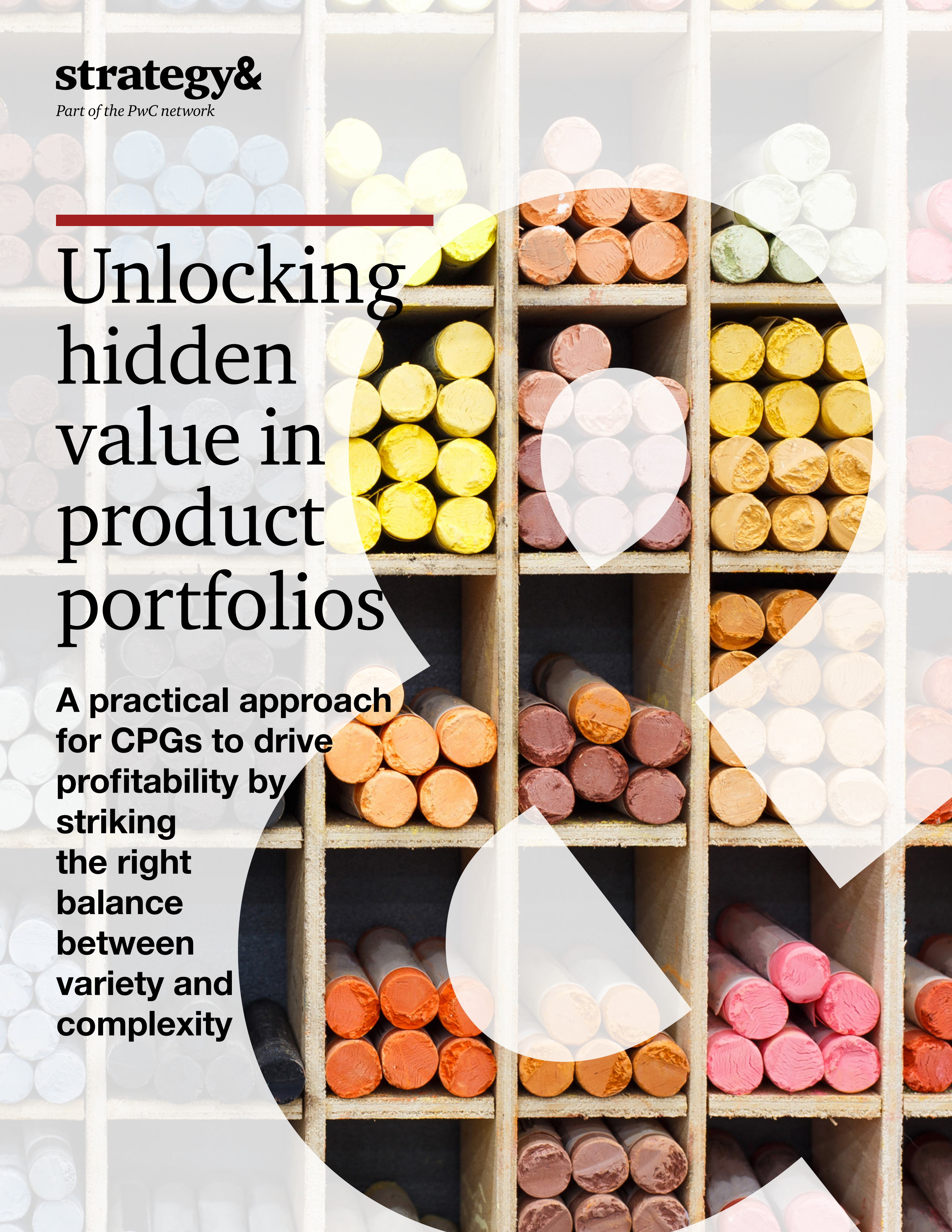
strategy&
Part of the PwC network



Unlocking hidden value in product portfolios

A practical approach for CPGs to drive profitability by striking the right balance between variety and complexity

Unlocking hidden value in the CPG product portfolio

Today's consumers want greater product selection and they value variety more than ever before. Today, over half of the world population has mobile internet access, growing at 4.8% CAGR.[1] E-commerce[2] drives over 13% of total retail sales in top-10 developed countries. The continued growth of e-commerce is helping drive SKU variety and complexity. CPGs (Consumer packaged goods companies) are facing enormous pressure to balance consumer demands with product variety. The result is often ever growing levels of stock keeping units (SKUs) and corresponding supply chain complexity.

