



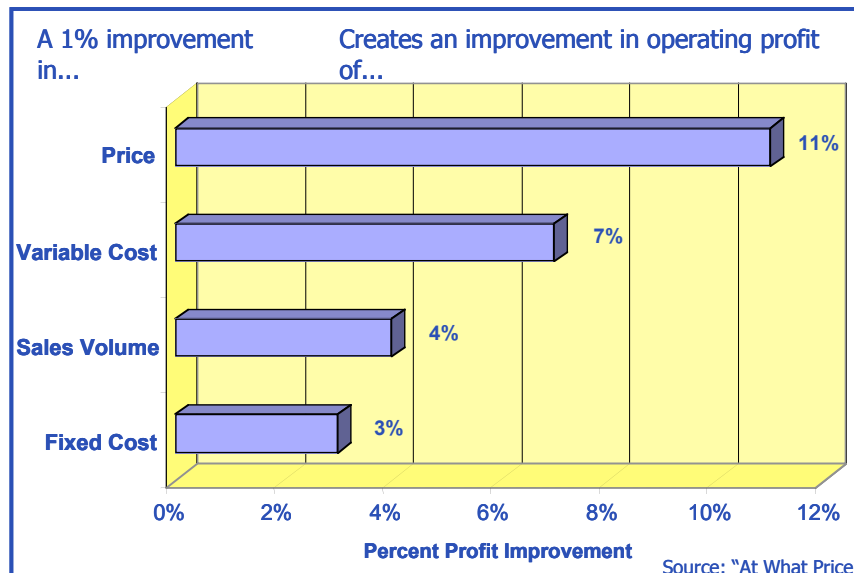
Price Optimization: Executing Strategy

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Price Optimization: Executing Strategy

In the retail industry, a company's pricing strategy is often governed by multiple factors, including promotional activity, competitive environment, price changes and price zones, to name a few. The merchandising team artfully takes these factors into account when setting the corporate pricing strategy. Science-based tools, specifically pricing optimization solutions, are rapidly gaining the confidence of retailers for modeling and implementing the chosen strategy. Given the right set of inputs, derived combined with timely and accurate historical data, these tools can model and recommend optimal pricing actions to achieve effective, consistent, and profitable pricing and price image. However, the strategy itself must originate with the merchandising executives in the form of business objectives.

The graphic below demonstrates that effective pricing will deliver more profit to the bottom line than any other retail task. Every penny gained through more effective pricing is a gain in operating profit. Industry studies have proven that a one percent increase in pricing effectiveness will result in a 10 to 12 percent gain in operating profit, an improvement that is unmatched by any other retail activity. Improvements in fixed costs, variable costs or volume all fall short when compared to the results realized by more effective pricing.



True profit potential can only be achieved when virtually every item in the store is optimally priced, meaning priced to produce the ideal balance between consumer price expectations, volume and profit. By integrating the art and science of merchandising, Price Optimization allows the retailer to achieve this ideal balance between volume and profit.

Historically, many merchants and category managers have viewed price optimization technologies with skepticism and some of that skepticism has been warranted. Earlier

we said that “given the right set of inputs”, price optimization tools are very effective. The more heavily a tool depends upon raw historical data, to the exclusion of the assumptive skills, experience, and frame of reference of merchants, the more likely it will be less effective in recommending optimal pricing actions. At KSS, we believe that the degree of effectiveness is highly dependant upon how well the price optimization tool balances the science of optimization with the art of merchandising.

To KSS, the “right set of inputs” requires much more than timely and accurate raw historical data to be manipulated in the context of predetermined business rules by the technology (Science) under the covers. It requires:

- Flexible business rules reflecting the business objectives of the merchandising experts (Art – Business Objectives derived from the Pricing Strategy)
- Cross consideration of the effect of promotional activities on base pricing optimization and visa versa (Science/Art)
- Assumptive capture of internal and external forces that will likely impact performance of specific pricing actions (Art)
- Rapid testing of alternate assumptions (what if) with immediate feedback and comparison prior to implementation decisions (Art – leveraging science)

The Art

In retail, the world revolves around the leadership and expertise of the merchandising team. This group aligns and supports the business in its quest to achieve merchandising excellence. Backed by many years of experience, the merchandising team provides strategic leadership and execution to the rest of the business. Identifying and supporting business differentiation while maximizing profit through display, product assortment, promotion and pricing, is the art of merchandising.

