OLIVER WYMAN

TAKING CONTROL OF GROSS MARGIN

Managing gross margin is such a fundamental process for most retailers that it seems like an odd topic to write about. But missing a margin target is a real problem, and often causes a productivity-sapping scramble to figure out the cause. This short article describes a way to better understand gross margin performance – and spend less time on the diagnosis, and more on the cure.

When gross margin falls unexpectedly, it can be difficult to identify the root causes. Because the gross margin metric bundles together many different effects, it tells you nothing about where a problem originated: getting to the underlying causes often takes days, or longer. In the meantime, management's only option is to pull the levers it can easily get its hands on – most often promotions and pricing. But nudging prices up or reducing promotional discounts is exactly the wrong thing to do if the real issue is, for example, a mix change as consumers reduce spending in a downturn.

In contrast, a few retailers have figured out how to break gross margin down into its component parts – independent metrics that directly relate to the levers used to run the business – and incorporated these into financial reports, budgets, and targets. It's a simple concept, but it can make a big difference.

GLOSSARY OF TERMS

List Cost Margin

Margin made at non-promoted retail price, excluding vendor funding, on total volume

Promotional discount

Promotional or loyalty program discounts (non-clearance)

Clearance markdown

Markdowns applied to clear excess or expiring stock

Vendor funding

All types of vendor funding (promotional funding, lump-sum funding, etc.)

FINDING THE RIGHT METRICS

The starting point is to identify a small number of metrics that between them account for all significant variation in gross margin: it's essential that these are genuinely independent of each another; otherwise it's impossible to pinpoint the true cause of any change in margin. These metrics need to be actionable so they can be used to steer the business. Four simple metrics – list cost margin, promotional discount, clearance markdown, and vendor funding – are usually enough, and retailers for whom clearance markdown or vendor funding don't generate significant variation in gross margin may only need three.

Although the relative importance of these metrics varies across retail sectors, they provide the foundation needed for understanding variations in gross margin, helping identify the places to dig deeper. For instance, promotional discount can be broken down into advertised and in-store-only promotions, and list cost margin can be broken down into mix effects, cost changes, or shelf price changes. The ultimate goal is to allow an appropriate, rapid, and well-targeted response: the case study gives a real-life example.

EMBEDDING NEW METRICS INTO THE BUSINESS

The next step is to embed these new metrics into the core reporting and management systems, including the budgeting process. This gives management teams much clearer visibility and control over the drivers of performance, and has two big advantages for day-to-day decision-making.

First, it clears the "fog of war" surrounding the gross margin line. When the new metrics appear alongside sales, volume, and margin in the weekly reports, merchants and finance will be using the same information, reducing misunderstanding and avoiding unnecessary disagreements about the drivers of performance.

Second, better metrics provide a greater degree of foresight about future performance. Because they're much easier to forecast based on the decisions that the business makes, it's easier to foresee impending problems early enough to avoid them. That same ability to forecast performance also allows merchants to break free of the pattern of cycling last year's plan, and provides more strategic freedom.

THE RESULTS

Better understanding and tighter control of gross margin brings many benefits. It gives senior executives a much clearer picture of what's really going on, helping them pull the right levers. Further down the organization, accountabilities become clearer. Merchants waste less time and effort troubleshooting problems, and are freed from the tyranny of cycling last year's plan – giving them more room for maneuver in day-to-day decision making. Meanwhile, budgeting and forecasting improve, creating fewer surprises for the analyst community.

Ultimately, then, there are many advantages to setting a few simple metrics at the heart of financial governance, and managing them independently. It might look like a trivial difference in approach – but the outcome can be far reaching, and can significantly improve how a business is run.

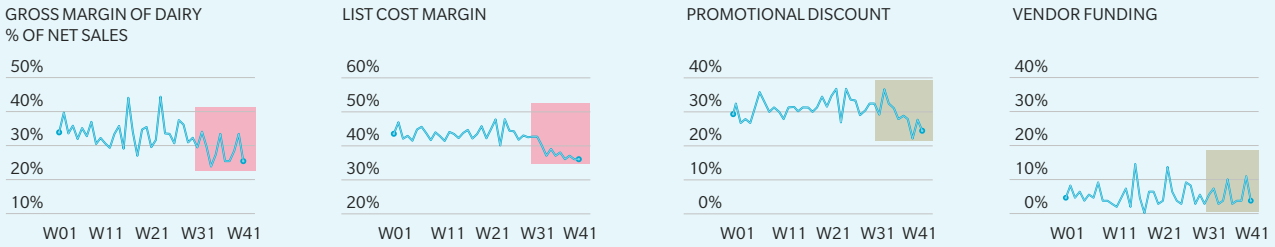
CASE STUDY

PRACTICAL APPLICATION IN GROCERY

A North American grocer was in the middle of a turnaround: margin was particularly tight, making it vital that any shortfall was quickly addressed. With this in mind, the grocer set up a new financial management framework. The following example from the dairy category illustrates how it worked in practice.

Dairy gross margin had fallen. The merchants had made changes to the promotional program that they thought would improve margins. Now they were worried they had misjudged this, but it was hard to tell because gross margin was so volatile (see Exhibit 1).

EXHIBIT 1: DAIRY GROSS MARGIN AND ITS COMPONENT PARTS



Note Clearance markdown did not generate significant variation in gross margin, so the metrics used were simply list cost margin, promotional discount and vendor funding.

In fact, the breakdown showed that the fall in gross margin was attributable to declining list cost margin – and that once the "noise" introduced by volatile vendor funding was removed, the drop was even starker than suspected. Meanwhile, the decrease in promotional discount had offset some of the list cost margin decline.

The next step was to understand why list cost margin was down: Exhibit 2 shows the potential explanations the grocer considered. The merchants quickly established that list costs had risen on a number of lines, but there was no room to increase prices or further reduce promotional discounts without losing competitiveness – they needed to renegotiate with vendors. This was a pattern they were seeing across many categories, and so the grocer held a vendor conference, followed by a large-scale negotiation program that turned around the margin decline.

EXHIBIT 2: EXAMPLES OF EFFECTS SEEN IN METRICS

Driving factor, list cost margin is down

Not compensated for in markdown reduction nor funding increase

EXPLANATION	POTENTIAL NEXT STEPS (SHORT TERM)
Costs have risen	• Raise prices if market allows – either on unmatched items that won't disrupt price architecture, or on lines where the market will follow, or where competitive price index rules allow • Reassess the level of promotional discount and markdown, with the aim of offsetting the cost rise • Renegotiate with vendors
Shelf prices have dropped	• Verify competitive price (before and after promotions) index on products whose price has dropped • Assuming prices have dropped to be competitive on key lines, seek vendor support, reduce promotional activity, or look to raise prices on other lines • Otherwise, reverse the price drops
Product mix has shifted to lower margin products	• Check whether competitiveness on higher-margin products has changed, and address as needed • Review whether assortment or price architecture changes have reduced the appeal of higher-margin products

ABOUT OLIVER WYMAN

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