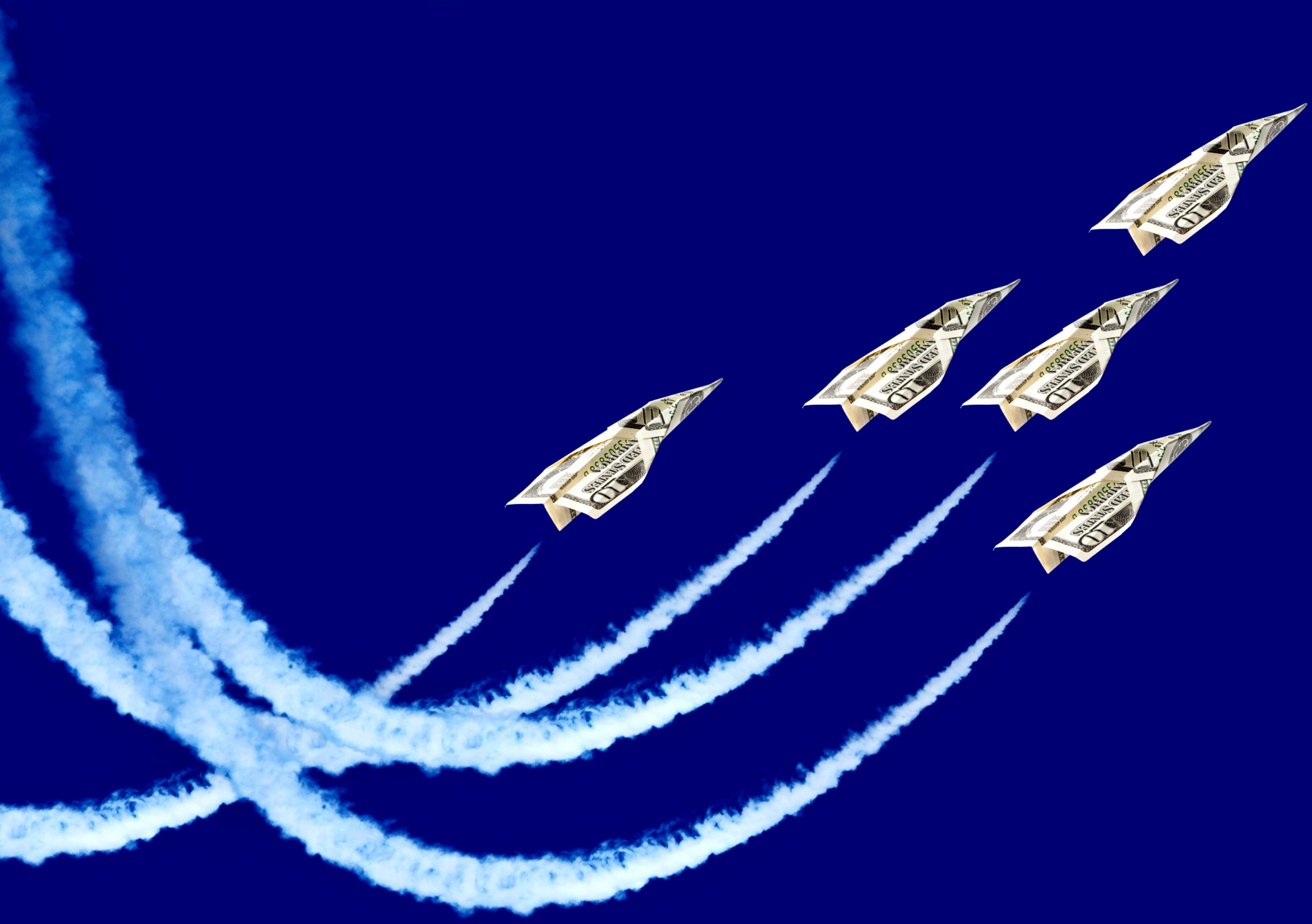
Wilson Perumal & Company

WP&C VANTAGE POINT

BEYOND CUTTING THE TAIL

The 5 Facet Approach to Portfolio Transformation



Not all revenue is good revenue

A parachute manufacturer starts making tennis shoes to increase factory utilization.

