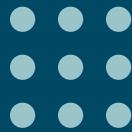


Reducing Shrink to Improve Retailer Profitability

Dean Sivara
Mike Miller
David Meany



Prepared by Cisco Systems, Inc.
Internet Business Solutions Group (IBSG)

Reducing Shrink to Improve Retailer Profitability

In the global retail industry, where average net margins are just 3 percent¹, losing nearly \$160 billion annually—or 2 percent of the industry’s \$8 trillion in total annual sales²—is a significant problem. The cause? Shrink—the amount of a retailer’s net margin eroded by waste, theft, and product spoilage.

Over the last decade, the retail industry has tackled the shrink problem in a variety of ways. Mistakes in ordering, receiving, and accounting have driven retailers to implement computer-aided ordering and automated receiving practices. To reduce employee and customer theft, retailers have instituted employee education programs, installed monitoring cameras, placed electronic article surveillance tags on items, and even hired guards to check bags when customers leave the store. And most grocery retailers, whose biggest challenge is product spoilage, now use predictive software that bases orders on expected demand and replenishes stores closer to consumer purchase dates.

But despite retailers’ efforts, the industry has hit a plateau in the battle against shrink. After declining 10 percent in the 7-year period from 1993 to 2000, shrink averages are down by less than 2 percent since 2000³.

Why? Because today’s approach to fighting shrink is disjointed. Implementing and managing the vast array of point programs, processes, and technologies is time-consuming and difficult—and has not always offered the measurable return on investment retailers need. According to recent research by the Cisco® Internet Business Solutions Group (IBSG), store and department managers typically spend up to 12 hours per week analyzing reports—generated by multiple applications

and delivered in different formats—to find shrink-related information⁴. And once they identify the root causes of shrink, the data is often weeks old. That’s too late to prevent a case of milk from spoiling or to stop an employee from taking a box of mobile phones from the receiving dock—each of which affects the bottom line.

Current Roadblocks to Reducing Shrink

So why is it so difficult to create an integrated approach to reducing shrink? Four pervasive issues prevent more significant results.

First, shrink-related data is stored in different, independent applications such as point-of-sale (POS), inventory, receiving, and store operations applications across the company. These disparate “silos” make it difficult, if not impossible, for managers to gain a comprehensive view of shrink. For example, a leading grocery retailer stores shrink-related information in numerous software applications. “Trying to get a comprehensive view of companywide or even store-specific shrink is difficult at times,” notes a store manager for the grocer.

Second, retailers must collect and analyze all data manually, which involves filtering through multiple paper-based reports or cutting and pasting data into spreadsheets for further analysis. Haphazard at best, the process also only identifies obvious mistakes—not real root causes. Many retailers find that by the time they collect the data they need to determine, for example, how many pairs of trendy jeans to order for the holiday shopping season, the information is outdated and irrelevant to the decision-making process.

The third issue is that applications storing shrink data also generate disparate types of reports at different intervals. For example, at a large home improvement retailer, the POS system generates weekly reports, but the inventory system's reports are generated monthly. Complicating matters further, many retailers store current data electronically and historical data on printed reports. The lack of a consistent format makes it extremely difficult for store managers to glean actionable information. Comparing current and historical data to uncover or understand trends is virtually impossible.

Finally, to collect and analyze shrink-related information, store managers must retreat to the back office for up to 2 hours per day—away from customers and employees—to collect and analyze shrink-related information⁵. Tethered to a shared computer or to heavy binders with years of paper-based reports, managers are denied instant access to information where they need it most—on the store floor—hampering their ability to react quickly to time-critical issues, such as ordering errors or theft. “We want to spend more time with customers and our employees, so reports should be less time consuming,” added the store manager.

A Step in the Right Direction

Understanding that a disjointed approach to controlling shrink is only marginally effective, many of today's leading retailers are pulling their various shrink programs and tools under a collective umbrella. They are also putting more valuable information in the hands of the most important person fighting shrink: the store manager, who is in charge of monitoring and managing each store's program and results. Since creating a comprehensive program that

aligns store metrics and mandates CEO involvement, one leading consumer electronics retailer has reduced shrink by more than 66 percent over the last 5 years.

Although this is a step in the right direction, it does not solve the fundamental problems of disjointed and siloed data, manual analysis, inconsistent presentation formats, and the lack of data mobility. Retailers cannot make significant strides in reducing shrink with today's piecemeal approach. Instead, the industry must change the way it battles shrink.

