BUSINESS GUIDE

How to Drive Profitability With Limited Resources

8 Steps to Maximize Margins and Meet Customer Demand

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8 Steps to Maximize Margins and Meet Customer Demand

Businesses are caught between cost pressures and challenges getting materials, components and finished products and customer demand that may exceed supply. Inflation continues to rise. Freight costs have doubled or tripled along some popular routes. International conflicts are driving shortages of critical raw materials like wheat and nickel while pushing up energy prices. In China, which is responsible for 12% of worldwide trade, strict lockdowns to curb COVID-19 outbreaks continued well into May and stalled the recovery of factories and ports that had just begun to catch up.

Whether we're talking semiconductors or steel, when businesses can't get what they need, they're left unable to meet demand and searching for ways to compensate for lost sales. And even when materials and components are available, they almost always cost more. Inflation has driven up the cost of materials and labor, thereby increasing the cost of goods sold (COGS) in a way that's obvious on income statements.

Today, careful resource allocation and profitability analysis are necessary to maintain financial health. Manufacturers, distributors and retailers must keep margins in mind at all times as they make or purchase goods. Businesses should also evaluate their full product portfolios to understand which items contribute most to the bottom line and use those insights to determine which to double down on, which are in need of a price or design adjustment and which to phase out.

The best SKUs combine high margins and high sales.

Not all products deserve the same treatment, so across-the-board adjustments like reducing total production by 10% or spreading capital equally across all categories is a mistake. Companies must look at both unit margins and expected demand to figure out which items warrant greater investment.

Decisions about what your business prioritizes and offers have far-reaching effects. Human resources go toward managing every vendor relationship, placing and tracking purchase orders, putting away and managing inventory and, for manufacturers, making goods. Analyzing your product portfolio will position you for success in a time of resource constraints by ensuring time and money are spent in the right places.

Table of Contents

CHAPTER 1

How Scarcity Leads to Tough Decisions

Scarcity issues often start with manufacturers and trickle down to distributors and retailers. Labor shortages have exacerbated the problem — even if a company can get all the supplies it needs, it may not have the labor necessary to assemble products and fulfill work orders.

Businesses risk major hits to the bottom line if they don't proactively manage scarcity. Without visibility into profitability by item, total volume, labor and machinery requirements and shared components, employees simply complete work orders as they are generated. However, this linear approach risks using up valuable resources producing products that yield lower profits. Then, you don't have the materials to fulfill priority orders that have a bigger impact on the bottom line.

To maximize profitability, prioritize anticipated demand by asking six questions:

1. Which products have the highest profit margins?
2. Which products have the largest sales volumes?
3. Which products share components and raw materials?
4. Do multiple goods require some of the same labor inputs?
5. Do rising costs impact the margin for this product?
6. How much does this SKU contribute to the bottom line?

Armed with this information, businesses know which items have the biggest impact on the bottom line and can expend resources accordingly.

Note: Leaders must alert sales to new priorities so reps don't make promises they can't keep. Prioritization can't be done after work orders are on the docket.

For example, consider two products that require a common material and component: Product A retails for $1,000 and delivers a 50% profit gross margin, while Product B sells for $500 with a 20% profit margin. Customers want 100 of each item, but you have enough supplies to manufacture only 100 products total. Make 80 of Product A and 20 of Product B, and you realize a total profit of $42,000. If the business instead made 50 of product A and 50 of Product B, its profits would be $30,000.

But decisions can't be made solely on numbers; you must also consider buyers. You might make exceptions for your most important customers when they place orders for less profitable products because you know the value of the long-term relationship.

Deciding how to allocate limited supplies can happen independently of product rationalization. Shortages will presumably taper off at some point, so it usually doesn't make sense to cut a product simply because it's difficult to produce or acquire right now. But until supply chains normalize, the results of such an exercise are an invaluable source of insights for allocation decisions.

CHAPTER 2

8 Steps to Evaluate Your Product Portfolio

A product rationalization exercise provides an in-depth profile of every SKU the business sells, an improved ability to track each item's profitability and insights into how sales and margins change over time.

Products that you prioritize should deliver healthy profits and significant sales volume, taking into account customer value.