A large brewery develops craft beers to chase the growing premium market.

An automotive tools manufacturer sells replica toy cars to capture a larger share of customers' wallets.

These companies have made portfolio decisions solely based on chasing revenue, without thinking about the internal and external impact the change may have on the business. They are not alone.

Product proliferation is a common issue across industries, resulting in increased costs and slower growth.

The parachute manufacturer was able to use the same manufacturing footprint to make tennis shoes, but the design process, customer base, supply chain, and distribution channels were completely different—the expansion into tennis shoes was short-lived and costly.

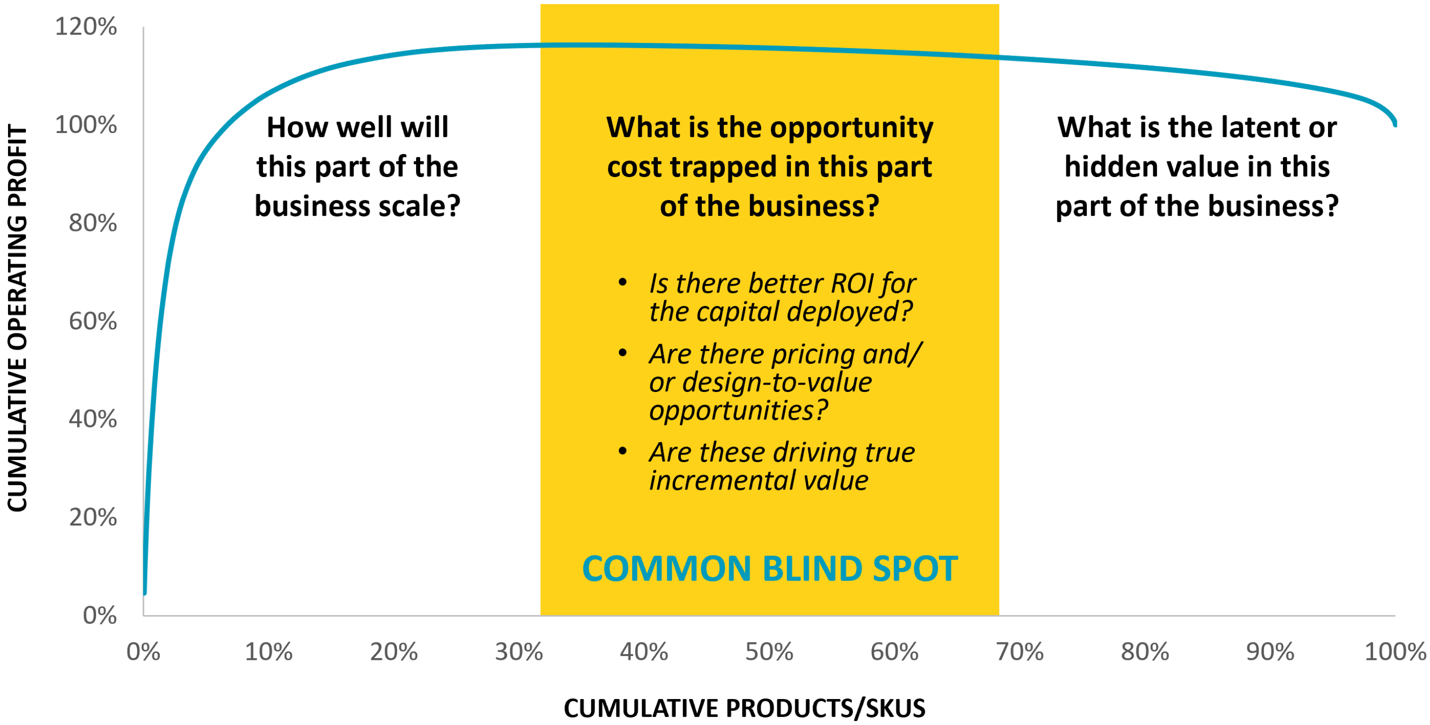
The brewery introduced a variety of craft beers in facilities built for high volume and low variety, but production inefficiencies and countless changeovers forced the brewery to implement a complex product scheduling process and increase spend on facility upgrades.

