

Pricing it right

In Brief: Markdown Effectiveness

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“When retailers’ merchandise hits the stores, they’ve essentially placed their bets,” says Rob Nemett, Senior Director for Merchandise Optimization at PwC Canada’s Retail Consulting Services.

Early in the buy cycle, retailers plan their budgets by determining what categories, trends, markets, and store clusters they will invest their dollars (Assortment Localization). Based on those decisions, a further tuning of the buy happens after quantity and size decisions are made based on the sales opportunities by location (Inventory Optimization). By the time inventory hits the stores, there is really only one variable left—price.

Used as a lever to balance inventory levels and consumer demand, retailers will adjust prices downward through the product lifecycle to clear goods and make room for new receipts. Retailers who leverage a Markdown Optimization toolset deploy processes and science-based approaches that make markdown decisions more objectively and maximize the margin dollars on their exit strategies.

Typically most retailers either take a historical or time-based approach to markdowns or allow their buyers to treat markdowns as an art rather than a science by employing their instinct to make subjective markdown decisions. In a time-based approach, retailers decide that by a certain date, they will reduce the price of an entire collection of merchandise by a particular percentage, and weeks later, make further reductions. These reductions generally apply equally to merchandise that is selling well and merchandise that isn’t selling well.

Looking to reduce the margin leak associated with “collection” markdowns, other retailers allow the buyers to take markdowns instead by style or item. As

original purchasers, buyers’ objectivity is often compromised and they commonly hold off on making a timely markdown hoping the customer will become interested in the product later in the season. Instead, they should address the balance of supply and demand immediately.

“To maximize the gross margins on inventory, retailers need to ensure they are taking markdowns on the right items, to the right depth, at the right time, in the right channel based on customer demand and are avoiding unnecessary markdowns on ‘good’ merchandise,” says Nemett. “The overall objective of Markdown Effectiveness is to streamline and standardize analysis and decision making for the entire markdown process and increase consistency in the markdown cadence.”

In 2008, PwC Canada’s Retail Consulting Services conducted research with 26 different retailers that have implemented Markdown Optimization (MDO). Early adopters are now in their sixth year of using MDO technologies. Over this time period, the approach has been put to the test over complete business cycles and through both highs and lows. Two thirds of these organizations feel they have been successful with MDO and have become even more sophisticated in their use of the technology while the other third admit they have regressed or failed to harness the precision of the technology.

“This research helped us determine that not every retail business model is a good fit for MDO, and it validated conclusions that we reached during remediation engagements at over a half dozen retailers,” says Nemett. As with all systems implementations, you need to focus on process and policy first, and technology second. A critical process question to answer is how the retailer plans to execute localized markdowns at the item level and communicate that value to its customers. To that end, retailers biased towards running classification and storewide discount events historically have had a tough transition to capturing the benefits for MDO and represent a majority of the failed implementations. The change management focus is very important and retailers need to reinvest in continuous improvement by maintaining and increasing sophistication by applying learnings, realigning rules with strategy, retraining and refreshing.

According to Nemett, Markdown Optimization is ideally suited for retailers with more than \$500 million in annual revenue. Smaller retailers seeking to increase their markdown effectiveness can benefit from an investment in a Rules-based Markdowns toolset, typically a fraction of the cost of MDO, but still incorporating exit dates and the identification of markdown opportunities. Both alternatives ultimately take emotion out of the decision to yield a precise markdown recommendation aligned with their merchandise profitability objectives.

The components of markdown effectiveness

Markdown Effectiveness is made up of two components designed to help retailers do this—Rules-Based Markdowns (RBM) and Markdown Optimization (MDO). A Rules-Based Markdowns approach introduces key Markdown Effectiveness principles and inventory discipline without the forecasting capability that is required to deploy Markdown Optimization technology. There are four principles of Rules-Based Markdowns:

1. Establish a clear definition of the life cycle targets: Buyers write purchase orders with a targeted date to be on floor and meet consumer demand, but don't necessarily plan the exit strategy with the same rigor. They assume that the goods will sell down in advance of the next collection and sell through in advance of the next season. Reductions in price can be used as a lever to drive inventory goals consistent with pre-determined sell-through targets.

2. The first markdown is the cheapest: A proactive, timely markdown will typically yield a proactive timely response from the consumer. For example, taking an aggressive markdown to clear non-performing inventory after four to six weeks of sales will yield a better gross margin return on investment than delaying the markdown, accepting lower unit sales at full price and then having to clear more units in an end of season clearance event

3. Markdown decisions must be precise: Retailers must markdown the right item at the right time at the right price in the right location. In today's environment, this means seeking opportunities to take markdowns at location rather than chain level, at style level instead of group or collection, and ultimately, enabling a capability to take colour/item markdowns at the location level. A long-term strategy that does not embrace localization of markdowns as a goal is a green light to waste markdown and ultimately gross-margin dollars needlessly.

4. Take emotion away from decision making: Rather than use intuition and history to drive the markdown cadence, objective and fact-based tools should be deployed. A Rules-Based Markdowns tool can readily identify slow-sellers based on pre-determined

criteria. A Markdown Optimization solution will combine pre-determined criteria with a forward-looking point of view on profit-maximizing actions. Both tools enable a buyer to spend less time gathering data (or highlighting selling reports) and more time evaluating scientifically-driven recommendations. Markdown Optimization captures all of the principles of Rules-Based Markdowns and then leverages advanced analytics in order to forecast demand by using historical data to calculate parameters for consumer demand and the elasticity of that demand relative to changes in price. Once calculated, it's applied to in-season trends to forecast the forward-looking demand for short life cycle merchandise. Markdown Optimization also leverages computing power to run more scenarios than a human being ever could. (See Figure A)

“After implementing Markdown Optimization at over a dozen specialty and department stores, we know that the typical implementation timeframe for a Markdown Optimization solution is five or six months, which means that retailers can start getting returns within the same fiscal year. So a retailer might make a \$2 to \$3 million investment and see a \$6 million in payback within six to twelve months after deployment— these types of returns can make the project a justifiable exception to capital restraints.”

Figure A

	Rules-Based MDs	MD Optimization
Technology	Simple, rules based, exception reporting	Advanced forecasting and price elasticity, rules
User Interface	Spreadsheet (Excel)	Markdown Optimization Application
Approach	Recommends markdown candidates, bottom up, by style	
Firm MD Budget	Does NOT consider top down Firm MD budget when making recommendations; Firm MD budget is our top-down risk control	
# of Price Zones	Limited (up to 3)	Large number of zones possible
Price Zone Approach	Geographic	Multi-Dimensional, Clustering (e.g. Sales, Turn, Demographics)
Taking Markdowns	Yes/No in Excel report by style; Either keyed into Host Application, or possibly fed	Approve by style on screen, MDs automatically fed into Host Application—no keying
Planned Promos	No knowledge – upcoming promo may be a reason to reject recommended markdown	Taken into account— will factor planned promos into the forecast

The PwC advantage

We can help you build value

Across Canada, PwC has a dedicated team of Retail Consulting professionals with hands-on experience helping retail companies optimize their allocation systems. We can work with you to assess your inventory and assortments and develop a sustainable solution to fit your needs. Our experience is based on working with retailers of all store categories to provide insight into both consumer behaviour and leading best practices for retailers.

Call one of our consultants listed here to discuss your unique needs.

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