Perspective

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The Missing Metric
Measuring Shelf-Space Profitability

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Originally published as:

The Missing Metric: Measuring Shelf-Space Profitability,
by Simon Harper, Amit Kapoor, John Potter, and Laura Thompson, Booz Allen Hamilton, 2007.

The Missing Metric

Measuring Shelf-Space Profitability

The shelf may well be the most precious real estate in the consumer-retail value chain: In some categories, as much as 80 percent of all purchase decisions are made at the point of sale. Regardless of how much effort went into promotion or product design, the shelf is the point where the consumer meets the retailer, the brand, and the product. The outcome of all those relationships and the buying decision depends entirely on what happens halfway down Aisle 2.

Yet surprisingly little is known about that interaction. In fact, many crucial shelf-space questions are still surprisingly difficult for retailers and manufacturers to answer on the basis of anything but gut instinct. How much is this store's shelf space worth? What products and brands would make the most profitable use of my space? What products and assortments drive the greatest growth at the shelf? How do I make sure that these are the products my customer wants? These essential questions are still very difficult for retailers and manufacturers to answer.

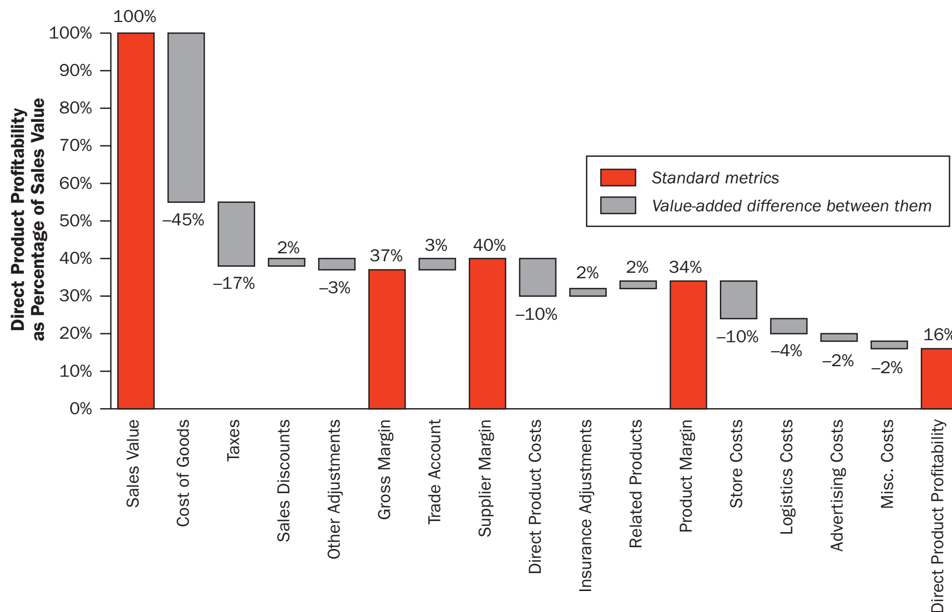
It doesn't have to be this way. If retailers and manufacturers had an objective and easily duplicated metric for shelf-space profitability, they could craft better decisions about which products to stock and how to best make use of all that space. Retailers would know which products to carry and which brands to push. Manufacturers would know which promotions were working and which products were underperforming.

The idea isn't new. In fact, a number of companies have tried to develop ways to find this missing benchmark but have never been able to create a solution simple enough to make the measurement useful. Technological approaches to measuring shelf profitability, such as the use of data from RFID tags, have turned out to be too expensive and complex to serve the purpose. Furthermore, the high level of distrust that typically exists between retailer and manufacturer has made it difficult for the two parties to collaborate deeply on anything, including data sharing.

Fortunately, there are relatively simple ways to measure shelf-space profitability (SSP). The first step is to calculate the cost per linear foot of space in the store network, including all product-related costs: for instance, total store costs, internally funded marketing support, distribution, and servicing and repairs. Next, to understand the overall costs associated with selling a particular product across the store network, apply these total costs to the space allocated to the product in a store. Apply this shelf-space cost to the net cash margin that the product or brand generates across the network to find the SSP for a given manufacturer, category, brand, or set of products and thus better understand growth and profit contribution. By using this metric, retailers and manufacturers are able to learn not only which items are most profitable, but which are most profitable given the amount of space each item uses (see Exhibit 1, page 2).

