Questions about future scalability cause a high performing HVAC manufacturer to revisit its product portfolio

HVAC Co, a large manufacturer of HVAC systems, was performing well, exceeding Wall Street's growth and margin expectations. While management was pleased with financial performance, leading indicators, in particular SKU and SG&A growth, began to raise questions on the ability to efficiently scale the business in the future.

While innovation helped grow revenue during challenging times...

In response to a challenging market environment in its recent past, HVAC Co developed an innovation focus, committing to refresh a third of the portfolio every year. Simultaneously, management adopted a "good, better, best" product strategy, micro-segmenting the market to align product features, price, and customer needs. Although these two strategies were initially effective in growing revenue, they also led to significant product proliferation.

...the true cost of SKU growth was unclear

While market conditions improved, HVAC Co was now left with a much larger portfolio, growing inventory, and increasing operating costs. A lack of product portfolio discipline was further complicated by an operating model which led to product decisions that were not aligned by channel, supply chain flow, or even profitability. HVAC Co was a highly matrixed structure with shared costs and often conflicting incentives. Moreover, these shared costs were not considered in product decisions.

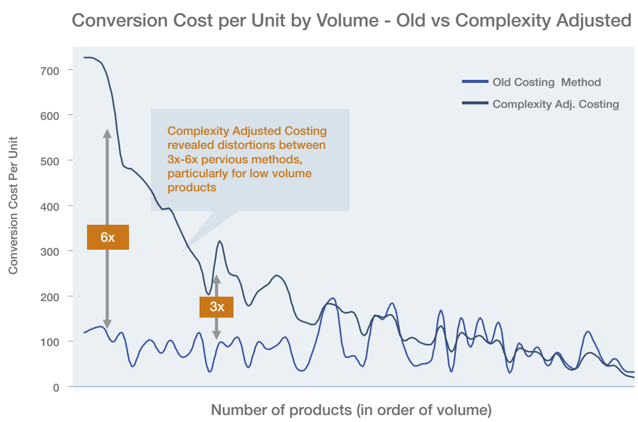
Management knew that gaining a clearer view of product profitability was the first step to understanding the size of the issue and identifying opportunities for improvement.

Understanding of the cost of complexity

A project team was formed to (1) understand the costs of complexity across the value chain and (2) identify opportunities for portfolio optimization. Through a series of interviews, process observations, and value stream mapping, the team was able to identify the sources and costs of complexity. They then leveraged this understanding to develop new allocation methods that accurately quantified the impact of change overs, demand variation, supply chain costs and promotional spend down to the product level.

Using data to drive to strategic decisions

From this analysis, management was able to better understand the different cost structures and profit drivers by product line. This led to immediate portfolio insights. First, the work revealed the true volume level at which products became operating profit positive. Previously, only gross margin was considered, making it difficult to identify underperforming products to be eliminated.



Second, this analysis provided a more granular allocation of an additional 35%-45% of total cost, including supply chain and rebate costs. Now, instead of a "standard mark-up", management understood how supply chain flow, channel, and engineering costs affected product profitability. Finally, applying this approach revealed that an entire product line (one of four total) was not just profit dilutive, but actually profit negative. While this improved view of profitability provided actionable insights, perhaps more importantly, it challenged management to rethink channel, pricing and product flow strategies.

Next steps

The journey to portfolio transformation would be a longer term endeavor, but HVAC Co knew it could take some immediate steps. First, management focused on rationalizing low incremental profitability products. Second, HVAC Co reviewed all optimization levers for one key product line including pricing, product flow and channel strategy. Finally, the costing model was expanded to further understand rebates and promotional spend by product.

Results

- Identified opportunities to improve EBITDA by 3%-5% via portfolio optimization
- Developed a more accurate costing model and established decision criteria for product portfolio reviews

www.wilsonperumal.com
contact@wilsonperumal.com

Wilson Perumal & Company, Inc.
One Galleria Tower, 13355 Noel Road
Suite 1100 Dallas, TX 75240

Wilson Perumal & Company, Ltd.
Longcroft House, 2/8 Victoria Avenue
London EC2M 4NS, United Kingdom