The steps outlined below will help you understand which products to prioritize to maximize profitability and mitigate the effects of higher costs and scarcity.

1. Apply the Pareto Principle

First understand what items drive revenue and, more importantly, profits. In the context of inventory, the Pareto Principle posits that for most businesses, 80% of profits come from 20% of products. Using the Pareto Principle to categorize your inventory is a great way to identify which items you should prioritize and which should receive less investment.

Take a close look at your top-selling, highest-margin goods to understand what makes up that 20%.

There is often nuance. Some items may be highly seasonal, for example, accounting for the bulk of sales in the winter but contributing little in the summer. Others may see a year-over-year decline in sales but could still rank among top profit drivers for the time being. There could be complementary products that are not in the top 20% but drive sales of related and highly profitable items.

Once you've identified the top 20%, break down the remaining 80% into mid- and bottom-tier performers. For those mid-level SKUs, is there a way to boost sales, assuming you have the capacity to produce more, perhaps by promoting them or packaging them with a related item at a good price point? Or is it difficult to get components for this SKU, and therefore production should be limited? Does an emerging trend suggest sales may jump for a mid-performer?

Items that rank toward the bottom are prime candidates for removal, barring a compelling reason from your customers to keep them. Knowing your average and low performers will also help place SKUs on a lifecycle curve.

2. Document the Product Lifecycle

At its most basic level, the product lifecycle includes four stages: introduction, growth, maturity and decline. Here's what is involved in each of these stages:

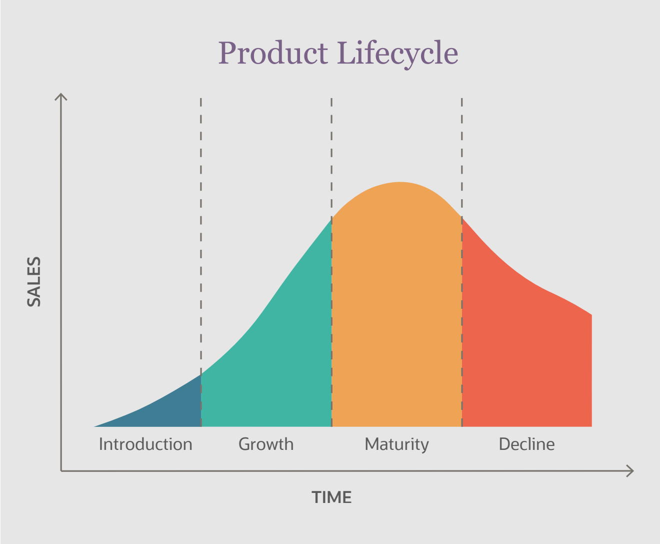
- Introduction. No product should be produced without understanding customer demand, especially in a time of resource scarcity. Customer needs assessments, through sales team discussions and market analysis, let businesses know if there's enough demand — and if that demand will support pricing that returns a good profit.

  In some cases, a company will want pre-orders in hand before a new product goes into production, understanding that early demand builds buzz. But that's just the start. The company must continue to explain the product's value proposition, messaging that usually comes through marketing campaigns. Most items don't take off right away; how long can you give the product to meet projections?

- Growth. Demand for a product increases, and it becomes a bigger contributor to your top and bottom lines. It begins to compete more directly with similar products or, if it's a new offering in the market, competitors start to emerge.

- Maturity. Sales for the product peak and demand stabilizes during this phase. The company may focus on improving the product or reducing the COGS — perhaps through economies of scale — to increase profitability. At this point, the item is a key contributor to the business's financial success.

- Decline. Once sales begin to slow, the product is in the decline stage. This could happen quickly or after an extended run of solid sales. Depending on how rapid the decline is, the business should either reinvent the product or initiate plans to stop selling it. However, if the decline is slow and margins are solid, there's no reason not to continue the product for some time.



The product lifecycle curve is an important framework because a product's phase affects how it's evaluated. For example, an item that is not among your bestsellers could still be in the early part of the growth stage and soon see a spike in sales.

On the other hand, a product in the maturity phase just beginning to see sales taper off may need production scaled down in anticipation.

