WHITE PAPER

# Lifecycle pricing for omni-channel profitability

Omni-channel transformation has had a bigger impact on retailers than any other phenomenon over the past few decades. Seamless, cross-channel shopping experiences and fulfillment options such as endless aisle and click-and-collect have supplanted previously linear sales and fulfillment operations, creating unprecedented complexity that threatens retail profitability. One aspect of omni-channel operations that is less-well understood, however, is how new lifecycle pricing capabilities can be leveraged to improve margins and profitability in this challenging environment.

The performance of inventory has always been of key importance to retailers. In the past inventory was segmented between channels, making linear inventory management and pricing processes straight forward. In today's omni-channel selling environment, however, inventory is shared, at least virtually, between channels and locations, requiring more consistency and transparency in pricing. This has elevated the importance of pricing from a focus on initial price and subsequent markdowns to the practice of lifecycle pricing—the ability to tie pricing and inventory performance to actual demand at a granular level at any stage in the lifecycle of a product to maximize margins and improve profitability. This is especially critical for seasonal products, sports and fashion apparel, and other short lifecycle merchandise. Products that are seemingly "out of season" and in markdown in one market may still be hot in another.  Price needs to be managed with an understanding of its margin impact for the entire lifecycle of the product.

## Markdowns vs. optimized inventory performance

The accepted practice for pricing short lifecycle merchandise is to:

- Forecast total demand for the product over its life span
- Set an initial price appropriate for the market
- Pre-set markdown price points and dates to help clear out the inventory by the lifecycle end date

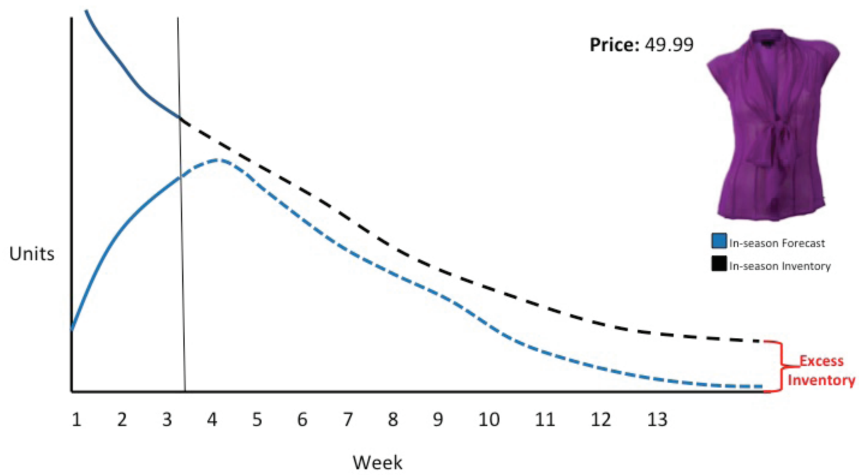
There are several challenges with this approach, however. First, actual demand seldom matches forecasts, especially at the store level. If the forecast is too high, there will be excess inventory at the tail end of the lifecycle which either has to be severely marked down or written off. (See figure 1) If the forecast is too low, you can run out of inventory, disappointing customers and leaving money on the table.

The real problem with the traditional approach is that it is based on forecasts, which are notoriously more inaccurate the further out you go, and does not reflect actual demand as it develops over the life of the product. Another problem with this approach is that it assumes markdowns are the best way to dispose of excess inventory—at least you get something for it, right? Yes, but at the cost of hurting your margins or even selling products at a loss.

The traditional approach also suffers from the fact it is usually done on a corporate level, seldom accounting for the variations in demand from one area to another, or even from store to store. Thus, in areas or stores where demand is high, markdowns can forfeit margin and profits when the merchandise would have sold out at a higher price. And in areas or stores where demand is low, standard markdowns may not be enough to clear inventory anyway.

There is a better alternative—lifecycle pricing. Lifecycle pricing looks at the problem from a whole different perspective. It focuses on how to optimize the performance of inventory across its entire life span and does not assume markdowns are the only or best way to move excess inventory. Lifecycle pricing is based on the principles of markdown optimization, but expands this functionality to optimize the broader scope of inventory performance issues inherent in omni-channel retail.

**Figure 1 – Typical short lifecycle forecast results**




## Selling vs. service

A fundamental shift is occurring in retailers' mindset concerning how to go-to-market in the omni-channel world. Traditional retail organizations and practices were organized around selling, a linear process that pushed products down through the supply chain and stores to the customer. Under this scenario, the concepts of price markdowns and markdown optimization make a lot of sense. They drive as much revenue as possible while minimizing excess inventory.

With the consumer now in charge of the shopping process, however, linear, push-based selling methods and markdowns are less effective. Today's consumers want products and shopping experiences personalized to their unique preferences across any and all of the many shopping channels now open to them. In the omni-channel world, retailers must change their mindset from selling products to serving each customer's needs and desires to create the best personalized shopping experience possible.

