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Catalog Success

Employ a Detailed Approach to Merchandise Analysis

George Mollo

Ensure profitability from the top down

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From a “bottom up” view, catalog/multichannel marketers must consider every aspect of an item’s performance or life cycle to ensure every touchpoint to profitability is being considered properly. An item’s profitability is impacted by much more than simply demand and margin.

I offer a top-down approach, which is extremely critical to the planning process. I also go to the opposite spectrum, however, and consider detail levels that often are overlooked when considering an item’s true profitability. If you hold your products to higher standards by factoring all their costs up front, you can gain greater profit to the bottom line. Let’s break down these components of profitability as part of a post-season analysis.

Determine Price, Profitability
Merchants often are pushed to achieve the highest possible margin. If an item’s price point is pushed beyond consumers’ view of “value,” however, then the item’s margin percent will yield nothing in terms of contribution. As you consider setting an item’s price, the way to ultimate profitability is to determine the retail price first, then find or negotiate the lowest cost possible to achieve that initial margin target. Bear in mind that an item may produce more margin dollars by increased unit volume at a lower margin vs. trying to achieve a higher margin percent.

In addition to item cost and retail price to determine initial margin, the next factor to consider is actual demand. Demand nets to actual sales, so you must factor item cancellations and returns. Then determine the initial gross margin by subtracting cost of goods sold (COGS). Most analysis simply adjusts for the actual cost of goods sold. What about the overstock that is generated and the subsequent cost of liquidating that overstock?

These are truly components of COGS and should be factored, as should the cost of returns (the difference between returns to good stock and those returns that are damaged).

Another factor that’s often overlooked is the hidden cost of inbound freight. If it has been factored into the initial cost of goods as most companies do for landed cost, you’ve done a great job. If not — as most companies don’t factor domestic

freight — inbound freight can run 2 to 4 percent of sales, and can be a significant number.

Derive Initial Gross Margin

Once you have net sales, the next step is to derive your initial gross margin, which includes the merchandise cost of the items sold. Additional impacts to gross margin, however, often aren't factored at this stage, but eventually impact margin.

These include the cost of overstock (the net hit to profit for moving excess inventory), as well as the cost of handling returns, particularly if the returns can't be recycled back as good stock. Draw the first threshold line and conclude that at least the item contributes initial margin. If you can't pass this hurdle, identify better performers for your offering.

Whether you use actual square inches or percent of page, recognize and monitor variable operating costs, a major component of item advertising costs. These costs (aka sell ratio) include the catalog printing, paper, postage and list rental. Although many companies look at net list rental cost, if you only factor list rental expense, you again raise the bar, and list rental income flows directly to bottom-line profits.

As these costs have increased, the industry has seen sell ratios climb between the upper 20 to lower 30 percent range of revenue. Factoring this at the item level helps control this cost.

Fulfillment Costs

The next largest variable cost is the cost to pick, pack and ship the product to the customer. For most companies, this cost ranges between 8 and 12 percent of sales. You may find using a set percentage for all products is the most efficient way to allocate these costs.

Keep in mind that depending on your business and product offering, certain products may have higher than average costs (oversize items, heavier items, ship-alones, etc.).

Too often, merchants will make a commitment to purchase excess inventory, perhaps due to lower costs or minimum quantities, with the intent to carry the item forward.

Besides the risk of the item not performing, if you apply a carrying cost, it'll show the profit impact due to warehouse costs, storage space or perhaps interest on borrowed money.

With interest rates currently hovering in the high single digits, applying, say, an 8 percent cost-of-money factor for carrying the inventory can shed a different light on the decision to buy excess inventory up front.

Having considered all these factors, we come to contribution. You've now determined that this item — contributed to gross margin and after nonmerchandise variable operating expenses are applied — still will contribute to overhead. Many companies stop here. But once again, in managing a profitable business you want to ensure you're still profitable after all costs are applied.

The final costs to apply are fixed (overhead) costs. Generally, these expenses are in the 8 percent to 12 percent of sales range.

So, applying a fixed percentage to all items provides a bottom-line view of what your season looked like or will look like in planning mode.

'Exactly Right Later'

On the surface, this approach may appear to be contradictory to the one I outlined in my July column (see "Stay On Top of the Metrics," pg. 47, July 2007 issue).

That approach is the "almost right now," as opposed to the more specific "exactly right later" approach described in this article, which provides a nonthreatening view of profitability. Factor in this post-season detailed analysis of item profitability, and you'll have guaranteed improved bottom-line results.

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To check out George Mollo's sample item profitability model, click on related content.

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