The tool maker increased revenue with expansion into die cast cars, but the additional product line distracted sales reps from the core offering and shifted customer spend to lower margin products.

Not all revenue is good revenue. Our research and work with clients consistently shows 70% of products destroy profits, regardless of company or industry.

Getting portfolio optimization or expansion right requires understanding the implications these changes will have on your business, customers, and market.

Beware the 'stagnant middle'—products with positive (but low) margins that consume scarce resources and may be better deployed elsewhere



Product portfolio decisions have far-reaching impact and must be made as part of a data-driven, holistic approach. Wilson Perumal & Company (WP&C) utilizes a proprietary 5 Facet Approach to portfolio optimization to ensure customer needs are effectively met while maximizing profitability and minimizing complexity.

By considering the strategic, market, financial, operational, and customer perspectives, you can understand the impact each facet has on your company—and the way those facets interact—to design a portfolio tailored to support your business's future growth and profitability by controlling costs.

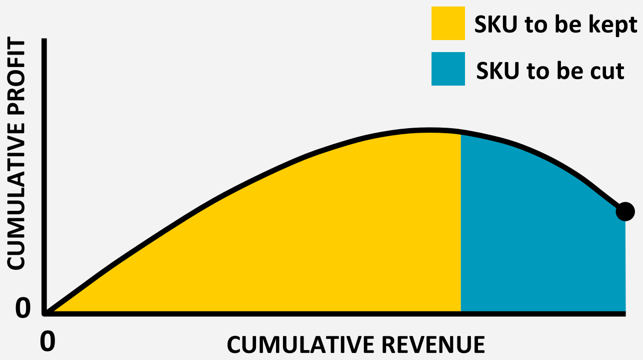
5 Facet Approach to Portfolio Optimization

The 5 Facet Approach in Action at Food Co.

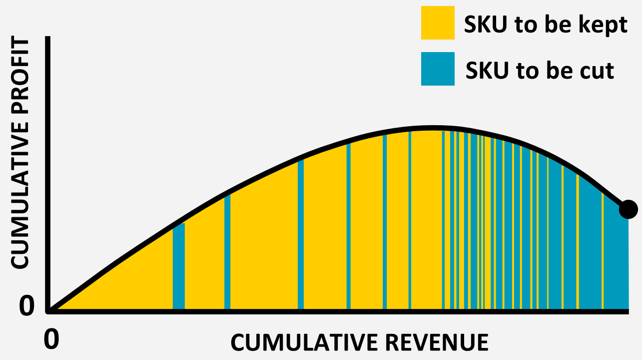
While most companies approach portfolio optimization as simply "chopping off the long tail" of low-volume products that contribute low or negative profits, true transformation and sustainable benefit require a more thoughtful and comprehensive approach.

Using the 5 Facet Approach as a lens through which you consider your portfolio, companies can gain an accurate understanding of product roles (market, customer) and how the portfolio is delivered (financial, strategy, operational). Each of the five facets plays a vital role in determining a product's value to the overall portfolio and understanding the impact that removing that product may have on the business.

Traditional Portfolio Reduction



The 5 Facet Approach



The graph on the left represents a traditional approach to portfolio rationalization. This approach simply 'cuts the tail', removing the least profitable SKUs.

The graph on the right represents 5 Facet Portfolio Optimization. The entire portfolio is considered through the lenses of the five facets. SKUs are selected for removal with a focus on portfolio strategy and maintaining (or increasing) profitability. Revenue is preserved through substitutable products.

This 5 Facet Portfolio is better aligned with the company's strategy and strengths and also better designed to compete and to meet customer needs.

Using the 5 Facet Approach, we worked with Food Co., a global manufacturer and distributor of consumer-packaged foods, to realign its portfolio after years of aggressive acquisitions and product line expansions that led to a bloated portfolio where costs increased without yielding higher revenue.