Accurately documenting an item's lifecycle stage is possible only with all current and historical data in one place. Details on sales, time on market and costs at the item level can provide decision-makers with valuable perspective as they rationalize the product portfolio.

Organizations should thoroughly evaluate their product offerings on a regular basis, often quarterly or every six months, to ensure resource allocation is always aligned with the current top performers. This doesn't necessarily mean eliminating SKUs from your portfolio. It could, however, help you decide to invest less time and fewer resources in certain goods.

3. Evaluate Products in Decline From a Sales and Marketing Perspective

Once you've put products in tiers and know where they are in their lifecycles, you have the necessary context to avoid making poor decisions based on short-term results.

Look closely at goods seeing weak sales. Are they still in the introduction phase and it's therefore expected? Is there a temporary issue that's causing a brief dip in demand for a growth-stage item? Or have they reached the decline phase of the lifecycle curve?

Don't ignore items in the decline stage or that have simply failed to gain traction — businesses cannot afford to let dying SKUs eat away at the bottom line, especially if their margins are low. Either revamp products in a way that gives them renewed life or make plans to sunset them. The key is to constantly monitor your lineup to understand what's trending down, and then identify the cause.

Not all products in decline should be discontinued. Does the item have reliable customers, is it relatively inexpensive to produce, and can you maintain enough demand make continued production worthwhile? The road down for well-established products might be less speculative than the road up for comparatively new or trendy items. But there will be a point where continued sales don't make sense.

4. Now, Consider Material Inputs for Those Declining Items

What goes into each SKU is another factor to consider as you review your product portfolio. Businesses that make or assemble goods often use common components or materials in multiple items they sell, and they must know where this overlap exists. What's required to manufacture average performers, and are those same parts needed for products among your top 20%? If not, ordering those supplies presents more risk because if sales tail off for a declining item, that could leave you with obsolete inventory.

Price increases and sourcing issues with these inputs should also factor into decisions to refine your product selection. Do several goods require scarce or pricey components? Are these products still your margin leaders after accounting for these higher component costs, or would customers be willing to pay more for them? If not, the items may not be worth carrying.

5. Recognize the Role of Labor

The number of US job openings has soared to record highs, and manufacturers know all too well that the labor shortage is especially acute in roles that require specific skills or experience. For example, Deloitte predicts that manufacturers will be short more than two million workers by 2030.

If you don't have the necessary labor to operate machinery and complete other tasks involved in making a certain good to fully satisfy demand, that limits sales.

Companies do have options here. They can upskill existing employees with targeted training programs, offer more flexible working hours and invite candidates from a wider variety of backgrounds to apply for jobs. Technology that can automate steps across the order-to-cash cycle can also free up staff to spend time in areas where you're running short on resources.

But these solutions all take time to implement, so in the interim you might need to adjust production based on priorities. There are cases where a temporary change makes sense in the short term, particularly as you use these methods to address your long-term skills needs.

6. Balance Costs and Pricing

Input prices have risen dramatically since the start of the pandemic and continue to rise, according to the S&P Global PMI. So it's as critical as ever that companies track the cost to produce or acquire each item they sell.

The first number to pay attention to is **standard costs**. For a manufacturer, these include the materials, parts, labor and machinery needed to make the product. For a distributor or retailer dealing in finished goods, standard costs are simply what you pay per item. It's critical now to monitor for variances between standard (targeted) and actual costs.

The second number to monitor is **landed costs**, which is more comprehensive and includes expenses like shipping, customs and duties, taxes, insurance and handling on top of standard costs.

A company must track these costs at an item level to understand the unit margin of each item in its portfolio. And it must have a system that updates numbers as prices change — especially important with high inflation and sudden spikes in material and transportation costs — to see the impact on margins. Only knowing the cost of some components or the prices shown on purchase orders is not sufficient.

Learn More

- How to Increase Prices Without Losing Customers, According to a Harvard Lecturer. Communicating proactively, framing an increase in context of the value proposition and using data-based approaches are all key.
- Services Firms and Price Hikes: 4 Steps to Increase Profits Without Losing Business. If you offer services as well as products, success tactics include introducing value tiers and premium features and grandfathering longtime clients.

