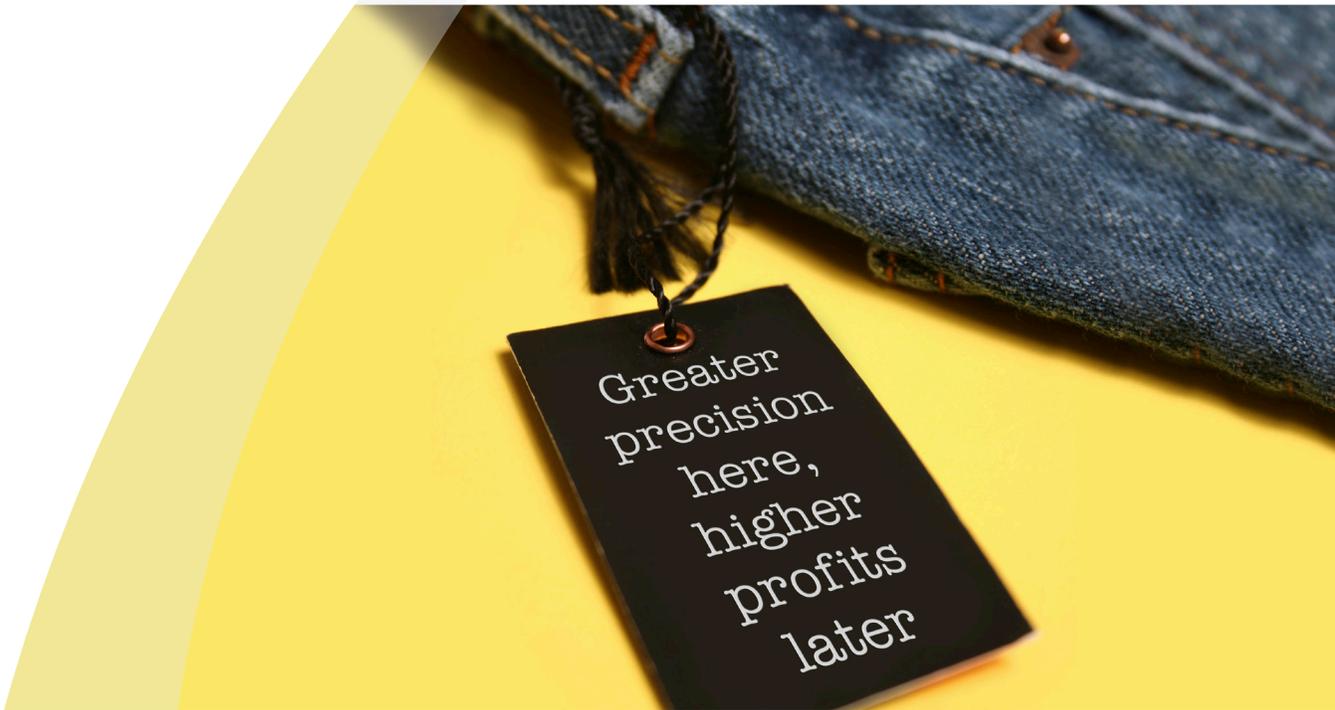


The Compelling, though Sometimes Elusive, Benefits of Markdown Optimization



Since 2001, scores of apparel retailers have invested in markdown optimization (MDO) solutions. They have been lured by the combination of a simple premise and an ROI promise that made the investment a no-brainer. In fact, many MDO sales cycles began and ended with the CFO, who was easily persuaded by its fast and significant payback—up to 6% gross margin—and quick and easy implementation.

But despite these compelling results, adoption rates have reached a plateau and dozens of early adopters have shut off MDO solutions in recent years.

*When MDO is executed successfully, it can be **transformative and generate significant benefits in the form of increased margins, reduced inventory and easier transitions from season to season.***

The timing is no coincidence. As competition increases in the face of slowing consumer demand, more and more retailers find themselves participating in the kind of broad, reckless promotions that are antithetical to the precision MDO is designed to deliver.

True, unlocking the potential of MDO in a hyper-promotional competitive environment does require some work. But when executed successfully, it can be transformative and generate significant benefits in the form of increased margins, reduced inventory and easier transitions from season to season.

MDO 101

The premise behind MDO is decidedly simple. It comes down to addressing the essential supply-demand balance. Much of merchandising and planning is focused on getting the supply right for the projected demand. But at some point in the life of a short-lifecycle fashion item, all inventory decisions are locked in and the supply side of the equation is fixed. The only variable still in play is stimulating demand with markdowns.

It's the relative magnitude of the markdown investment that makes it such an obvious target for optimization. Consider a \$1 billion fashion retailer who might have an average initial markup of 75% and a maintained markup of 58%. That retailer's markdowns represent \$500 million. Being just a little bit smarter in managing those markdowns can yield huge results. Some adopters have attributed significant gross margin gains to MDO, up to 200 basis points.