FACET #1
Strategy

Let Strategy Drive the Portfolio, Not the Other Way Around

Many companies allow strategy to evolve to support growing portfolios which can lead to an “all things to all people” approach.

The 5 Facet Approach emphasizes core portfolio strategy—if a product does not leverage the firm’s competitive advantage or align with desired strategy, the product is likely adding complexity and distracting from the company’s focus.

Food Co.’s CEO knew the company had a problem. While the intended strategy focused on leveraging scale in manufacturing and distribution, as new brands and suppliers were added to the portfolio, those benefits were not achieved.

In fact, the firm’s expanded portfolio began to dictate strategy and direction. By expanding into the ‘fresh’ and ‘impulse’ categories, the company effectively diluted its scale with a larger salesforce and distribution footprint.

The CEO recognized that the company was moving further away from its core and looked to WP&C to address this strategy and execution gap.

Food Co.’s packaged nuts offerings demonstrated a lack of strategic focus. They expanded into flavored nut varieties (e.g., jalapeño almonds) that came in a variety of sizes. Sales were spread across a large, unfocused portfolio where most SKUs destroyed profits.

To get back to a strategy-driven portfolio, we recommended consolidating SKU offerings to align with Food Co.'s stated goal to leverage scale in manufacturing and distribution.

This meant investing in a few core, profitable flavors and sizes, and eliminating the rest.

The new portfolio met consumer preference for trying new flavors in smaller packaging and buying core flavors in bulk.

As a result, the nut portfolio shrunk by more than 25%, but generated $1.5M more in operating profit and released $3M in working capital.

Current Portfolio

CORE FLAVORS	Unsalted	2 OZ	6 OZ	12 OZ	24 OZ
	Salted	2 OZ	6 OZ		
	BBQ	2 OZ	6 OZ	12 OZ	
	Smokehouse	2 OZ	6 OZ	12 OZ	24 OZ
NEW FLAVORS	Jalapeño	2 OZ		12 OZ	
	Salt & Vinegar		6 OZ	12 OZ	24 OZ
	Thai Chili		6 OZ		24 OZ

Strategy-Driven Portfolio

CORE FLAVORS	Unsalted			12 OZ	24 OZ
	Salted		6 OZ	12 OZ	24 OZ
	BBQ		6 OZ	12 OZ	24 OZ
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NEW FLAVORS	Jalapeño	2 OZ	6 OZ		
	Salt & Vinegar	2 OZ	6 OZ		
	Thai Chili	2 OZ			

FACET #2 Finance

Get a Better View of Profitability

Using WP&C's proprietary Square Root Costing methodology, the 5 Facet Approach goes beyond the traditional fixed and variable cost paradigm used in traditional approaches to portfolio optimization.

This method allocates costs to products based on the complexity (and related costs) that they introduce. The result is a full view of the financial value a product brings to the portfolio, and a clear picture of where profit is made and lost.

Given Food Co.'s model (paying slotting fees for shelf space and supporting customers with marketing spend), it was important to understand end users as well as product profitability. We applied Square Root Costing methodology to account for the impacts of complexity on product costs and applied marketing spend to the appropriate products.

Counter to the common belief at Food Co., our analysis showed that high-volume products with low gross margins were more profitable than most low-volume, high-margin products due to the added complexity of managing these products.

We proved that, despite having to pay slotting fees and for marketing, larger customers were more profitable because functions like distribution were more streamlined than "mom-and-pop" shops. We advised Food Co. to refocus on large retail customers and reduce the number of monthly deliveries to smaller shops.

FACET #3 The Market

Consider Positioning and Trends

When considering the market, many companies find they have defaulted into the practice of matching competitors' portfolios one-for-one. However, competition is only part of the market context.

Macroeconomic headwinds may impact the role a product plays within the portfolio and companies. The 5 Facet Approach considers these factors from a balanced perspective, helping to provide a complete picture of a product's true market value.