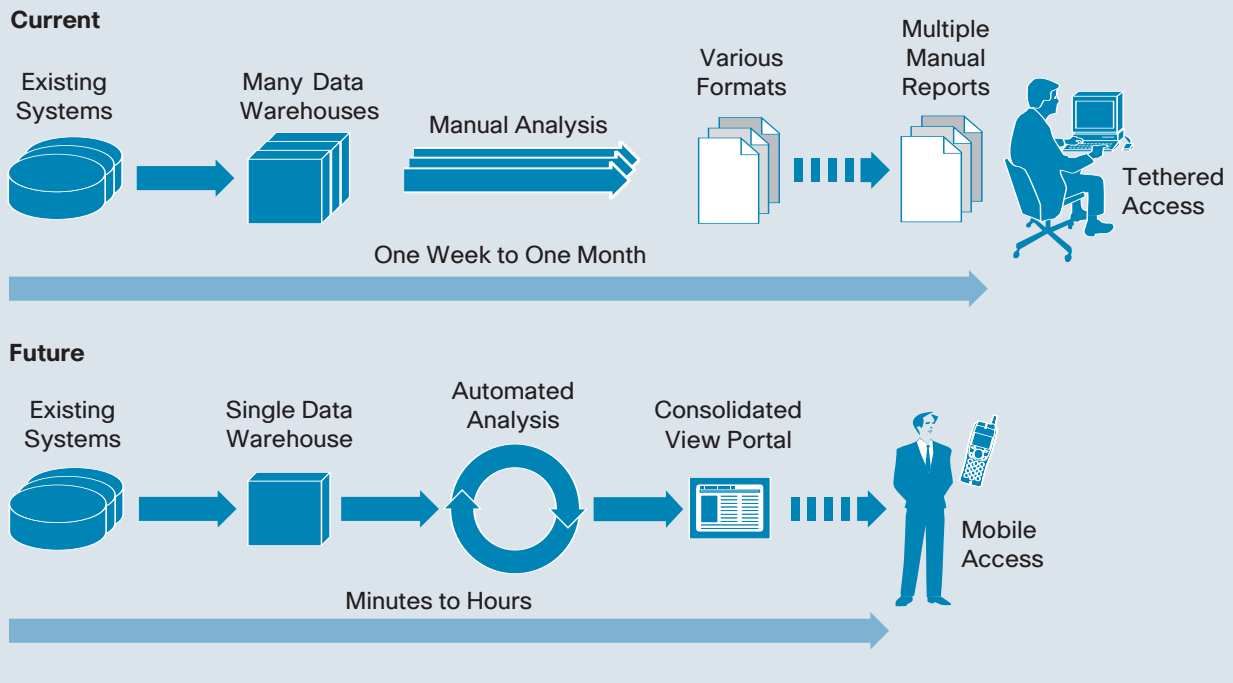
Taking the Shrink Battle to the Next Level

Working with progressive retailers, Cisco IBSG has found that integrating people, processes, and technologies into a comprehensive strategy is the best way to drastically reduce shrink and reclaim the industry's \$160 billion in lost annual sales. This means using the retailers' core systems and consolidating shrink-related data from all sources into a single data warehouse. Using middleware applications to accomplish this task, retailers gain a comprehensive, unified view of shrink-related data, with actionable information that is more timely and more accurate.

Once the retailer's shrink-related data has been consolidated, workflow applications automatically analyze the data in real time. Store managers are able to make more intelligent, timely decisions, because they receive automatic alerts when inventory levels are low and when products are about to expire or are due to be shipped. These proactive alerts can reduce the time it takes for store managers to get critical shrink-related data from weeks to mere minutes, transforming spoiled products into sold goods.

FIGURE 1

Time Benefits of Consolidating Shrink Data



Moving from a manual, disjointed shrink-reduction program to an integrated strategy can reduce the time it takes for store managers to access critical shrink-related information from weeks to hours or minutes.

After consolidating the data and automating analysis, retailers can, for the first time, view all of their shrink data in a single, consistent, and easy-to-understand format. Using portal technology, retailers gain an instant, comprehensive view of all root causes of shrink: spoilage, theft, waste, and poor inventory control. Comparing current and historical data to uncover trends, proactively preventing potential spoilage due to upcoming expiration dates, and uncovering and remediating unusual employee-override activity in the POS system is simplified with a single ‘shrink portal’. And every employee, from the floor worker to the director of operations, is empowered to reduce shrink.

Ultimately, an integrated approach to reducing shrink needs to go one step further: employees

need access to shrink data anytime, anywhere. This means using mobile technologies to “push” data to users. With mobile access to inventory, POS, and shipment information, managers can make more timely decisions about ordering, stocking, monitoring employees, and servicing customers, whether they are in their office, on the store floor, or even off site (see Figure 1).