Prices often need to be changed to reflect changes in costs. Price is one of the biggest levers businesses can pull as they try to pull more profit out of the goods they sell. While it's complicated and challenging to get right, there are two common situations where price adjustments make sense.

1. High volume, low margins: If products have low profit margins but consistently strong demand, customers may be willing to accept a price increase. If you're struggling to even keep up with demand, that's all the more reason to raise the price, as it can curb demand. Experimenting with different prices will help you find a sweet spot that leaves room for profit and generates healthy demand.
2. Direct demand: Pricing is also a tool businesses can use to push demand to certain products. For instance, if a few SKUs have great margins but sales have been lower than expected, it might be smart to lower the price per item or reduce the purchasing volume threshold for discounts. Similarly, lowering the price of a new product in the introduction or early growth phase can help it attract interest until buyers recognize the value and demand takes care of itself.

Note that price optimization is not a solution for every item you're considering scaling back. It should be applied selectively where the data suggests it would make a product a stronger contributor.

7. Factor in Macro-Economic Conditions

In these turbulent economic times, decision-makers should consider not only a product's performance today but how it will fare in the near future. Inflation is the highest it's been since the early '80s, and the Fed has raised interest rates in response. Both affect your customers and have increased concern about recession.

How could these macro trends affect your sales?

For example, realize that items viewed as must-haves rather than nice-to-haves will sell despite inflation. Companies that have been through previous downturns can use that experience to predict what items will see demand drop off and which will see steady or even stronger interest. As B2B buyers pay more for the lines of credit they use to buy inventory, they may place smaller purchase orders.

Check in frequently with customers to understand how changing conditions are affecting them and what they need from you. Don't overlook suppliers, either, who work with a wide array of companies and can serve as bellwethers for entire industries. The sooner you can prepare, the better.

8. Always Follow the Metrics

As we've pointed out, data plays an invaluable role in product rationalization. Sales history, trends and profitability are important numbers on their own, but they provide additional value when they're used to calculate KPIs.

A few metrics to watch closely, and how to calculate them:

- Inventory turnover ratio. This ratio measures how frequently a company sells through all the inventory it purchased. It shows how quickly a company moves through on-hand stock of a certain item or category of items. Generally, the higher the inventory turnover ratio, the more important that product is to the overall business; note, however, that if it's too high, that may indicate you're not buying enough inventory per order.

  Inventory turnover ratios can vary greatly by industry, but many businesses target five to 10 turns per year. To calculate the inventory turnover ratio, a business first must find its average inventory by adding its beginning inventory and ending inventory for a certain period and dividing the result by two.

Inventory turnover ratio = COGS / Average inventory value

- Sell-through rate. While similar to inventory turnover, sell-through rates look at how much inventory you sell rather than the speed at which you sell it. It calculates what percentage of all products that a business receives is sold during a specific time period, such as one month.

  Companies often target a sell-through rate of at least 80% over the selected period. Obviously, sales volume can have a big impact on a product's financial importance to a business, so this is another metric worth watching closely.

Sell-through rate = (Number of units sold / Number of units received) × 100

- COGS. Every products business measures the cost to manufacture or purchase the goods it sells. But they must monitor COGS with a particularly close eye now, given fast-rising prices. Increases in labor, input and shipping costs — many organizations are experiencing all three right now — can sink gross profit. This makes COGS another crucial metric in making decisions about your product lineup.

COGS = (Beginning inventory value + Purchases) − Ending inventory value

  Learn more about what COGS is and how to calculate it.

- Average age of inventory. This calculates the amount of time your organization typically holds products. The age of inventory is far more important in some industries than others — consider a food seller where products expire in a matter of weeks versus an industrial manufacturer that sells many of the same items year after year. But by understanding how long different SKUs sit, you can pinpoint your slowest sellers or items seeing a decline in demand and determine which no longer provide much value.

Businesses often create an inventory aging report that classifies inventory by how long it's been on-hand, like 0-30 days, 30-60 days, 60-90 days and so on.

Average age of inventory = (Average inventory cost / COGS) × 365

- Labor cost per unit. Manufacturers must understand how much they spend on labor for every product they make to get a clear picture of profitability. This requires breaking down direct labor costs at an hourly rate. Direct labor costs include wages, benefits and even payroll taxes, and calculations should be done for each employee needed to manufacture a particular good. It's especially important to watch this metric closely now as businesses increase pay to attract and retain talent.

