supply chain.

Profitability will be influenced by how efficiently we deal with our suppliers and by our capability to attract customers to our stores.

Store Profitability

When one enters a store they will notice that it is divided into groups of products - for example household cleaning products, cold cut meats, dairy products etc. Most of these are grouped into what we call product categories. These categories are organized in a way to manage consumer traffic and influence purchasing decisions by the customer.

Stores often offer discounts in certain areas to promote sales of those products, as well as to generate traffic and get consumers to buy products throughout the store while getting to the promotions and discounts. We found one store offering discounts on a specific good in order to generate traffic throughout the entire home appliances section, however consumers in this demographic were found to be very price sensitive for home appliances. The discounted product was selling well, however other home appliances were not. The ABC analysis found that the good placed on discount to generate traffic was marginally covering its direct costs but nothing more and the ABC analysis showed this product losing money. The worst part was that the goods it was supposed to promote sales of were also losing money. This business is highly dynamic and product profitability needs to be tightly monitored. Managing the store layout based on category profitability is essential.

With Activity Based Costing all costs and activities associated to each product and service will be identified, and so we can determine the real profitability of each item, service or category.

Sales revenue alone is an insufficient indicator of profitability. Averaging individual product or service costs over the entire product line makes it difficult to see which products are leaders or losers.

Area		S 1	S 2	S 3	S 4	S 5	S 6	S n	Total
Gen. merchandize	Ingreso	13,024	16,002	19,191	14,094	14,037	8,014	7,051	91,413
	Margen	1,541	1,634	2,516	1,681	1,699	1,241	946	11,258
	%	12%	10%	13%	12%	12%	15%	13%	12%
Meat	Ingresos	1,429	1,258	1,955	1,009	1,380	930	834	8,795
	Margen	40	45	-17	62	20	39	-46	143
	%	3%	4%	-1%	6%	1%	4%	-6%	2%
Preparados	Ingresos	480	262	163	116	112	128	86	1,347
	Margen	105	87	50	21	28	28	27	346
	%	22%	33%	31%	18%	25%	22%	31%	26%
Candies	Ingresos	466	714	486	872	505	310	414	3,767
	Margen	60	92	23	103	55	55	38	426
	%	13%	13%	5%	12%	11%	18%	9%	11%
Cold Cuts	Ingresos	773	860	1,169	735	880	541	572	5,530
	Margen	130	134	203	136	145	89	95	932
	%	17%	16%	17%	19%	16%	16%	17%	17%
Vegetables	Ingresos	2,579	1,970	3,123	1,913	1,875	1,198	1,350	14,008
	Margen	102	63	98	52	-18	112	119	528
	%	4%	3%	3%	3%	-1%	9%	9%	4%
Dairy	Ingresos	1,570	1,539	2,520	1,406	1,610	1,310	1,530	11,485
	Margen	240	243	434	223	277	280	338	2,035
	%	15%	16%	17%	16%	17%	21%	22%	18%
Bakery	Ingresos	220	383	320	368	274	64	120	1,749
	Margen	48	152	114	117	92	14	33	570
	%	22%	40%	36%	32%	34%	22%	28%	33%
Poultry	Ingresos	1,088	957	2,244	785	1,327	922	834	8,157
	Margen	194	118	383	72	170	190	280	1,407
	%	18%	12%	17%	9%	13%	21%	34%	17%
Total Ingresos		21,629	23,945	31,171	21,298	22,000	13,417	12,791	146,251
Margin		2,460	2,568	3,804	2,467	2,468	2,048	1,830	17,645
%		11%	11%	12%	12%	11%	15%	14%	12%

All products have to be analyzed - no product is immune from scrutiny. Even products that generate a high market share may actually be putting a profit drain on the company. As per the example above, a store may be under the impression that costs for a particular product are relatively low, so set prices below those of competition and gain market share, but they are losing money with each item sold. Correct costing (using ABC principles) must be

undertaken to find the winners and the losers. Price must be set with a view to the cost of providing that product to the customer along with the market realities the store operates in.

Activity and Process Analysis

While ABC will provide product and supplier profitability information, it will also help with internal cost control. Activity and Process analysis will lead to efficiency improvement and cost reduction opportunities. Doing a value / non value analysis will help determine which activities should be done or with what frequency. When activities are examined from a process view we can determine were activities should be done in the value chain independent of the area they are actually being performed.