The Science

The complexity of grocery retail today is such that effective software solutions are a business imperative. Merchandising experts are tasked with interpreting an avalanche of data and multiple options within severe time constraints in order to reach mission critical decisions on a daily basis. How quickly and how thoroughly this can be done directly impacts the merchant’s ability to achieve strategic objectives for pricing and profit.

Some relatively common solutions assist with vendor item management, procurement, cost maintenance and rules-based pricing. These solutions have become entrenched in the daily lives of merchants to such a degree that users often take them for granted. However, category modeling and price optimization solutions are only now beginning to enter the mainstream of grocery retail, leveraging science to improve the merchant’s daily lot.

Grocers recognize that these new tools can bring astounding improvement to operating profit as well as provide new insight into category performance. These new modeling and optimization solutions serve as a vehicle for achieving the merchant’s strategic objectives for pricing and profit. In fact, fed with well-defined merchandising

objectives, they are capable of optimizing the strategy itself. Merchants can now propose a strategy, predict and evaluate the results rapidly and refine the strategy based upon the educated assumptions of the merchant, without changing a single price in the store. This is the essence of price optimization and modeling.

Art + Science = Optimal Pricing

It is this fusion between the art and science of merchandising, between the merchant and the tool, which KSS Retail believes is critical to achieving true profit potential. Anything less will be less effective. The merchant provides the necessary strategic inputs and variable assumptions, which will guide the tool as it progresses through its algorithms and millions of computations, resulting in optimal pricing necessary to achieve full profit potential.

Retail Differentiators

A merchant must ensure that pricing supports the business differentiators and is in line with business strategy. They must consider the bigger picture of business type, markets served, and market positioning. For example, a business positioned to be Hi-Lo would certainly price differently than a business positioned to be Every Day Low Price (EDLP).

A retailer with upscale product lines, assortment, service and facilities that serves a higher income demographic will demand premium prices and deservedly so. When all aspects are in alignment, consumers will accept higher prices in an upscale facility serving an upscale market. The combined offering dictates the higher prices.

Conversely, the consumer will expect lower and more competitive prices in a discount store or outlet with reduced services, or one that serves a lower wage demographic. It follows that an effective pricing plan as well as merchandising plan must reflect these business factors in a cohesive, strategic approach.

Facility condition, service, quality and assortment are primary business differentiators. A common example is the one of perishable departments. Nearly everyone will recognize which retailer has the best service, quality and assortment of produce in a market area. The executive and merchandising teams have built marketing, merchandising and pricing strategies around reinforcing that image. The result is that the retailer has a distinct differentiator in the market and will demand-- and receive-- a premium price. When the merchant provides the optimization tool with this strategic guidance and input, it will deliver optimal prices aligned with business objectives.

Challenges of Pricing

Retail pricing is an enormous task. With tens of thousands of items, numerous price zones, vendor cost changes, competition and promotions, it is easy to understand why pricing does not get the attention it needs. The workload is enormous and often it seems there is not enough time. At KSS, we call the complexity and time pressures within the retail industry, "merchant-time".

In today's fast moving retail world, retailers make hundreds, even thousands, of pricing decisions every single day. In fact, changing the price of a single item may necessitate numerous additional pricing decisions, including those relating to:

- Like item, but different flavors
- Same item, different sizes
- National brand and/or private label equivalent
- Competitive like item

All of these variables add to the complexities of pricing and the challenge of ensuring that price strategy stays intact.

Because of the enormity of the task, merchants must make these pricing decisions in seconds and usually without time to consider how each decision will affect movement and profitability of other items, the category as a whole, and other categories.

A price change is most often made in reaction to a vendor cost change or a recent competitor price change. Pricing is more often tactical than strategic, and oftentimes more reactive than proactive. In the heat of the battle, reactionary pricing without tools of automation will not provide the analytical insight required to make strategic decisions. Without a category modeling toolset, merchants will price sub-optimally and be unable to answer the following questions:

- Does this price change support our differentiation?
- Will this price change result in cannibalized sales of a similar, higher profit item?
- Will this price change result in more or less profit?
- How will this price change affect volume and profitability of the item?
- Is this price change consistent with established price strategy?
- How will this price change affect consumer price image?

At KSS, we believe that pricing optimization tools should be available to the merchant when needed, answer all of the above question, with no restrictions on when it can be run to provide recommendations on the most current data available. And the feedback should be immediate so that the merchant will not find it necessary to take shortcuts to keep up with busy schedules or meet competitive pressures because there isn't enough time to analyze all the potential scenarios. Pricing optimization should be available 24/7... "Real-Time, Anytime"...meeting the demands of merchant-time.