Labor cost by product = Hourly direct labor costs × Hours spent making product

Earning Internal Buy-In

Phasing out items in your product catalog can be controversial internally. Sales reps may be annoyed you're getting rid of an item they've always had success selling, and longtime employees may not be happy you're pulling back on items they're comfortable making. But there are steps project leads can take to earn buy-in from skeptics.

Lean heavily on data to justify your decisions or recommendations. Using our earlier criteria, explain why the numbers point to discontinuation as the best option. This demonstrates that it's an objective decision in the business's best interests.

Set up a cross-functional team that can bring qualitative perspective on the impact of slowing or stopping sales of a product. This team should include representation from sales, finance, operations, marketing and any other relevant department. Each person brings knowledge based on their own experiences and can cover others' blind spots.

For example, perhaps a below-average performer is something one of your biggest customers counts on you to supply. Pulling it could risk that entire relationship, which has financial repercussions beyond this one item. Or maybe a product with average margins ranks highly in search engine results and attracts a lot of new customers to your site.

Thinking this through will prevent any department from feeling blindsided by the decision to stop selling a certain good. It gives them time to plan for the change, and including them in the evaluation process should help secure buy-in.

CHAPTER 3

Managing Your Product Portfolio With a Unified System

Manually crunching the numbers on every SKU you sell could be time-consuming or completely unrealistic, depending on the size of your product catalog. That's why you need software that can help at each step, from managing the product lifecycle to tracking costs to pricing management to product development.

> A leading cloud ERP system, like NetSuite, can serve as a central data repository for your entire business.

For most growing and midsize companies, an ERP has everything necessary to act as the product lifecycle management system. NetSuite's inventory management and order management modules can track all sales in real time so you can see sales and profitability trends. Because NetSuite is a single, centralized system of record, the inventory record serves as the product information management (PIM) solution, holding all relevant data regarding COGS, MSRP, bill of materials details and more. These solutions track specs on each product and provide details, like release date and historical performance, to help you understand where it sits in the lifecycle. They can also show standard and landed costs by item and how they've shifted over time.

NetSuite users can easily see reports on top sellers, their most profitable items and their most expensive to make or buy. That makes it easy to distinguish top performers. NetSuite has prebuilt dashboards to track common KPIs, and non-technical users can quickly set up custom dashboards.

The planning capabilities in an ERP help businesses project future demand so they don't buy the wrong products or too much inventory. For instance, companies can see how best-case or worst-case economic conditions would affect sales of different products. Manufacturers can take this to the next level with NetSuite MRP, creating production plans that detail the exact amounts of materials, parts, machine capacity and labor required to meet expected demand. Businesses can then spot any issue — like a shortage of workers — and understand how that will affect financial results. They can devise plans to minimize the impact before it's too late.

Finally, the data in NetSuite inventory records, like sales trends, costs and price history, can help determine the ideal price. The system can also help with promotions management. Users can set price changes for a certain period of time, offer discounts only at certain volumes and mark products ineligible for promotions if they don't meet certain profitability thresholds. Once discounts are in effect, you can monitor the results in NetSuite.

Conclusion

At times, it seemed that supply chain snafus, inflation and other challenges would be fleeting. Yet some have lasted for years, and as one disruption fades, another appears. These same forces have businesses staring down a potential recession.

Evaluating your entire product portfolio and making informed choices about which SKUs to phase out or increase is one way to prepare to weather a downturn. This can mitigate the impact of higher costs and protect profitability.

And, even in a strong economy, businesses must be laser-focused on profitability. Inventory is a great place for products-based organizations to start implementing this tenet. Insights into the top- and bottom-performing items allow you to allot resources — financial, human and otherwise — where they will boost revenue, profit and cash flow.

An even-handed approach to resource allocation will do none of those things.

As product rationalization becomes standard practice in an organization, it will inform other areas, like product research and development. Eventually, it will turn into a guiding philosophy for the company. While there may be urgency to turn a critical eye on the products you sell now, this exercise will serve your business well during both the best and worst of times.

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