Food Co. offerings could be grouped by the roles its SKUs played in the market. A 64oz resealable jar of fruit was a 'family pack' product while a single-serving easy-open can was considered 'convenience.' We helped Food Co. understand how products in its own portfolio cannibalized sales of more profitable offerings. For example, if a 64oz product meets the needs of the 'family pack' buyer, there is little reason to also offer a 72oz version. These overlapping SKUs artificially segmented the market and provided unnecessary options to customers.

Food Co. was quick to add redundant SKUs to segments with declining consumer interest and demand in hopes of capturing lost revenue. We helped Food Co. apply SKU roles as a lens to reveal trends in demand and identify areas of cannibalization.

These insights enabled Food Co. to make better decisions about pricing, promotional spend, and investments in innovation to address changing consumer behavior and reverse profit dilution in declining product segments.

FACET #4 Customers

Busting Myths on Linked Revenue and Substitutability

Companies should only retain an unprofitable product if they have compelling evidence of substantial linked revenue or a lack of substitutability.

By incorporating customer feedback and historical revenue analyses, the 5 Facet Approach provides more realistic substitutability and linked revenue estimates to accurately measure the impact of discontinuing a product.

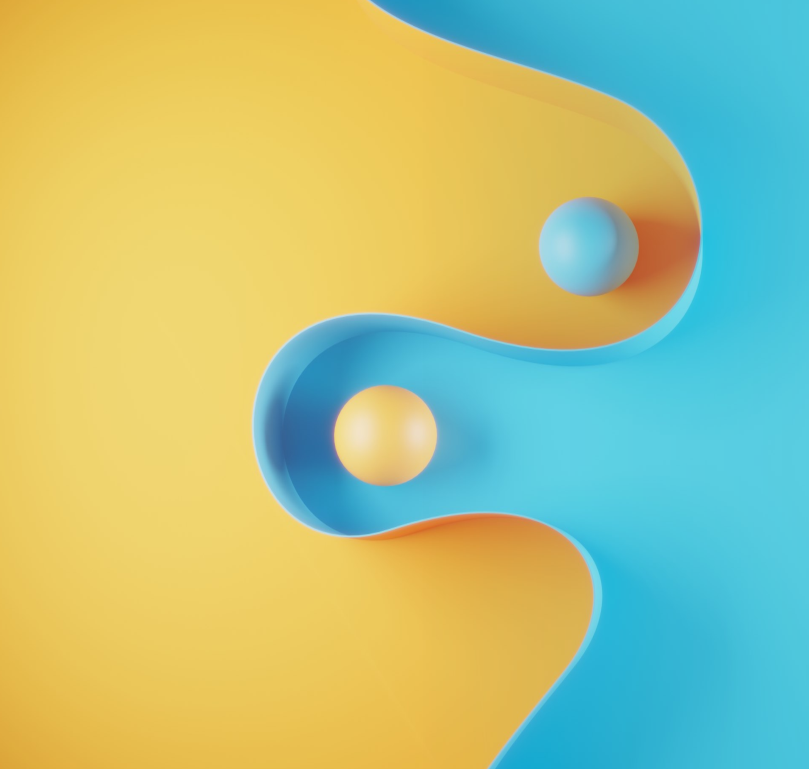
The concept of product substitutability was not widely embraced at Food Co. If a product was discontinued, management assumed the company would lose all associated revenue. They also overestimated linked revenue between products.

For example, they assumed a customer would only buy peanut butter if jelly was also available—if a store stopped carrying peanut butter, customers would stop buying jelly. But things are rarely that simple.

Using point of sale data to assess how the market reacted when certain products were unavailable, we provided Food Co. with a macro-level view of customer decision-making.

By taking this top-down view, we helped Food Co. identify where cannibalization was occurring, where promotional activity was protecting base sales, and where the company could compete more effectively.

As a result, Food Co. began to cut marginally profitable SKUs where enough revenue would be retained in more profitable alternatives. This resulted in the company having a 3% EBITDA margin increase despite a reduction in revenue.



Understanding Revenue Substitutability

Even profitable products can detract value from a business.

For example, a product with low profit margin can cannibalize sales from a product with a higher profit margin. If enough of such product's revenue can be retained in higher margin products, then removing it would be beneficial.