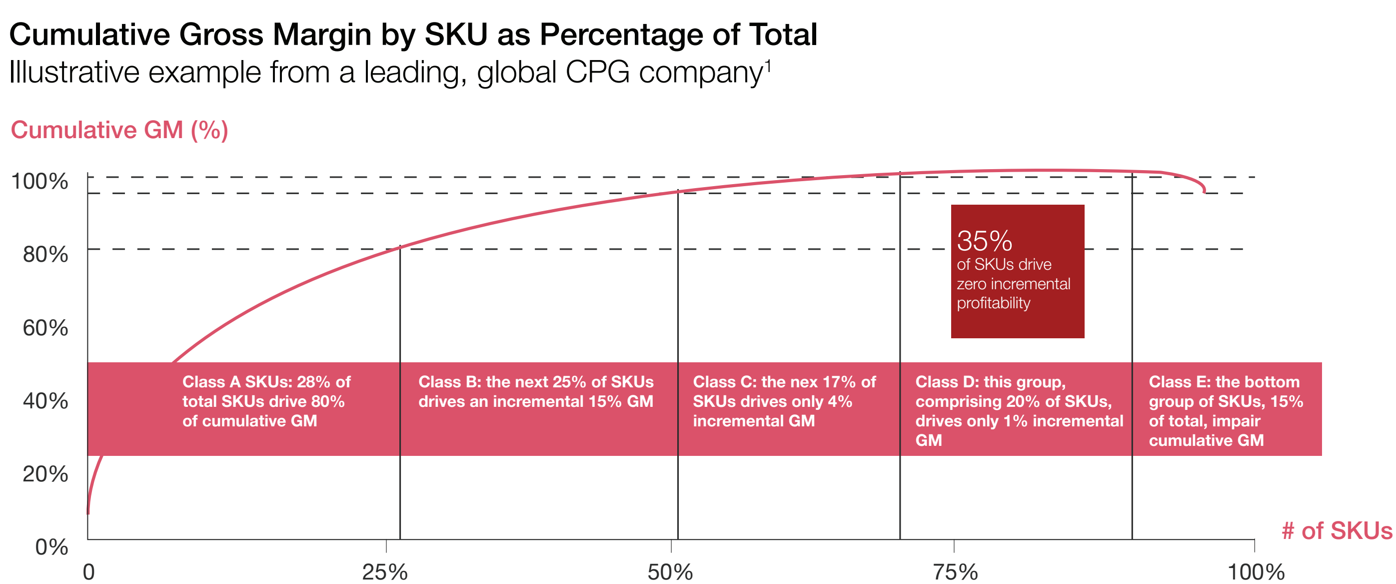
SKU proliferation can be seen as an indicator of innovation, signaling a positive outlook for CPGs. However, when new products and variations are not strategically introduced and rigorously assessed, they fail to produce the anticipated bottom line results. Most CPGs are willing to launch new SKUs if standard gross margin (gross sales - standard COGS) is positive. In truth, understanding the incremental bottom-line profitability and overall portfolio impact is key to overall health and profitability.

In Figure 1 below, which is typical for most CPGs, half of the SKUs in the portfolio drive less than 5% of the gross margin, and this does not even account for the true cost of complexity within the long tail. Imagine the hidden costs that could be unleashed from weeding out this marginally profitable part of the portfolio.

---

1 Source: Global Entertainment & Media Outlook 2019–2023, PwC. https://www.pwc.com/outlook.
2 Source: UNCTAD, https://unctad.org/en/pages/PressRelease.aspx?OriginalVersionID=505

FIGURE 1
Example of how long tail of SKUs do not drive profitability



Source: Strategy& analysis

The concept of holistically determining the true health a portfolio is simple on the surface. In reality, companies face significant challenges:

- **Clear strategic objectives** - The approach to optimizing the product portfolio across product groups and brands is not always aligned across stakeholders - e.g., top-line growth through volume and market share vs. bottom-line profitability.
- **Cross-functional collaboration and communication** - Assortment choice decisions are inherently cross-functional, yet many decisions are made in functional silos, optimizing for narrow objectives and not fully assessing the overall result.
- **SKU-level data accuracy and availability** - Systems often do not capture activity-based, actual costs accurately or completely at the SKU level.
- **Substitution effect** - It is challenging to measure the true incremental impact of new SKUs after accounting for substitution or cannibalization of the full portfolio.
- **Operational excellence** - Data to measure the effect of portfolio size and complexity on the supply chain and sales channels is limited.