Another weapon store managers will have in their future arsenal is radio frequency identification, or RFID. While Cisco IBSG believes that RFID will also help to reduce shrink once individual items are tagged, item-level tagging—particularly for low-priced items—is still years away. Currently, an integrated approach is the best way to dramatically reduce shrink.

Driving Significant Results

Cisco IBSG research indicates that retailers can reduce shrink by as much as 50 percent using the methods and solutions described in this article.⁶ A \$25-billion grocer could halve an industry-average annual shrink of 2.32 percent by consolidating shrink-related information and receiving proactive alerts.⁷ For example, the delicatessen department manager can receive an alert that a large order of chicken wings will be pushed from the warehouse next week and must be put on sale right away to reduce spoilage. Similarly, the produce manager can know instantly that a box of spoiled bananas was thrown out, and can adjust the amount of bananas to order the following day. As a result, the grocer could increase profits by almost \$400 million, or 122 percent.

For a \$15-billion consumer electronics retailer with a current annual shrink of 0.87 percent, an integrated shrink approach could mean \$65 million in annual savings and a 29-percent profit improvement.⁸ By consolidating shrink data

and automating analysis, the retailer can reduce the time managers spend searching for shrink data and can also make that data more timely, enabling swift and proactive action to prevent shrink. For example, automated analysis of POS data quickly uncovers cashier fraud, enabling the electronics retailer to discipline responsible employees before the bottom line suffers further damage.

For a \$10-billion apparel retailer with an annual shrink of 2.14 percent, better and more timely access to consolidated shrink data can translate to a \$107-million annual reduction in shrink and a 24-percent profit improvement.⁹ With better access to data—either through a portal or using mobile handheld devices—store managers can get a better handle on product sales, unusual POS activity, and theft. Mobile access also allows managers to spend more time on the floor monitoring customer activity and providing guidance to employees on how to battle shrink (see Figure 2).

FIGURE 2

Potential Profit Improvement for Various Types of Retailers Using an Integrated Shrink-Reduction Strategy¹⁰

	Grocer	Consumer Electronics	Apparel
Revenue	\$25B	\$15B	\$10B
Current Net Margin	1.34%	2.00%	7.28%
Current Net Profit	\$335M	\$300M	\$728M
Current Shrink	2.32%	0.87%	2.14%
Total Shrink	\$580M	\$131M	\$214M
Future Shrink	1.16%	0.44%	1.07%
New Net Margin	2.92%	2.56%	8.84%
New Net Profit	\$730M	\$386M	\$884M
Profit Improvement	122%	29%	24%

Cisco Source: IBSG Analysis, 2005 (uses cost accounting for shrink figures)

Reclaiming the Retail Industry's Lost \$160 Billion

The retail industry is at a crossroads: current approaches to fighting shrink have reached a plateau in their effectiveness while retailers scramble to combat the problem on multiple fronts—customer and employee theft, product spoilage, and poor inventory control—with a fragmented effort.

To reclaim the industry's annual \$160-billion in lost revenue, retailers must rethink their

approach to the problem. Those that move quickly to an integrated approach that consolidates data, uses automated analysis tools, creates a common presentation format, and provides employees with mobile access will reap the benefits of enhanced profitability and improved profit margins in an increasingly competitive retail market.

End Notes

- ¹ 2002 U.S. Economic Census: Advanced Comparative Statistics for U.S. based on 1997 NAICs.
- ² 2003 National Retail Security Survey, University of Florida, December 2004; 2003/2004 Supermarket Shrink Survey; The National Supermarket Research Group, 2003; Worldbank; Euromonitor.
- ³ 2003 National Retail Security Survey, University of Florida, December 2004.
- ⁴ Based on information Cisco IBSG gathered in customer interviews, March and April 2005.
- ⁵ Cisco IBSG customer interviews, March and April 2005.
- ⁶ Based on average industry financial results, independent shrink research, and analysis by Cisco IBSG to determine the impact of an integrated approach to reducing shrink on a typical retailer.
- ⁷ Based on average industry financial results, independent shrink research, and analysis by Cisco IBSG to determine the impact of an integrated approach to reducing shrink on a typical grocer.
- ⁸ Based on average industry financial results, independent shrink research, and analysis by Cisco IBSG to determine the impact of an integrated approach to reducing shrink on a typical consumer electronics retailer.
- ⁹ Based on average industry financial results, independent shrink research, and analysis by Cisco IBSG to determine the impact of an integrated approach to reducing shrink on a typical apparel retailer.
- ¹⁰ Information for this table was gleaned from 2004 10K SEC filings for multiple retailers in each category. Cisco IBSG then calculated the current shrink averages for each of the three segments of the industry represented in the table, as well as the future shrink based on Cisco IBSG's estimate of a 50-percent reduction in shrink after implementing an integrated shrink strategy.