Every Retailer Needs a KPI Strategy

Part 1 of 3: **The Big Questions**

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Key performance indicators only tell you how well you are performing. To actually ***improve*** *your performance you first have to know what KPIs mean and how to use them. In the first of three parts in this series we look at the role KPIs play in answering the big questions successful retail companies ask themselves to achieve outstanding results.*

To run a retail operation successfully, you must know three things when it comes to KPIs:
1. what a particular KPI is
2. what it means relative to your bottom line
3. how to control it

How would you answer these questions:

What is your single biggest opportunity to improve profit this month?

Which products are the 10 top sellers that are most likely to go out of stock before your next re-order?

Which items in each of your stores have the biggest impact on sales of other products?

Answer these and the questions in this 3-part series and you'll become a **retail pro**.

The answers to these and similar "big" questions have obvious value. They tell you how to attract more customers, where to lower operating expenses, how to get more revenue per customer, where to save money on inventory — and generally how to take more money off the table from your retail operations. Like any complex fast-moving system, your retail operation has (or should have) gauges that let you stay "between the lines" to remain on course. On one side you have customers with more choices than ever about where to shop — offline, online, big-box store, boutique, pop-up store and more. Those customers need a compelling reason to shop with you. That could be price, convenience, selection, personal service, brand image or something else. On the other side you have competitors; each with its own special mix of variables it hopes will drive customers to them — and away from you.

There's not a lot of room for error. It's not like you can spend as much as you want; charge whatever you want; order everything you want; or be all things to each customer. By necessity you make decisions. And those decisions reflect your strategy, even if not consciously. How you make those decisions (and even whether the strategy is conscious) all depends on whether you can answer those big questions. And those answers depend on your KPIs, or **key performance indicators**. Your KPIs are your gauges that tell you whether you are really following your strategy — i.e., you are making decisions day-to-day, week-to-week, and so on, that reflect and also guide how you expect to succeed.

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1. what a particular KPI is
2. what it means relative to your bottom line
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In other words, a retail strategy requires a KPI strategy. Just like you're limited in your retailing actions, you're also limited in your KPI actions. And where retailing strategy is largely about where to spend money; KPI strategy is largely about where to spend time. You can't possibly look at each piece of data, or spend all your time looking at data. You've got a store to run (or several). Nor is each KPI equally important all the time to every decision maker in the organization. Some KPIs are more relevant depending on the type of store, type of merchandise, time-of-year, the role of the person managing the KPI, the choice of strategy and other factors. At the end of the day, it's not the KPI that matters, but what it means to the business and what actions you take as a result.

What It Is Versus What It Means

The definition of KPI is simple — a metric that measures how well a business is doing in some dimension that is important to business success. In other words, every KPI is a metric, but to be "key" a metric has to be important to the business.

The following is a list of the most commonly used KPIs:

Daily sales	Labor costs
Customer returns	Turn
Conversion rates	Stock-to-sales ratio
Sell through	Days of supply
Transaction counts	ROCE

Let's look at a KPI that is considered by many to be one of the most important to use on a regular basis — ROCE, or return on capital invested. It's a good example because, for most owners, GMROI is the definition of business success. Pre-tax profit, which is included in ROCE, is sales minus cost of goods sold. Sales, cost of goods sold, and pre-tax profit are all also obviously important KPIs in their own right. The formula for return on capital invested is: For example, a store with $80,000 of capital invested (in inventory, office equipment, furniture, etc.) and a pre-tax profit of $10,000 would have a ROCE equal to 12.5% or ($10,000 / $80,000) x 100.

The reason for saying ROCE is the primary KPI is clear: A retail operation will not even qualify as a business worthy of investment unless it returns more money over time to the investors than the investors put in. The reason for saying, "over time," is because few businesses return their invested capital on day-one. But at some point investors will want to be compensated for the risks they took, the length of time they waited for a return, and for foregoing the opportunity to invest that same money elsewhere. In an environment where a CD or money market fund pays 5-8%, a return of 16% might be considered the minimum required for a viable business — in light of the three factors just mentioned. One other factor might be the "sweat equity" invested by the owner as measured by nights and weekends away from family.