Leading CPGs nurture healthy, high-performing product portfolios by following a proven, pragmatic approach:

- Develop analytical capabilities to understand the true **drivers** of **incremental bottom-line profitability.**
- Establish cross-functional teams and rigorous processes to actively **review and rationalize the SKU portfolio.**
- Define metrics and develop leadership **dashboards to monitor product portfolio performance.**

STEP ONE

Understand the true drivers of bottom-line profitability

In isolation, the standard Gross Margin for a SKU may not show true profitability. Without analyzing the incremental cost of supply chain complexity, large areas of cost can be veiled, creating the illusion that a SKU is profitable when, in reality, it is driving losses. (see Figure 2)

FIGURE 2

Understanding the drivers of true profitability

True Profitability = *Function* (Financial metrics, Supply chain complexity, Strategic requirements)

For example, a customer / retailer is requesting a new SKU for their exclusive use from a CPG company, guaranteeing a sale of 10,000 units per year at $10 / unit, or a total potential order size of $100,000. The CPG company quickly determines its standard COGS to be $6 / unit, resulting in a Gross Margin of 40%, or $40,000, from this order, and confirms the order with the customer.

While going through the process of launching a new SKU, the CPG company realizes the following:

- Cost to launch a new SKU (e.g., development costs, sampling costs, etc.) is $7,000
- Minimum order quantity (MOQ) from its vendor is 25,000 units, thereby blocking a total capital / cash flow of $50,000 ((25,000 * $6) - $100,000))
- Inventory on hand for a duration of 1.5 years, assuming that the retailer will continue to sell 10,000 units / year
- Other indirect costs involved with inventory management, warehousing, etc.
- Wrong yield assumptions leading to lower actual margins than initially predicted

With all of the above considerations, the company, which initially believed that it was fulfilling a profitable order, is actually losing money.

FIGURE 3

Framework to evaluate true SKU performance

1 Financials - Impacts the ultimate bottom line

- $ EVA (Economic Value Added)
- $ Net Sales
- EVA (% of Net Sales)
- % Gross Margin Growth
- Incrementality/Cannibalization
- Forecasting Accuracy

2 Supply Chain - Demonstrates the level of complexity to produce and maintain a SKU

- Inventory Turns
- Substitutability
- MOQ (Vendor)
- Minimum Batch Size
- Direct Ship %
- # of items in BOM
- # of routings
- Yield
- Setup Costs

3 Strategic Requirements - Quantifies the importance to customers and to CPG company

- Business Objective – Top Line Growth vs. Bottom Line Profitability
- Importance to Strategic Customers
- Strategic Value to CPG Company
- Part of a Set / Program
- Distribution (# of Customers)
- Maturity (Launch Date)

Source: PwC Strategy& Analysis

Based on numerous client experiences, PwC Strategy& has developed a digital solution to accelerate the implementation of the analytics in this framework.