Cold Cuts Store S1		
ACTIVITIES	\$	
Attending customer complaints	5	
Cleaning the area	4	
Coord with other areas	0	
Customer Serving	11	
Deal with returns and exchanges	4	
Dealing with suppliers	8	
Inventory management	1	
Price change	3	
Store merchandize	5	
Supervision	<u>19</u>	
Temperature control	1	
Training	1	
Total Activity Cost	62	8%
Direct Cost	541	74%
Revenue	<u>733</u>	100%
Contribution	130	18%

In the figure above, we can examine all the activities involved in providing services and products in the cold cuts section of store 1. As we do a detailed analysis of the area of a store we can start questioning if each activity adds value or not. As can be seen above, the activities of attending customer complaints and deal with returns and exchanges represent 16% of the areas cost. Is that cost high? What is causing this? Could it be a problem caused in another area? Value and process analysis will bring all these questions to light and draw management attention to finding the answers.

During activity analysis we found that one of the activities that carry significant costs was "cleaning the area". The first reaction to this was that it looked looks expensive but that's what customers expect from us. When going into more detail, this activity was found to be done mainly by the cashiers at the store and by the personnel that replenish the exhibitions. So when there was no customer to attend or products to replenish they used their time cleaning. Is this good, bad or something else? Is this an issue of poor personnel scheduling or a reality of the business. Is there something else they could be doing or is this acceptable? The next step would be to determine if customers value it and if products sold are paying for this activity.

Activity and process analysis identifying values vs. non value added help us increase efficiency and reduce cycle time.

Best Practices

Activity Based Costing is also used to determine best practices between stores. As each store layout is based on product groups, we can determine the activities required to support each product group and then perform best practice analysis between stores to determine optimal layout, cost structure and costs. Once considerations such as product mix and consumer habits by geographical area are taken into account, it is possible to calculate operating standards and identify learning's from one store and apply it to all other stores.

Unitary cost by store area

From the figures on the left, we can identify the Stores with the lowest unit cost by area or category and then we can look at the activities that drive this cost and identify the best practice between stores.

Supermarkets operate in a very dynamic business environment with business many variables. They move high volume of

SECTION	S01	S02	S03	S04	S05	S06	S07	S0n	Aver.
Gral. merchandize	0.07	0.06	0.03	0.05	0.05	0.08	0.10	0.07	0.07
Library	0.87	0.79	0.51	0.94	0.82	0.79	0.69	0.98	0.95
Meat	0.39	0.36	0.28	0.38	0.33	0.59	0.71	0.72	0.55
Prepared food		1.45	2.03	4.45	4.47	4.31	7.23	5.73	3.59
Candies	0.73	0.47	0.48	0.30	0.44	1.01	0.61	1.12	0.67
Home appliances	9.39	5.59	6.57	6.56	7.92				7.10
Cold cuts	0.30	0.24	0.32	0.35	0.28	0.99	0.84	0.85	0.56
Pharmacy	0.13	0.19	0.15	0.16	0.15	0.14	0.14	0.20	0.18
Fruits & vegetables	0.03	0.06	0.06	0.05	0.04	0.10	0.12	0.12	0.08
Dairy	0.15	0.14	0.08	0.14	0.14	0.17	0.16	0.16	0.16
Liquers	0.66	0.68	0.43	0.73	0.57	0.68	0.53	0.63	0.69
Sea food	1.15	0.77	0.81	0.98	0.71	1.10	1.52	1.72	1.20
Bakery	0.92	0.75	1.01	1.25	1.01	2.81		0.61	1.07
Poultry	0.20	0.15	0.08	0.25	0.14	0.25	0.34	0.27	0.24
Textiles	3.14	1.79	1.51	2.02	2.02				2.05

products at low margins. Obtaining correct cost information in order to make correct pricing decisions is critical long term success.

There are great opportunities for internal learning and measurement. Activity and process analysis allow continue improvement to become a way of living for all employees of the organization. Retailers often find that it becomes much more strategic for them to concentrate on managing the relationship with their suppliers rather than trying to cut costs on the products they purchase. By focusing on the activities performed with the supplier, costs can be reduced and quality improved dramatically better than by constantly demanding only price decreases.

ABC is the best tool we have found to manage the supplier relationship which exists between store and producer; to understand which store layout works best; to reduce costs while increasing profitability; and to improve the management of the organization.

After implementing an ABC analysis nothing will be the same.

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