Better information about product performance enables retailers to make better stocking decisions. Better stocking decisions, in turn, make it easier to build a strong relationship not only with manufacturers but with consumers as well. Stocking the right products in the right places is a good way to engender consumer loyalty toward both the store and the brand. Everyone wins with good shelf-space profitability metrics: The store earns a reputation for carrying a strong assortment of goods that are always available, and the manufacturer can focus on stocking product lines that are recognized as winners.

Exhibit 1
Measuring Shelf-Space Profitability, Company Example



Source: Booz Allen Hamilton

Benefits beyond the Shelf

The benefits of adopting a shelf-based metric extend beyond the shelf, in both directions—shelf-forward and shelf-back. For the retailer, use of this metric makes it possible to see where true profitability lies. Allotting fees and cash to promotional support often masks underperformance at the shelf by creating a short-term win for the retailer. However, if retailers accept promotional funding with little understanding of the true cost of the shelf space they are giving away, long-term profits can suffer. Fund the wrong products, and it's easy to cannibalize sales that would have occurred in a more profitable line. Slow-running, second-tier brands consume shelf space that should go to higher-velocity products, making out-of-stocks more likely and damaging long-term loyalty to the store.

For the manufacturer, avoiding out-of-stocks is also an obvious gain. A recent study by IDG Research found that 59 percent of consumers rate out-of-stocks as very frustrating, and 25 percent say if they can't find what they want, they won't buy anything at all or will wait to make their purchase until they visit the store again. This can represent a substantial loss: In one collaborative effort between Tesco and Kellogg's, for example, the retailer and the manufacturer found they were losing a massive percentage of sales because desired products were not in stock. A close analysis of a Tesco in Shoreham, U.K., showed that the average availability for a box of Kellogg's Corn Flakes was only 83.6 percent. This meant that Tesco and Kellogg's were losing as much as £2.1 million (US$4.3 million) annually in the category owing to predictable, and preventable, out-of-stocks.

Perhaps most important, the metric can be used to begin building more productive, collaborative partnerships between retailers and manufacturers. Historically, the push and pull of negotiations with manufacturers has often led the retailer to take a role more akin to that of a landlord than of a partner. Slow-moving product lines, out-of-stock items, and underperforming promotions that take up valuable shelf space without generating a justifiable level of sales are typically seen as the manufacturer's problem, not factors that serve to reduce the retailer's profitability as well. Manufacturers have essentially viewed retailer campaigns for collaboration as just a way to wring more advantages for themselves. Even where the two parties have overcome those instincts, what collaboration exists is typically conducted at arm's length, or over a limited range of products.

Used properly, an SSP metric can help bring the two sides together, by allowing them to see their common interests clearly for the first time.

Four Steps toward Higher Shelf-Space Profitability
To achieve the full potential of SSP, companies must take four steps, some of which demand profound changes in old corporate habits and reassessment of long-established relationships (see Exhibit 2).

1. Measure Shelf-Space Profitability. As outlined above, a very basic SSP calculation isn't difficult. Simply having these numbers available can prevent many counterproductive decisions. Even today, many buyers still base their biggest business decisions (product assortment and choice of manufacturer) on total sales and gross margin percentage. This often turns out to be shortsighted, particularly when they are making a comparison between fast-growing categories and better-established brands and categories. How many highly profitable manufacturers are tossed every year simply because they never had enough shelf space to be identified as such?