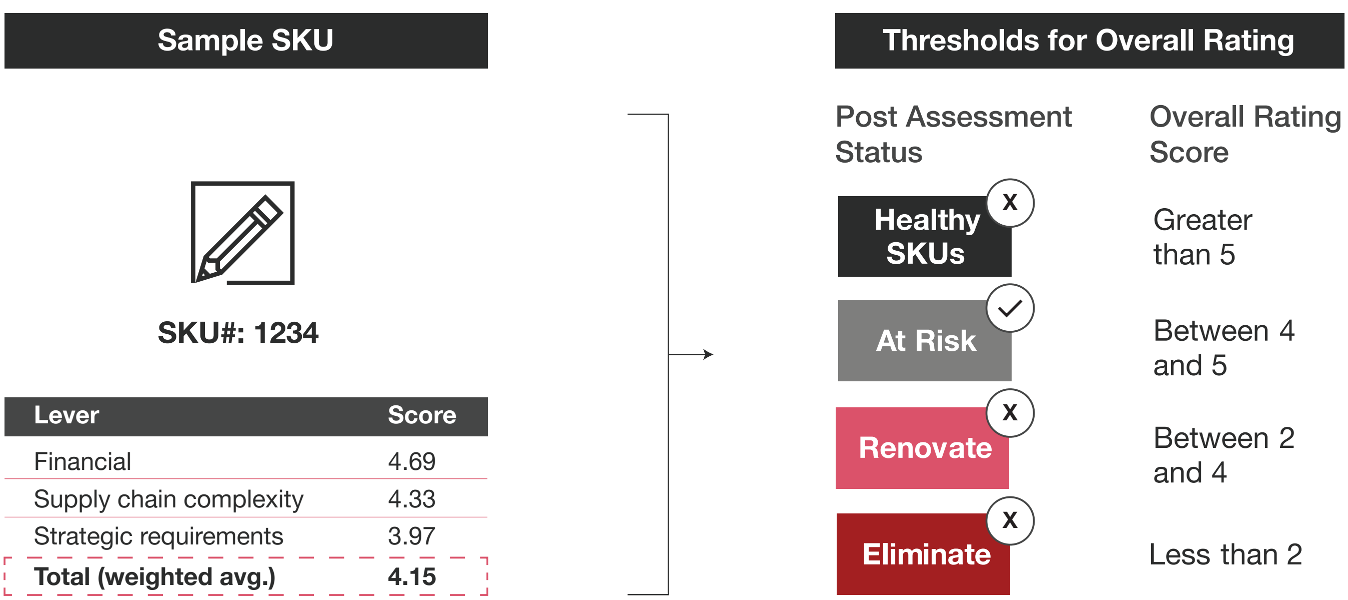
STEP TWO

Rigorous process to clean up SKU portfolio periodically

First, analyzing true SKU performance comes with its own set of challenges. Creating an analytical model requires cross-functional data at the SKU level – from Finance, Supply Chain, Operations, Manufacturing, Vendors, IT and HR. CPGs that maintain activity-level costing data and truly understand the cost drivers for each SKU will be better positioned to create a highly accurate analytical model. A cohesive enterprise resource planning (ERP) system that maintains accurate cross-functional activity-level data is key to analyzing true SKU performance.

Second, based on the financial objectivity, short- and long-term vision of the CPG company, metrics need to be weighed appropriately. For example, for a fast-growing CPG company, more emphasis should be put on supply chain and strategic requirements levers; however, for a more mature CPG company, highest emphasis should be on financials.

FIGURE 4
Illustration of SKU health card



Lever	Score
Financial	4.69
Supply chain complexity	4.33
Strategic requirements	3.97
Total (weighted avg.)	**4.15**

Source: PwC Strategy& Analysis

Lastly, each SKU should go through a rigorous process so the CPGs can determine its true health – is the SKU viable or at risk? – and decide whether it should stay in the portfolio, or be eliminated or renovated.

Once the true health of a SKU is determined, CPGs should then come up with action plans to minimize the risk of SKUs that may eventually be eliminated due to poor performance. As CPGs continue to do the SKU clean-up exercise, they will often find specific underperforming patterns within each category, and need to make sure that those symptoms are addressed during the SKU innovation and launch process as well.

FIGURE 5
Possible action plan for SKUs

SKU health	Possible action plans
Healthy	• No action required
At risk	• Monitor trends closely • Consider phase-out plan • Lower the cost of complexity to improve performance
Renovate	• Establish timelines for improvement • Identify substitutes to retain shelf space • Improve performance by considering opportunities within pricing, cost, packaging, marketing, sales strategy, Design to Value, etc.
Eliminate	• Liquidate remaining inventory • Establish phase out date • Communicate plans to customer

In addition to evaluating the true health of the existing portfolio periodically, it is of utmost importance that the same kind of rigor and metrics are applied to the early innovation and development phase to reduce the risk of launching underperforming SKUs in the first place.

