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Healthy Profits for Healthy Products

Four keys steps can help strengthen a company's profits, improve its margins and heighten its chances of winning at the retail shelf.

Pat Schneider | Oct 13, 2015

The dietary supplement category continues to show strong growth increasing 5.1 percent in 2014 to US$36.7B, coming off a healthy showing of 7.5-percent category growth in 2013 at $34.9B, according the *Nutrition Business Journal*. As this Boomer-friendly category continues to expand at retail, the

competition for shelf space heats up, and the cost of entry in both trade and consumer promotional spending is increasing. Since the pressure is on companies to support brands at shelf, as well as the need to increase the corporate bottom line, savings must be created in other areas of the profit and loss (P&L) to meet both objectives.

To ensure that healthy products grow healthy profits, the COGs (cost of goods) line on the P&L statement should be rigorously scrubbed every year to remove those hidden profit drains—the biggest culprit being SKU proliferation. By undertaking a few simple exercises every year, a company can reduce its COGs and allow for either a direct drop to the bottom line or allocate those funds to greater promotional spending to help new and existing SKUs remain competitive at retail.

Four keys steps can help strengthen a company's P&L, improve its margins and heighten its chances of winning at the retail shelf:

SKU Rationalization. Companies should adopt a mantra that for every new product launched, one should be discontinued. The age-old "80/20" has never been more applicable than in the dietary supplement category. The dietary supplement category is still young (21 years since the Dietary Supplement Health and Education Act [DHSEA]), and there are always new exciting ingredients being discovered, additional indications for existing ingredients, innovative ingredient delivery systems and novel product platforms that continues to spur new product development. Organizations often get caught up in the latest "shiny new thing," the "president's pet project" or the need to constantly bring "new news" to the retailer that they frequently fail to delete a floundering or unprofitable product when they launch a new offering. By not limiting the total product portfolio, companies end up with hundreds of SKUs, many of which are unprofitable due to low volumes and uneconomical order quantities based on high production minimums. Many times, SKUs only have minor differences (e.g., tablet count, pack size, unique labels, etc.). By simply conducting a SKU profitability analysis, and applying the Pareto principle, a majority of companies will likely find that the bulk of their contribution margins (80 percent) are concentrated in a limited number of SKUs (20 percent), and it is time to cull the herd or using a Darwinism—it should be "survival of the financially fittest." Adopting a less is more strategy for many companies is often painful, but in doing, a company will reduce its COGs in many areas due to lower inventory carrying costs (finished goods, work in process, raw materials, etc.), more efficient production run times and improved purchasing power with your vendors. From a marketing standpoint, having fewer SKUs also allows promotion spending to be more effective and laser focused instead of diluted across dozens of SKUs.

Formula Simplification and Ingredient Harmonization. Once a limited and profitable set of SKUs is identified from the rationalization exercise, all of the formulas and ingredients for the remaining SKUs should simplified and harmonized. Unfettered new product development over several years frequently results in minor formula tweaks and minimal ingredient changes in an effort to launch a differentiated “new" product. Unless there is strong scientific support for these marginal product variations, new uniform formulas should be adopted. This will reduce the number of ingredients required for purchase which in turn, results in greater purchasing efficiencies and vendor volume discounts and rebates. With fewer ingredients, production runs can be optimized and reductions in COGs, both fixed and variable components, can be realized. The downside is that this will require significant, focused R&D and product development efforts. If a company has limited resources in these departments, then outsourcing this function should be considered.

Vendor Consolidation. Once the SKUs are condensed, the formulas simplified and the ingredients harmonized, vendor reduction should be conducted. Having fewer vendors streamlines the purchasing process and the entire supply chain. Having fewer vendors often results in higher volume purchases, simplifies the buying cycle and gives a company stronger bargaining and purchasing power. Additionally, less raw material needs to be purchased, stored and scheduled for production. Production runs can be optimized, and COGs can be driven down.

Limited New Product Launches. New product launches should be thoroughly vetted, with robust hurdle rates, to ensure they support incremental new net revenues and profits with a projected positive ROI (return on investment) by the third year, or they should be cancelled. As part of the NPD stage-gate process, a post-launch analysis should be conducted on all new products to assess the “net incremental value" generated 12 to 18 months after the new product launch. Most new products that are line extensions often show high cannibalization rates of existing SKUs resulting in negligible, or negative, revenue growth for the company. Additionally, when a plethora of new products are launched, they are often not supported by sufficient promotion and ultimately fail because the SKUs cannot meet the retailers’ annual shelf turn hurdle rates. This leads to even greater profit erosion due to high retailer discontinuation expenses in the form of delisting fees, RMAs (return material authorizations), off-invoice credits and other customer account deductions and charge-backs. Companies should limit launches to only those products with adequate promotional support.

Although there is no simple answer for improving a company’s bottom line, a critical set of action items for key departments in your company should be:

- **Finance Department**: Analyze profitability on all SKUs, and make recommendations to eliminate unprofitable, or marginal, SKUs
- **Product Development/R&D**: Assess product formulas and ingredients, and provide recommendations for simplification and harmonization
- **Purchasing Department**: Review current vendor list, and make recommendations for reductions and consolidations
- **New Product Development**: Evaluate the ROI all new products launched in last 12 to 18 months, develop a strong vetting process for all new products, and make recommendations on limiting the number of new product launches.

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