WP&C developed and applied a statistical analysis that allows clients to quantify their portfolio's substitutability. By understanding which attributes are driving customer buying decisions and by estimating the switching likelihood across meaningful product segments, our consultants have been able to optimize product assortments to align with specific goals (e.g., profitability, shelf space, growth targets).

We define products as the sum of their attributes: price, package size, package type, brand, flavor, etc. People value these attributes differently and make conscious decisions to pick the product that represents the combination of attributes that maximizes its utility.

For example, a shopper who highly values Coca-Cola is more likely to substitute their favorite 2-liter Coke for a 6-pack of 12-oz cans or a few 20-oz bottles than to choose a 2-liter Pepsi. A brand-indifferent shopper, on the other hand, might instead opt for convenience, choosing 2-liter Pepsi instead.

To calculate substitutability, it is important to analyze historical sales data to see how customers behave on average when faced with such choices.

Sales Comparison:
Average week vs. a week with 2L Coke out of stock

	Average Week Sales	Week Sales with 2L Coke Out of Stock	Sales Change
	$1,000	$0	($1,000)
	$500	$1,300	$800
	$600	$700	$100
	$2,100	**$2,000**	**($100)**

We see that during the week with 2-liter Coke out of stock, customers bought significantly more Coke 6-packs than they did previously. So Coke's size substitutability can be calculated as $800 (2-liter-to-cans substitution sales) divided by $1,000 (average 2-liter sales) or 80%.

Since Pepsi's 2-liter sales also went up by $100, we can presume that the defect rate (or brand substitutability) from Coke to Pepsi is 10%. The remaining 10% lost sales could be from defectors to other brands or categories (e.g., iced tea) or from customers waiting for a restock.

While stock-outs cannot always be found, companies can also look at cross-store availability and apply a similar logic. Imagine a store that has a SKU assortment that excludes 2-liter Coke. Look at that store's sales to see how SKU-specific market shares have redistributed and how those are different from the norm.

It is also important to note that external factors such as hot weather, causing inflated soda sales, should also be controlled. Take such intricacies into account to make the best use of available data to produce accurate substitutability rates.

FACET #5 Operations

Understanding Impact Across the Value Chain

Companies often attempt to apply lean processes and continuous improvement to fix operational issues created by complexity. But those actions only treat symptoms and not root causes. Product complexity introduces operational challenges in a variety of ways:

- Requiring unique raw materials
- Increasing prep time
- Making production time longer or more variable
- Requiring additional quality testing
- Creating unique distribution channels

The 5 Facet Approach requires managers to understand how products create complexity across the value chain. By grouping products based on similar metrics, companies can identify interrelated products that have the greatest impact on costs or speed to market.

In the past, Food Co. expanded to recapture lost revenue. It entered markets beyond its core shelf-stable, packaged products and began producing items such as fresh cakes. Management believed these higher-margin products, which required similar ingredients, equipment, and processes to existing packaged snack cakes, would increase Food Co.'s revenue and profits. However, minor differences in production processes and equipment made fresh cakes difficult to produce and had a negative impact on other products made in the same facility.

The new raw materials were similar, but not identical and required new suppliers, additional warehouse space, and special handling. The specialized skills needed to make the new products required more training and created a less versatile workforce. The short shelf-life made the large batch production strategy utilized in making packaged snack cakes wasteful and ineffective while also requiring much stricter finished good inventory management.

We identified the true costs of new products introduced across the value chain and calculated the negative impact changes had on the production, efficiency, and profitability of legacy products. WP&C recommended focusing the portfolio on products that were more operationally consistent to minimize complexity across the value chain.

How healthy is your portfolio?

Do any of these symptoms of misaligned and bloated portfolios seem familiar? When undertaking optimization efforts, assessing how well a portfolio is supported by the five facets can reveal a company's biggest opportunities.