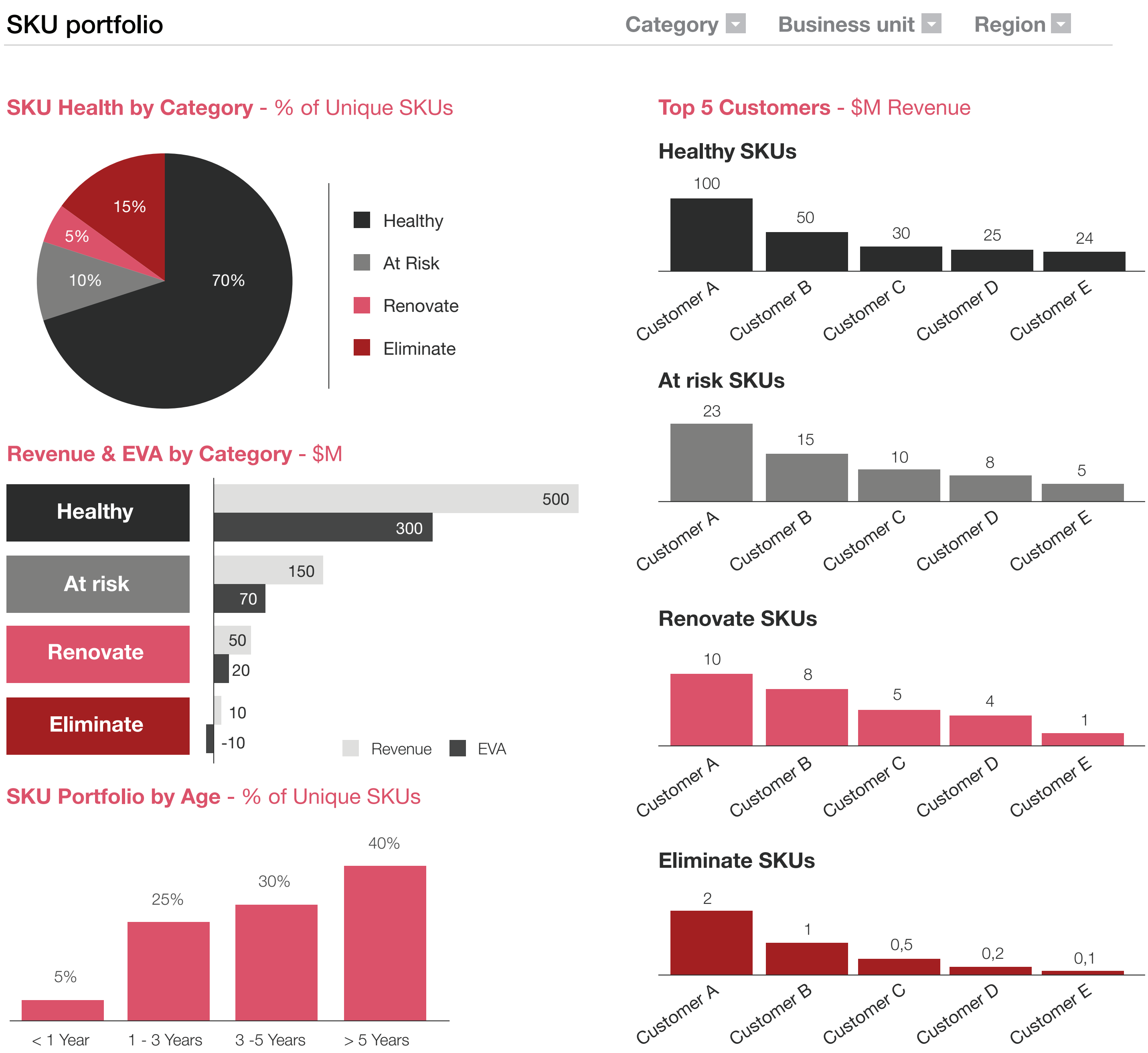
STEP THREE

Leadership dashboard to monitor and track the performance of entire SKU portfolio

It is crucial for leadership teams across different brands and business units of CPGs to have visibility over its existing SKU portfolio performance. Maintaining a real-time dashboard will not only help with current performance, but will also help leaders set targets for their teams. The kind of visibility as illustrated in Figure 6 will also help leaders to set the right thresholds and frequency (annual, bi-annual, etc.) of the SKU portfolio clean up, and determine product launch cycles / events.

FIGURE 6

Example of a typical leadership dashboard to monitor SKU portfolio - illustrative



Source: PwC Strategy& Analysis

Conclusion

Embarking on the three pragmatic steps above can have significant impact on bottom-line profitability as the examples in Figure 7 show. Importantly, creating the analytics, process and metrics for portfolio health has the transformative effect of bringing functions together so that they can have fact-based discussions and jointly make better and more holistic decisions.
To get started, launch a small, cross-functional team and task them with getting the analytics right. Then pilot the portfolio health program in a subset of the portfolio before rolling out more broadly. Set aggressive targets for impact to force a different mindset.

