HYDRIAN

Item-Level Profitability: Strategies for Maximizing Product Performance

Introduction

In industrial distribution, managing a large inventory can be challenging. The sheer number of SKUs, combined with fluctuating demand, extended lead times, and varying customer needs, presents a significant hurdle. Traditional approaches are often inadequate, leading to excess inventory, tied-up capital, and diminished profits.

A granular, item-level approach to profitability is essential. By shifting from broad categories to individual products, you gain a precise understanding of how each item contributes to your bottom line. This in-depth insight enables data-driven decisions, allowing you to optimize inventory for higher profit margins, improved operational efficiency, and better inventory control.

This ebook provides the strategies and information needed to master item-level profitability and maximize your product portfolio's potential.

Understanding Item-Level Profitability

Moving beyond simple gross margins is crucial for optimizing your product offerings. While a product might look profitable based on its initial markup, a deeper dive often reveals hidden costs that significantly impact the bottom line. True item-level profitability requires considering all associated expenses, not just the difference between cost and selling price.

Beyond Cost-Plus Pricing

Traditional cost-plus pricing models, while simple, often fail to capture the true complexity of item-level profitability. They typically overlook critical factors like storage, handling, and obsolescence, leading to inaccurate profit calculations.

Item-level net profitability provides a more granular view, considering all costs associated with the product. This includes:

- **Direct Costs:** Cost of goods sold (COGS), inbound freight.
- **Holding Costs:** Warehousing, utilities, insurance, labor, obsolescence.
- **Outbound Shipping:** Where relevant, costs related to shipping the product to the customer, including dropship fees.
- **Other Costs include** minimum order quantities (MOQs), vendor performance (lead times and reliability), and even the influence of customer order composition.

The SKU Diet: Identifying Your Star Performers and Underachievers

The "SKU Diet" is a systematic, data-driven approach to reviewing product performance and optimizing your inventory. It's about identifying the high-performing items and eliminating the SKUs that drain resources and complicate operations.

The SKU Diet involves a deep dive into several key metrics:

- **Sales Volume:** A fundamental measure of how much of each product you're selling. While high sales volume can indicate a healthy product, it's crucial to consider this metric in conjunction with profitability.
- **Profit Margin:** This goes beyond just the gross margin. It represents the actual profit earned on each sale after all costs are factored in — COGS, holding costs, shipping, etc. This provides a much clearer picture of a product's true contribution to the bottom line.
- **Inventory Turnover** is a crucial metric that measures how efficiently you move your inventory. A slow-moving item, even if profitable, can tie up valuable capital, increase holding costs, and become a liability over time. Conversely, high turnover indicates efficient inventory management and minimizes the risk of obsolescence.

Hydrian offers a practical framework for applying the SKU Diet. We recommend segmenting your inventory based on both sales transactions and COGS, creating a more nuanced view of your product portfolio. This typically involves categorizing items into A, B, C, and D groups, with A items representing your top performers based on sales volume, and the remaining categories reflecting different tiers of cost and demand. This approach allows you to prioritize inventory investment and service levels, ensuring high availability for your bestsellers while efficiently managing the overall investment in inventory.

To put the SKU Diet into practice, follow these key steps:

Gather Comprehensive Data

Collect detailed data on each SKU, including sales history, COGS, selling price, current inventory levels, holding costs, and any other relevant expenses.

Calculate Key Metrics

Using the gathered data, calculate the profit margin and inventory turnover for each SKU. This provides the foundation for your analysis.

Segment Your Inventory

Implement Hydrian's classification system or a similar method to categorize your SKUs based on the calculated metrics. Remember that the A, B, C, and D categorization is just a starting point; you can adapt the system based on the unique dynamics of your business and the specific demands of your customers.

Analyze and Interpret

Carefully review the performance of each segment. Identify your star performers (high sales, high margin, high turnover), your underperformers (low sales, low margin, low turnover), and the products that fall in between. Look for patterns and trends that can inform your inventory strategy.

Develop Action Plans

Based on your analysis, create specific action plans for each segment. This might involve adjusting pricing for certain products, optimizing inventory levels to minimize holding costs, implementing targeted marketing campaigns to boost sales of promising items, or even making the difficult but sometimes necessary decision to discontinue underperforming SKUs.

By systematically applying the SKU Diet, you gain valuable, data-driven insights into your inventory and empower yourself to make informed decisions that maximize profitability and optimize your overall operations.

Case Study: Successful SKU Optimization

In 2022, Hydrian implemented a SKU Diet for a $150 million revenue aftermarket and OEM parts distributor. Like many distributors, this client faced the challenge of managing a large and complex inventory. Working closely with Hydrian, they established clear parameters for classifying their existing catalog and embarked on a year-long optimization journey.