Common Symptoms of Neglecting the Five Facets

STRATEGY

- Multiple paths to growth dilute focus leading to lagging market share gains
- Cut-and-paste strategy across new markets reduces scale without addressing unique market requirements
- Portfolio deviates from competitive advantage and corporate strategy

FINANCE

- Operating profit stagnates as SG&A continues to grow faster than revenue
- High profit concentration in a small number of products, SKUs, or customers
- Working capital and inventory grows to compensate for demand variability
- ROIC erodes as CAPEX and cost base grows to manage complexity

MARKET

- Business cannot quickly respond to market or technology changes
- New product development capacity is eroded by too many projects
- Business cannot effectively flex to profitably weather market down turns
- Business copies competitors' strategies creating additional complexity

CUSTOMER

- Portfolio expansion creates confusion with customers and the sales team
- Service levels and delivery metrics suffer, leading to customer churn
- Overlap across the portfolio drives cannibalization and heavy discounting
- Complexity hides portfolio gaps and leads to missed revenue opportunities

OPERATIONS

- Increased changeover down time erodes manufacturing capacity
- Quality suffers as operations struggles to keep up with the portfolio variety
- Increased costs from increased purchasing, materials, and logistics
- Scrap and obsolescence increase as forecasting and planning are stressed

CONCLUSION

Using 5 Facet Analysis, the WP&C team helped Food Co.'s management make smart decisions to move toward an optimal portfolio mix while addressing customer needs and minimizing complexity.

The company successfully refocused its business and simplified product offerings to minimize cannibalization. Food Co. cut marginally profitable SKUs, removed SKUs that introduced complexity to the value chain, and redesigned the trade spend strategy.

Together, these changes resulted in a 10% EBIT increase and a 18% decrease in working capital costs.

These changes brought a portfolio of products to market that was more consistent with Food Co.'s core strategy—scaling production effectively. Leaders continue to leverage these insights when making acquisitions to understand the fit and impact of additions to their portfolio. Ultimately, Food Co. reversed the trend of declining profitability and forged a path toward sustainable growth.

About Wilson Perumal & Company

Wilson Perumal & Company (WP&C) is a premier strategy consultancy that helps clients navigate an increasingly complex business environment. For the last decade, WP&C has served multinational corporations, private equity firms, and government entities, supporting their growth agendas.

Our focus is helping these organizations develop and execute strategies for successfully competing in the Age of Complexity. We are laser-focused on client value and results—our projects often yield a 20–40% improvement in EBITDA.

Co-founded by experienced consultants and bestselling authors Stephen Wilson and Andrei Perumal, we are not only practitioners but also thought leaders. We have published two books on competing in a complex world: *Waging War on Complexity Costs* and *Growth in the Age of Complexity* (McGraw-Hill).

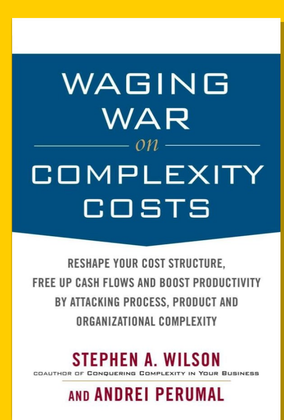
Our services range from growth strategy to business simplification—whether that be your portfolio or your business operations—to organizational transformation. Our work is informed by a distinct perspective and supported with unique methodologies.

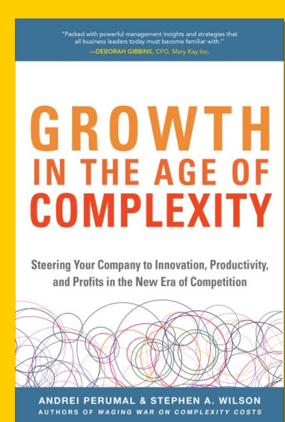
Given our focus on complexity, our employees have deeper knowledge and more experience on this topic than any other consultancy. This translates into faster insights, and ultimately better results.

Learn how we can help you:
info@wilsonperumal.com

"Perumal and Wilson offer a nuanced and evidence-based analysis of the paradox of complex growth, but they move beyond description to offer practical and field-tested advice on how to avoid the traps they identify."

Don Sull, Senior Lecturer
MIT SLOAN SCHOOL





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