The investors have to decide for themselves what is a "fair" return and how long they are willing to wait for it. Benchmarks are useful — such as a money market comparison. They are even more useful for KPIs that can tell you *how* the business could be improved or *what piece* of the business could be improved — as opposed to ROCE, which generally only tells you that *something* needs to be improved.

That's the difference between knowing what a KPI is and what it *means*. As in the ROCE case, just knowing the definition or the equation may not tell you how to take corrective action. In other words, the KPIs may not tell you what is the underlying *cause*. To answer a big question like "Which items have the biggest impact on store profitability?" you would have to look at multiple KPIs, such as costs, sales, product turnover, customer returns, marketing expenses and ultimately profit individually for multiple products with all of those KPIs synchronized to specific periods.

Knowing that product X is unprofitable tells you that it costs more to sell product X than product X produces in revenue. That's the definition of "unprofitable," and it is useful knowledge. It puts you on notice that you may want to discontinue selling product X after investigating in greater detail the reasons why product X is unprofitable. Then you would know what the KPI means. For example, you might learn that, say, distributor Y is overcharging you, or that even though sales are high, customer returns are also unreasonably high (compared to some benchmark). Alerted by the product

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profitability KPI (again, relative to some benchmark) you can drill down into factors that impact profitability and look at their KPIs — like, say, customer returns. Once you know the state of those "junior" KPIs and their relative contributions to the "senior" KPI, you can take action. In fact, those junior KPIs often pretty much tell you what to do; for example, to renegotiate with a supplier or to ask sales associates why customers are returning a particular item so often.

How To Control Your KPIs

The faster you can go from knowing what a KPI is, to knowing what it means, to taking appropriate action, the faster and better *retailing strategy* you'll have. A better KPI strategy then is an approach to managing KPIs that consistently gets you down that path faster, with better results, and with less distraction from other tasks.

As mentioned already, every decision maker in an organization can't look at every KPI all the time. One issue is that different KPIs fall naturally within different areas of responsibility. As discussed later, inventory turn is appropriately a C-level concern (i.e., for someone with a "C" in his or her title, as in CEO). On the other hand, daily store-level sales is more appropriately a local store manager's KPI.

Another issue is that the people running retail stores simply don't have time to look at every KPI every day. And even if they did, doing so would not achieve good results anyway. Like most areas of business, an 80/20 rule applies. That is, for most retail operations, 20% of the KPIs have 80% of the impact. That said, there are two key decisions involved any KPI strategy:

1. deciding on which KPIs to manage deciding when, how often and on whom that responsibility falls for a particular set of KPIs

Helping you make those decisions is what the rest of this paper is about. First we'll look at techniques for picking the right KPIs to focus on. And then we'll look at the most important KPIs and how best to allocate responsibility for managing them across the organization.

KPI Clues

Obtaining the raw data for KPI analysis should not be a problem. Today's automated retail POS systems can potentially produce mountains of it. The real challenge is what to do with the data after you've got it. In other words, how do you "see the forest instead of the trees"? How do you quickly identify the most relevant 20% and present it in a form that speeds good decision-making?

A good KPI tracking system will automatically extract data directly off operational systems, such as point of sale software, ordering and inventory control. Operational systems are the natural source since they already possess up-to-the-second knowledge of what's being sold, ordered and held in inventory. A different approach — reentering data manually into a standalone analysis tool like Excel — wastes time and introduces errors. Also, the tool may not be tailored for the retail environment. In that case, a developer (who also may not be well-versed in retail) has to program whatever formulas are required (like for ROCE, linking sales, cost of goods sold and capital invested). Another alternative is to use an operational system — for example, retail management software — directly for KPI extract and analysis. The issue here is that operational systems are typically designed for transactions, not analysis. They often lack the functions that allow easy selection and interpretation of the most critical KPIs. Even with the most powerful tools, however, you still must know what to look for.