The results were impressive:

- **Reduced Stocking SKUs:** From 14,500 to 8,250, freeing up valuable warehouse space and reducing holding costs.
- **Stable Dropship Offerings:** Maintained around 9,000 dropship items, strategically removing 2,000 underperformers and adding 2,000 new, promising products.

- **Increased Just-in-Time Products:** From 4,500 to 5,500, allowing for efficient handling of specific items without the burden of excessive stock.
- **Discontinued Products:** Over 4,000 underperforming products were discontinued, streamlining the catalog and eliminating unnecessary complexity.
- **Improved Fill Rates:** Increased from 86% to 94%, leading to improved customer satisfaction and reduced lost sales.
- **Increased Inventory Turns:** From 3.3 to 5.5, demonstrating a significant improvement in inventory efficiency and capital utilization.
- **Increased Gross Profit:** From 34% to 36%, showcasing the positive impact on the bottom line.
- **Increased Revenue:** An 8% increase in revenue, demonstrating that a streamlined, optimized inventory can actually drive sales growth.

By strategically managing their inventory, Hydrian's client achieved significant improvements in efficiency, profitability, and customer satisfaction.

Strategies for Optimizing Item-Level Profitability

Once you have a clear understanding of true item-level profitability, you can start implementing strategies to optimize your product offerings and maximize your returns. Here are some key strategies:

Pricing for Profitability

Moving beyond cost-plus pricing unlocks more strategic approaches, such as value-based pricing (based on perceived customer value) and dynamic pricing (adjusting prices based on real-time market conditions). For instance, a distributor could implement value-based pricing for specialized, high-demand components and dynamic pricing for commodity items with fluctuating market prices.

Inventory Optimization

Hydrian's approach highlights the importance of balancing sales velocity, volatility, and supplier reliability when determining optimal inventory levels. This allows for minimizing stockouts for high-demand items while keeping overall inventory lean and efficient. Demand forecasting and inventory management software play crucial roles in this process, providing data-driven insights for optimizing stock levels and responding effectively to changing market conditions.

Managing Item Affinity

Item affinity — the relationship between products frequently purchased together — significantly impacts order fulfillment and customer satisfaction. For instance, a distributor might strategically stock a low-margin gasket because it's crucial for installing a high-margin valve. Understanding and leveraging these relationships is essential; ignoring them can lead to frustrating stockouts and lost sales, even for your most profitable items.

Actionable steps include analyzing sales data to identify affinity groups and adjusting inventory strategies accordingly. This proactive approach ensures that all necessary components are available when needed, leading to smoother order fulfillment and increased customer satisfaction.

Making Informed Decisions: Drop-Shipping, Stocking, or Discontinuing

Optimizing inventory requires strategic decisions about each product: drop-ship, stock, or discontinue. The best approach depends on several factors.

When to Drop-ship:

Drop-shipping, where the supplier ships directly to your customer, benefits certain products. It minimizes inventory costs and reduces obsolescence risk, especially for low-volume or high-cost items. However, it creates supplier dependencies, potentially affecting lead times and customer experience. Consider drop-shipping for bulky/expensive items, low-demand products, or those with dependable suppliers.

When to Stock:

Stocking items in your warehouse maximizes control over fulfillment, minimizing lead times, and ensuring consistent customer experience. It suits high-demand, high-affinity (frequently purchased together) items with reasonable size and cost. Consider sales volume, supplier lead time, and storage costs. Prioritize stocking essential components for larger, more profitable orders.

When to Discontinue:

Discontinuing a product is sometimes the most strategic option. Consider this for items with consistently low demand, low margins despite improvement attempts, high holding costs, long lead times, readily available equivalents, or those negatively impacting customer satisfaction. Phase out discontinued products strategically, offering alternatives and minimizing disruption.

Conclusion

Mastering item-level profitability is an ongoing process of analysis, optimization, and adaptation. New tools and strategies for inventory management are constantly emerging. Advances like AI-powered pricing and predictive analytics offer opportunities to refine item-level strategies further and optimize your product portfolio with even greater accuracy.

Act now to transform your inventory from a source of complexity and cost into a driver of profitability and growth. Implement the SKU Diet, analyze item-level profitability, and make data-driven decisions about each product.

About Hydrian

Hydrian is a supply chain consulting and implementation firm that partners closely with purchasing and supply chain teams to optimize inventory management. Our goal is to help clients reduce stockouts, prevent excess and aging inventory, lower operational costs, and increase revenue through improved stock availability.