Why MDO Solutions Get Abandoned

Some retailers adopting MDO struggled right from the implementation, making mistakes that could

undermine the adoption of any potentially transformative enabling technology: weak sponsorship, misaligned configuration, poorly defined business processes and insufficient change management.

Others, however, initially had successful implementations and saw early benefits before somehow falling off the bandwagon. It is this latter group that is most concerning.

It turns out that the beautiful simplicity of supply-demand balance is not always so simple in practice—and there is a big difference between tweaking demand for a given style or location and stimulating demand in the aggregate, especially in the economic and competitive context of the past four years. In almost every case, retailers who abandoned MDO were struggling in some way with aggregate demand, either in the form of missed sales plans and swelling inventories (fine-tuning the supply-demand balance is out of the question when you have too much of everything) or increasing competitive pressures leading to escalating promotions. The tactics that win footsteps in the short term often run counter to full lifecycle optimization.

In these situations, MDO ends up like the satellite navigation system on a vessel that is taking on water—setting the optimal course is deprioritized in favor of staying afloat.

Take the case of one specialty apparel retailer who was an early—and very public—supporter of markdown optimization, attributing a 200 basis point gain to the technology. However, faced with the recession and increased competition, that retailer quickly abandoned MDO and became one of the most promotional in its space, driving its margin down 1,200 basis points from 2009 to 2012.

Despite the challenges of making it work in a highly promotional macroeconomic environment, MDO remains a must-have technology for managing fast-moving, short-lifecycle merchandise.

Unlocking MDO's ROI—Sustainably

The key success factors for achieving MDO's benefits all relate to how well the retailer is able to operationalize MDO technology within the entire end-to-end merchandising process. The biggest mistake is treating MDO as a bolt-on technology that is somehow separate from the rest of pre-season and in-season inventory management.

The more promotional the retailer is, the more challenging it is to carve out space in the item lifecycle for MDO to do its job. What's more, a successful promotion (measured by traffic, comp lifts and daily margin) looks very different from a successful markdown and liquidation period (measured by sell-through, carryover and total life margin).

Retailers who have been able to achieve MDO's promised ROI and sustain it year after year have the following four factors in common:

- 1 They define a space in which MDO can work.**
Successful adopters plan what time of season or what part of the merchandise lifecycle is reserved for precise course-correcting markdowns and how to leverage MDO insights into managing inventory liabilities during other parts of the lifecycle.
- 2 They reconcile competing performance motivations.**
This includes recognizing the limits of MDO compared to other demand stimulators, such as promotions and marketing, and defining discrete metrics to motivate the right behaviors for both short-term top-line and total lifecycle bottom-line results—not to mention ensuring that individual performance goals and financial incentives are consistent.
- 3 They align MDO goals and settings with overall business strategy and plans.** Most importantly, when performance changes and top-down financial plans are revised, item-level targets need to move in concert.

- 4 They maintain sponsorship and knowhow.** At launch, it's critical to invest in adoption and provide training and coaching at all levels to help the change stick. But as time goes on and people and roles change, maintaining a structured MDO role will be necessary to keep the organization on track. Continued sponsorship is important too. When the original benefits of MDO get too far in the rearview mirror, the organization can easily forget that smarter markdowns are making a big contribution to the bottom line.

The Future of MDO

Despite the challenges of making it work in a highly promotional macroeconomic environment, MDO remains a must-have technology for managing fast-moving, short-lifecycle merchandise. Any fashion apparel retailer not doing something to maximize its markdown effectiveness should be.

Even those early adopters who have shut off their initial MDO solution are not necessarily abandoning the value of optimization. The majority of those who turned away from their original MDO solution have ended up reinvesting in markdown effectiveness, sometimes with other solution providers, sometimes incorporating the key principles of MDO into sophisticated homegrown or rules-based solutions. These early adopters of MDO also tend to continue applying more science to the art of retail by embracing other optimizing technologies to improve the supply side of the equation—such as size optimization, assortment localization and demand-driven allocation.

New challenges and new opportunities are also emerging as retailing evolves, particularly when it comes to omnichannel selling, which will make MDO's insights even more powerful. On one hand, retailers have a new strategic dilemma in weighing the value of price transparency and consistency

against legitimate localization and customization of pricing in terms of the customer experience. On the other, the potential of inventory optimization and optimized order fulfillment opens a whole new approach to managing that supply-demand balance simultaneously. While many retailers such as Macy's and Nordstrom are investing in ship-from-store capabilities, a few have already made strides in routing online orders for fulfillment to the stores least likely to sell without deeper markdowns. The opportunity to merge the analytics of MDO with the execution of distributed order management has yet to be exploited by any of the leading software vendors, but it is only a matter of time.

Clearly, MDO is a proven technology with a bright future, and despite some waning enthusiasm, should still be a must-have component of the decision-support toolkit for all fashion retailers. ♦

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