The best clues fall into the following categories:

- ✓ Exception to a benchmark
- ✓ Business objectives
- ✓ Co-variance (i.e., shopping-basket analysis)
- ✓ Differences
- ✓ Business type
- ✓ Industry type
- ✓ Business longevity

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Exception to a benchmark

In general, when you're looking for problems, you're looking for exceptions, and very often it's an exception to a benchmark. Sales are too low; shrinkage is too high; inventory turns are too slow — any of which your system can quickly highlight, saving you the time and effort of always looking at every KPI. Of course that means knowing what "too" means — i.e. what's a good benchmark? There are basically two kinds — 1) those that come from you, like a business objective (to be discussed below) and 2) those that come from retail industry experts.

Business objectives

Just because a KPI falls outside an industry norm, doesn't necessarily mean there's a problem. For example, in implementing a loss-leader strategy you may decide to sell an item at below cost so you can attract customer traffic. In that case, the product's gross margin or return on sales KPIs might be too low as measured by the industry benchmark but could be within limits as measured by your business objective.

KPI co-variance

Of course, if you were implementing a loss-leader strategy you would probably not just look at one product's KPIs in isolation to other products. You would also see if, due to the extra traffic, sales (and perhaps margins) on other products ticked up. In other words, you would expect a co-variance among multiple KPIs. Another type of co-variance is captured by shopping-basket analysis. An example would be when sales of one product drives sales of another, such as the effect that diapers have on beer sales at all-night convenience stores at hours when the typical customer is a man.

Differences

Another clue that ought to make a KPI stand out is when you expect it to be the same as KPIs elsewhere but it's not. It could be different in any of two ways, either 1) by location (e.g., a product that sells well in one store sells poorly in another), or 2) by time (e.g., a product that sold well in the past sells poorly now). "Location" in retail can also be viewed two ways: 1) physical location — i.e., how a store at one address performs differently from a store at another address; and 2) channel — i.e., web versus catalog versus brick and mortar and so on. To help make these differences standout, program your systems to look for

them automatically so you can quickly move on to the next step. That step is to drill down into the data to identify variables that might cause these differences, such as a different customer demographic, different competition, different intensity of competition, different marketing support and so forth. Your KPI analysis system should help you with that step as well.

Business type

Which KPIs are most relevant to your business also depends on the type of business you run — i.e., big box, boutique, catalog, web, etc. And even if you look at the same KPI in several places, the benchmark considered acceptable for one type of store may be too high or too low for another type. A good example is return on labor, a critical driver for big-box decisions but less so for a boutique where only one or two sales associates may be working at a time.

Industry type

The same principle applies here as for business type — i.e., the KPIs selected or the benchmarks applied to them vary depending on the types of products sold. Take inventory turns. In fashion, a 2-4x turn rate is required because of seasonal and style changes. In a category like pillows, however, a 1x turn rate might be fine provided, of course, that the pillows remain in saleable condition in inventory for a whole year. That means that the fashion retailer might be looking at inventory turns on at least a quarterly basis; while the pillow seller might only look at that KPI annually.

- **Business longevity.**

How long you've been in business, or in business at a particular location, also helps determine which KPIs matter. Shrinkage, for example, is a KPI you would wish to start looking at from the moment the doors opened. Sales per square foot, on the other hand, is an example of a KPI that isn't meaningful until much later — perhaps six months or a year down the road — after customers have really experienced the store and other factors such as marketing have had an opportunity to work.

Some of these clues may be self-evident in a given situation. Others may require years of experience to apply effectively, which is another reason to select the right KPI system partner. They'll have the retail background to help you identify which KPIs and which benchmarks work best for you with minimum distraction from your other tasks. That's the other aspect of a good KPI strategy — and the one covered here next — deciding when, how often and by whom your KPI analysis gets done. Those decisions very much depend on the specific KPIs involved, which basically fall into two groups: *tactical* KPIs, i.e., those that are tracked daily or weekly (covered in Part 2 of this series), and *strategic* KPIs, i.e., those that are tracked monthly, semi annually or annually (covered in Part 3).

This is Part 1 in a 3-part series about KPIs or Key Performance Indicators. If you're interested in receiving Part 2 and 3, click on the link below and submit the form.

Part 2 and 3
document request

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