The good news is that focusing on customer-centricity actually opens up opportunities to improve margins by optimizing inventory performance across all channels and locations.

## Improving inventory performance

It all starts with better understanding your customers, their paths to purchase, and their actual purchases as they occur. Normally, forecasted demand for short lifecycle merchandise is based on sales of similar merchandise in a previous season. Oftentimes what is not taken into account in those forecasts are all of the contributing factors to those sales numbers.

For example, sales history may show that you sold 12,000 of a team's jerseys last season and therefore predicts you will sell 12,000 more this season. What the forecast may not consider, however, is that only 4,500 of those jerseys sold at list price, with the rest having been sold at severely reduced prices at the end of the season resulting in unacceptably low margins. Or the forecast might not take into account the fact that sales of the jerseys spiked last year because the team went far into the playoffs.

To provide a true forecast of demand, sophisticated demand decomposition technology is needed that breaks down sales history into the baseline volumes on which forecasts should be based and derived demand caused by special promotions, deep markdowns and extraneous events. By understanding true demand, you can optimize inventory levels to drive higher margin sales.

Even the best forecasts don't always conform to actual demand over the course of the season, however. Sales of swimwear, patio furniture or BBQ accessories that started out well may quickly slow down over the course of a cool, wet summer, for example. And this pattern may vary from one region that is experiencing this wet, cool summer and another that is actually hotter and drier than normal. That's why it is important to monitor demand locally on a regular basis, such as weekly, and adjust inventory and pricing plans accordingly to shape demand to sell out close to the end date. The goal is greater precision in inventory placement and pricing at increasing levels of granularity.

## Making profitable inventory decisions—it's not just about the red tag

Lifecycle pricing is based on the principles of markdown optimization, but goes beyond this to analyze demand and potential inventory performance at a granular level to maximize both margins and customer service. Thus, while it recommends optimal price points throughout the product lifecycle (see Figure 2), it also analyzes many inventory placement and movement options, including:

- Can inventory in slower moving stores be used for online order fulfillment? This enables you to sell the inventory at normal prices instead of discounting it, helps reduce excess stock, and can be beneficial in supporting same-day or next-day delivery options that increase customer loyalty.
- Can allocation and replenishment plans be altered to funnel more inventory to stores who are selling more of those items at higher prices? This increases average selling price and margins, reduces out-of-stocks and excess inventory at the respective high and low selling locations, and improves product availability and sell-through at higher selling stores.
- Would promotional efforts enable increased sell-through at a higher price than markdowns? For example, would a 20 percent promotional price as part of a bundled promotion drive higher total revenue and sell-through than a 30 percent "red tag" markdown?
- Can replenishment orders be cancelled and/or merchandise returned to the supplier? Are there other salvage options?
- Will the vendor provide support through additional promotions, rebates or other concessions?

**Figure 2 – Optimized pricing recommendations**

All of these factors must be considered along with regular updates on actual demand at a granular level in order to arrive at the most profitable inventory decisions. While red tag markdowns are still useful, they are just one of a number of options open to retailers to maximize inventory performance.

## Optimizing inventory performance with Lifecycle pricing

Lifecycle pricing is to omni-channel operations as markdown optimization is to traditional linear selling processes. It maximizes the margins and sell-through of merchandise, especially short lifecycle items which are typically the hardest to manage profitably. Lifecycle pricing methodology and technology expand the conversation from just pricing to all the potential uses of inventory at a local, granular level. The methodology includes the following steps:

- Capture item-level demand at the store level and from all other channels on a regular basis, such as weekly
- Systematically identify which items, by store and channel, won't reach the desired sell-through by the intended end date based on local demand
- Evaluate pricing options and alternate uses of inventory (as described earlier in this document) based on what-if analysis and decision support metrics
- Recommend optimal uses of inventory, including price points and dates, at a granular level to maximize margins and sell-through
- Calculate the opportunity costs of not implementing the recommendations to give executives a clear picture of all alternatives
- Repeat this process on a regular basis to course correct throughout the season or product lifecycle

Why go through all of this effort? First, advanced lifecycle pricing software automates many of the more burdensome steps in the process, reducing the effort typically required for manual practices or the use of spreadsheets. This makes pricing decisions easier and better informed. Second, those retailers who have implemented this approach have experienced the following benefits:

- 3 to 10 percent improvements in margin
- Up to 5 percent increases in revenue
- Higher sell-through with decreased amounts of excess inventory
- Improved omni-channel order fulfillment
- The ability to better leverage natural demand while it is available

In addition, by better understanding actual demand at a granular level, lifecycle pricing enables you to make better merchandising and inventory plans, improve purchasing decisions, and better position and replenish inventory to reflect customer buying patterns.

Let's face it, omni-channel has made retail operations more complex, putting downward pressure on margins and profits. Lifecycle pricing is one sure-fire weapon to combat omni-channel's impact on profitability. And since omni-channel is here to stay, those who are the quickest to accommodate it profitably will be the winners going forward. You can't afford to wait.

You can learn more about markdown optimization and lifecycle pricing here.

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