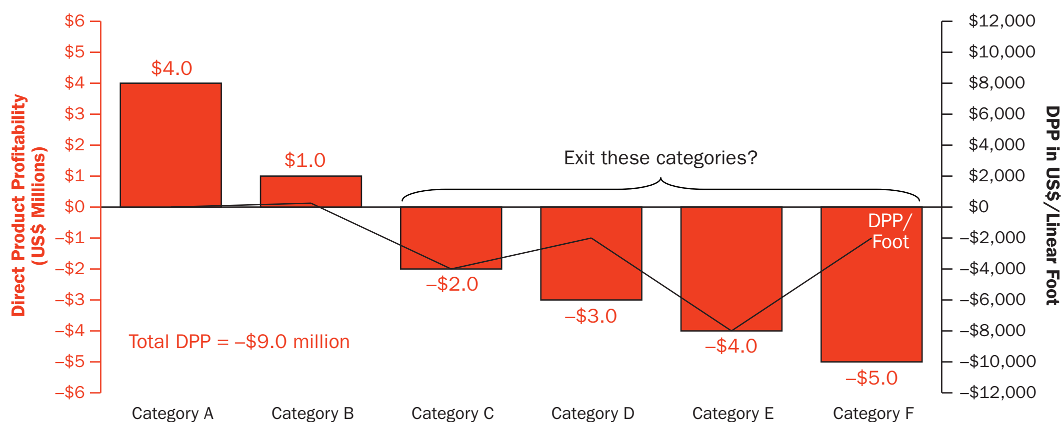
For instance, one large, upscale retailer operating in a fast-moving market was faced with declining profitability in one of its key categories. In response, the company used the SSP methodology to restructure and optimize its categories. SSP analysis revealed that the category's overall profitability was being dragged down by poor performance in four of the subcategories. The company was then able to analyze the drivers of poor performance at the product and brand level to see if they could be improved, confidently dedicating more shelf space to subcategory A (see Exhibit 3, page 4).

2. Understand What Drives Profitability. The work involved in producing the profitability metric makes it easier to identify and understand some of the underlying drivers of that profitability, such as shelf-space velocity (sales per square foot or meter) and true net profitability margin (net margin divided by sales). An understanding of the relative strength of these drivers for any given product assortment can help a retailer make fact-based judgments about, for example, whether it should use shelf space for a promotion or dedicate the space to well-established, highly profitable products.

This metric also allows retailers (and manufacturers) to compare the relative performance of two brands, leveling any discrepancies in shelf space allocated to one of them that could skew the absolute performance. Objectively comparing brand performance within a category also allows retailers to determine an overall manufacturer strategy. Closer scrutiny of midrange performers will reveal how to improve their performance—by reducing the cost of the product, repositioning its retail price, or taking steps to drive sales. Those brands that are clearly lagging the pack need to offer a unique customer proposition or should be dropped.

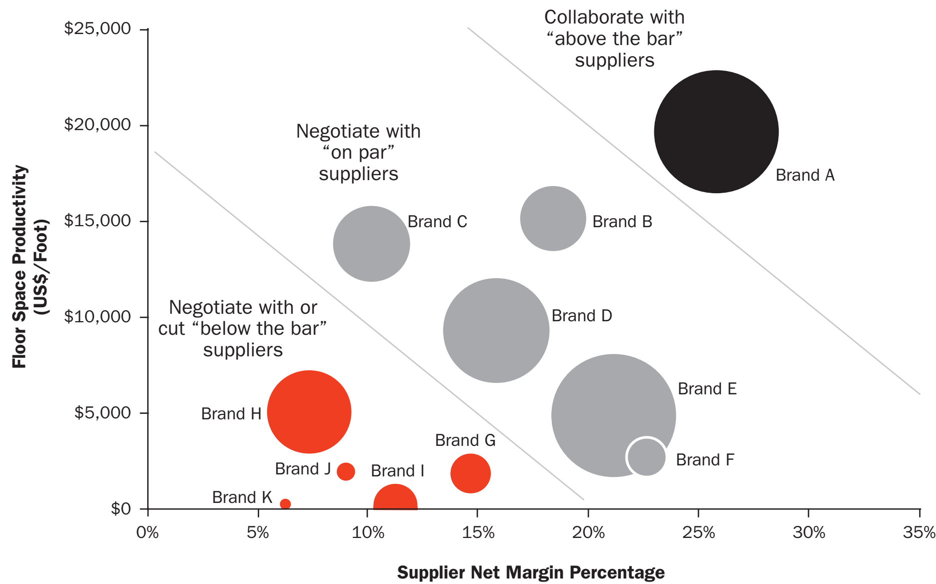
Once the core metric of profitability is well understood, other kinds of data should be gathered and incorporated into the model as well to improve decision making along the value chain. Consumer insight, for instance, can be used to help companies understand which part of the product assortment or which product is working and why certain products lose at the shelf.

