Wilson Perumal & Company

Spotlight

Substitutability

What is Substitutability?

A customer looking for Diet Coke finds that it is out of stock in the vending machine and settles for a Coke Zero instead. This is the idea of Substitutability. It means that for certain products or services, some customers may happily switch to a similar product or service that they deem a substitute. The degree of Substitutability varies greatly by product, service, customer segment, sales technique, sales channel, pricing, promotion, or competition. In this case, Substitutability refers to the products or services offered by the same company, not by a competitor. It is the opposite of cannibalization, whereby companies introduce more and more products which in effect "steal" sales from existing products or services.

Why is Substitutability important?

One of the biggest barriers preventing companies from taking action against complexity is concern about top-line impact. Substitutability plays an important role when considering portfolio optimization, as applying the concept correctly can reduce costs while maintaining revenue. It is the answer to the question: to what degree are the sales of a certain product incremental to the sales of a similar product in the company's portfolio?

If the incremental revenues are low, then a company may decide to rationalize the product with little concern over revenue loss. Company XYZ could, for example, eliminate the red screwdriver from its portfolio and see existing sales migrate to its blue screwdriver.

The concept is particularly interesting when considering products with high volumes. Most portfolio consolidation efforts focus on cutting the tail of the profitability distribution. Companies frequently target the bottom 5% - products that are low in volume, with little cost attached to them - and therefore it is not surprising that the impact of such initiatives is disappointing. However, with the Substitutability concept in mind, portfolio optimization efforts can be transformative: changing the overall profitability and trajectory of the portfolio. And in the process, a company may decide to cut a very profitable, high-volume product as long as it is highly substitutable by another product.

Example of how Substitutability is used?

WP&C considers Substitutability a major part of portfolio optimization exercises. We study the Substitutability of products and we work with clients to incorporate customer experiences to determine if one product can be substituted for another. While many companies initially struggle to determine the level of substitutability within their portfolios, it is important to remember an order-of-magnitude estimate of Substitutability is sufficient to begin the analysis. Many companies behave as if Substitutability of their products is 0% - which is seldom the case. Once we arrive at an estimate of Substitutability across the portfolio, we incorporate it in to the decisions about what products or services to keep and cut (see Six-facet Approach to Portfolio Optimization Spotlight) and develop the right portfolio for the business.

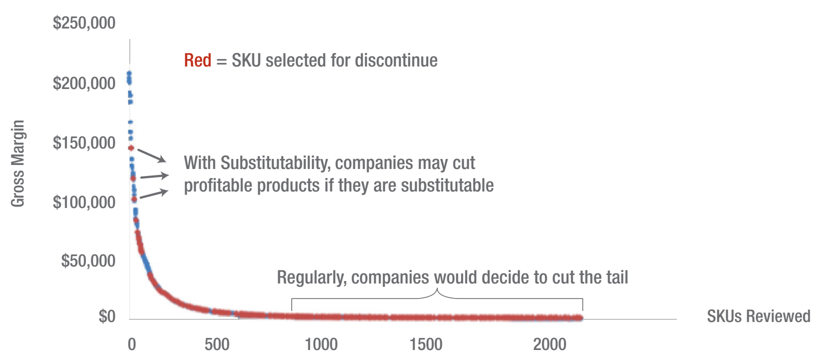

Figure 1. SKU Profit Distribution Curve

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