The Results

Modeling and price optimization solutions for retail are precise and efficient tools, developed to assist retailers with effective price and promotion management and to provide answers to the above questions. When combining these tools with strategic merchandising plans, the results can be phenomenal. Like highly tuned engines, they provide optimal results for demand forecasting, category modeling and price optimization.

However, to achieve these superior results, merchants must have a sound strategic pricing plan in place. This strategic plan, when aligned with business goals and consumer expectations, provides the foundation for optimization success. Today's new breed of price optimization and category modeling tools, when combined with a

strategic approach to pricing, will deliver superior revenue and profitability while also improving price image.

Applying the Strategy

Retailers are beginning to understand the importance of a price-modeling tool for many of the everyday tasks performed by the merchandising team. The tools can assist with analytical effects of vendor deal programs, vendor negotiations, impact of promotions, competitive balance and underperforming categories. When merchants are able to perform modeling in real time, resulting in immediate tactical action, the use of the tool becomes an everyday occurrence.

With super stores and club stores taking more and more of the conventional grocery market, competition for market share has never been fiercer. Maintaining a strong price image is one competitive tactic employed by many grocers faced with this challenging competitive environment. However, without the benefit of robust modeling tools, it is difficult to choose the optimal pricing actions in a timely manner. This often means a significant decline in category margins, at least in the short-term. However, the ability to integrate price optimization tools (Science) with strategic pricing practices (Art) and be given immediate feedback on predicted results now makes it possible to improve profits as well as price image.

It may be obvious that not all items have the same degree of price elasticity, but determining which items are most important to consumers, from a price sensitivity perspective, is not always so obvious. Modeling a category to find the items that are most likely to respond to price changes, including those that are most and least price sensitive, can help accomplish this.

Category modeling will help decision makers find balance between volume and profit. Identifying the varying degrees of price sensitivity will provide guidance when setting business rules. This allows for the possibility of increased profit on less sensitive items while improving the price image on more sensitive items. Setting rules based on sensitivity will allow the optimization tool to maximize profit opportunities. Operating profit is strengthened, while price image and consumer confidence are also improved. The net result is an improved consumer perception of price image, and a better pricing balance across the category.

This is just one example of how price optimization can assist the merchant to improve competitive strategy. Finding the correct balance between price sensitive and non-sensitive items will be a differentiator when optimizing for improved profit.

Optimizing Strategy

At KSS, we strongly believe that optimization is a critical tactical component for implementing pricing strategy but caution retailers to not rely solely on technology. The merchandising team sets the strategy while the optimization solution is the vehicle used to model and implement the strategy. It can model and optimize strategy, but the strategy itself must originate with the merchandising executives in the form of business objectives.

As optimization solutions become more robust and enter the mainstream of retail, it is easy to forget that price optimization is not a strategy itself. Without merchant direction, intervention and input, even the most sophisticated optimization solutions will potentially create results that are inconsistent with established strategy.

True price optimization is the result of integration of merchant and tool. It is the combination of the merchant's years of experience and knowledge of marketplace together with the computing power of a sophisticated optimization engine.

It is this balancing act of weighing the merchant's strategic goals, and the scientific resolution of these goals, that accounts for the achievement of optimal profit potential. Achieving true profit potential in a manner that is consistent with established business strategy is the ultimate goal. This is the integration of the art and science of merchandising.

About the author:

Bob Phinney has more than 30 years of retail experience, combining Retail Merchandising and Operations (Retail and Wholesale) with software and technology development. A member of the Professional Pricing Society, Bob has conducted numerous lectures and workshops to organizations looking for practical and visionary pricing strategies. His solid retail management background has enabled him to design and implement creative approaches to problem solving, process improvement and creating productive teams. As the VP of Strategic Pricing at KSS, his mission is to drive the creative vision of the pricing solution set for KSS, combining the art of pricing with the science of price and promotion optimization.

About KSS Retail:

KSS Retail is the leading supplier of comprehensive pricing intelligence, optimization and execution solutions to the convenience store, grocery and chain drug industries, helping retailers manage in excess of \$50bn annual revenue from over 17,000 outlets. Retailers use KSS Retail solutions to add discipline to the pricing process, make better-informed pricing and promotional decisions, and implement decisions more efficiently, driving more profit to the bottom-line. KSS Retail software is available as an on-site, fully integrated system configured by experienced consultants from US headquarters in Florham Park, NJ and European headquarters in Manchester, UK. For more information visit www.kssretail.com

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