Exhibit 2
Direct Product Profitability (DPP) by Product Category



Source: Booz Allen Hamilton

Exhibit 3
Supplier Productivity and Margin Distribution for One Product Category



Note: Size of circles is proportional to total sales value in dollars.
Source: Booz Allen Hamilton

Supply chain factors may also be included in SSP calculations. For example, the cost of taking an unsold bulky item such as a refrigerator back through the supply chain is often higher than the cost of a steep markdown. Insight into SSP can also highlight poor promotional performance. Simple tools that track, adjust, and predict promotional product volume can help improve service levels for promotions and ensure that the shelf space is working as hard as possible in that vital promotional time window.

3. Reduce the Assortment Range. Using the underlying performance data that the profitability metric provides, the retailer can determine how much space to give each category, as well as each product and manufacturer within that category. We find that many retailers carry many more brands than the profitability data can actually justify; the cost of managing those extra brands outweighs the benefits for consumers. Reducing the number of players in the category allows the retailer to focus on only the strongest brands. In the end, the retailer ends up working with fewer but better partners, and the consumer isn't distracted by second-rate offerings.

Sometimes, shelf space can be used tactically to benefit both first- and second-tier brands. Seeing a manufacturer's brand performance alongside that of a private label may lead a retailer to either drop or minimize support for the private label. On the other hand, the knowledge that a private-label brand is performing very well could give one of those competitive brands an incentive to manufacture the retailer's private-label product.

Greater visibility into shelf-space profitability can allow retailers to make more macro-level decisions, too. By using a similar approach, some consumer packaged goods (CPG) companies improved the profitability of existing shelf space by showing retailers what they could potentially gain by moving away from lower-margin products, such as confectionery, at the cash register and moving toward higher-margin batteries and shaving equipment.

4. Embed and Keep Measuring. Today, determining assortment is typically an annual exercise. However, with the operational point-of-sale data now available, retailers and manufacturers can analyze sales at the item/store/day level. To ensure that shelf space continues to deliver optimum profitability for a retailer even as cost structures and customer demographics change, products and shelf performance must be reviewed much more regularly.

The larger goal is to embed a dynamic review process that constantly recalibrates the product mix for optimal profitability. In the fast-moving world of retail, good shelf profitability metrics and good communication between retailer and manufacturer are needed to ensure that the key partners are the manufacturers with the most profitable products, not simply those who have the sharpest elbows.

Because the SSP numbers are so important, they should be used to drive strategy, not just tactics. Sometimes, margins do need to be cut to build traffic, or space ought to be allocated to a less-profitable product to reflect an emerging trend. Pursuing a shelf-centered approach doesn't mean ignoring consumer research done by manufacturers that forecasts a wave of consumer demand long before the sales numbers warrant making a shift in shelf space. If manufacturers and retailers had ignored such harbingers, they would have missed the growing enthusiasm for gluten-free foods in groceries, or the well-established shift toward flat-screen televisions in electronics stores. What changes, when shelf-centered insights are used, is that the retail executive and CPG executive can finally understand the true size of the bets they are making and their likely impact on the other categories' net profitability.

The numerical nature of those insights may even create other kinds of opportunities. In a world where an increasing number of investment decisions are made by algorithm, it is not too far a stretch to imagine using the data to work out an options formula that would help retailers decide whether to carry a new product.

One simple metric can't drive all those changes overnight, but it can be used to drive a profound evolution in the retailer-manufacturer dynamic over time. A fact-based, shelf-centered approach to managing assortment and store marketing decisions enables the retailer and manufacturer to see where their mutual interests lie. Using SSP as the key metric gives both the retailer and the manufacturer a firmer foundation on which to build mutually profitable partnerships, helping to minimize the short-term need for cash margin maintenance. Only by using every centimeter of space to maximum advantage will the retailer and the manufacturer be able to please their consumers best—and earn the most.

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10/08 Printed in USA
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