Strategy& has developed a digital solution for SKU portfolio management and successfully deployed this analytical capability at various clients, which can be quickly tailored and implemented for other clients, as needed.

Recent success stories

In recent years, many large CPG companies have gone through a SKU rationalization process, and in doing so have eliminated up to 50% of their SKUs and improved overall profitability of their SKU portfolio.

FIGURE 7

Example of companies who have undergone SKU rationalization (2013-18)

Company	Year	# of SKUs	% SKU rationalized	YoY Op Margin Improvement (%)	Outcome / Impact
Large Housewares Company	2016	N/A	Significant portion rationalized	18.3%	"At the end of 2017 third quarter, *inventory was $38 million lower year-over-year, an 11% reduction*"
Global CPG Company	2013	~50,000	~20%	9.8%	"Unilever aimed to *make savings by reducing product lines*, known as "stock keeping units (SKUs)", and cutting stock levels"
North American Food Company	2016	100	50%	1.5%	"Efficiency from streamlined portfolio; *saw subsequent sales increase of 9%* despite negative effects of SKU rat (and other operational) initiatives"
North American Beverage Company	2017	N/A	Ongoing initiative	3.8%	"These actions [SKU rationalization] impacted wine and spirits revenue growth by almost 100 basis points for fiscal '18, *while improving operating margin and ROIC*."

Note: YoY operating margin improvement compares the operating margin in the year in which SKUs were rationalized to the operating margin in the following year.
Sources: Company Filings and Presentations, Strategy& analysis.

Meet the team

KB Clausen
Principal
Retail & Consumer Strategies
kb.clausen@pwc.com
+1 650-353-1364

KB Shriram
Principal
Consumer Markets
kb.shriram@pwc.com
+1 312-956-9024

Martha Turner
Principal
Operations Strategy
martha.turner@pwc.com
+1 203-430-7285

Maurya Modi
Manager
Operations Strategy
maurya.modi@pwc.com
+1 832-977-8401

Paul Leinwand
Principal
Consumer Markets
paul.leinwand@pwc.com
+1 973-610-3713

How PwC Strategy& can help

Depending on the maturity of the firm, improving operational effectiveness and agility could require incremental or transformational change. PwC Strategy&'s platforms offer companies the ability to focus on the right aspects of their business to navigate the changing marketplace and effectively execute strategy.

Fit for Growth - Transform how the business operates while creating the capacity to invest in growth; articulate a clear and compelling cost agenda; build lean and resilient processes, systems, operations and organizations; and, ultimately, institutionalize capabilities that direct resources towards investments in growth

Digital Operations - Redesign capabilities and operating models to take full advantage of emerging technologies to improve market insights and decrease decision times, lower operating costs and attract talent

Capabilities-Driven Strategy - Set a clear strategic direction, build a system of differentiated capabilities and offer products and services consistent with that positioning to win in the market and outpace competitors

strategy&
Part of the PwC network

Strategy&

Strategy& is a global strategy consulting business uniquely positioned to help deliver your best future: one that is built on differentiation from the inside out and tailored exactly to you. As part of PwC, every day we're building the winning systems that are at the heart of growth. We combine our powerful foresight with this tangible know-how, technology, and scale to help you create a better, more transformative strategy from day one.

As the only at-scale strategy business that's part of a global professional services network, we embed our strategy capabilities with frontline teams across PwC to show you where you need to go, the choices you'll need to make to get there, and how to get it right.

The result is an authentic strategy process powerful enough to capture possibility, while pragmatic enough to ensure effective delivery. It's the strategy that gets an organization through the changes of today and drives results that redefine tomorrow. It's the strategy that turns vision into reality. It's strategy, made real.

www.strategyand.pwc.com

© 2019 PwC. All rights reserved. PwC refers to the PwC network and/or one or more of its member firms, each of which is a separate legal entity. Please see www.pwc.com/structure for further details. Mentions of Strategy& refer to the global team of practical strategists that is integrated within the PwC network of firms. For more about Strategy&, see www.strategyand.pwc.com. No reproduction is permitted in whole or part without written permission of PwC. Disclaimer: This content is for general purposes only, and should not be used as a substitute for consultation with professional advisors. 657424-2020