EXECUTIVE INSIGHTS

# How to Optimize a CPG Portfolio

Consumer packaged goods (CPG) manufacturers are currently facing a raft of macroeconomic challenges: Consumer elasticity has returned, concerns about operations as well as labor (specifically availability) persist, and manufacturing and portfolio complexity is compounding the effects of both.

But by optimizing their stock-keeping unit (SKU) assortment — and in the process, optimizing both their packaging and procurement — CPG companies can relieve margin pressure, improve operational efficiency and, by extension, reduce labor concerns to drive profitable growth of their respective overall brands.

With that in mind, L.E.K. Consulting has observed more than 20 large public CPG companies that have been embarking on portfolio optimization programs. While their individual reasons and goals may differ, their efforts make clear that before launching a strategic portfolio optimization program, there are some core questions every CPG company needs to answer in order to ensure the program's success.

To start, let's look at the current challenges facing brand owners.

## How the post-COVID-19 economy is impacting CPG manufacturers

While price increases have been easy for CPG manufacturers to implement over the past few years, now manufacturers are either slowing them down or, in some cases, outright reversing them. At the same time, consumer elasticity is increasing, as evidenced by decreasing savings rates, the resumption of student loan repayments and the increasing number of 30-day credit card defaults, rising interest rates, and the reduction of government programs like SNAP, which are making consumers even less tolerant of price increases and have them looking for options to "trade down" or "trade out."

Compounding the challenges for CPG manufacturers are operational concerns that have arisen due to the rapid shifting of packaging types (e.g., as food and beverage manufacturers converted production from foodservice packs to retail or to-go packs in 2020-21 and back to retail as in-person dining resumed) and channels (e.g., to ecommerce, foodservice), as well as record low unemployment (which makes finding employees difficult).

Meanwhile, innovation, which was deprioritized during the pandemic, has returned as CPG manufacturers seek to drive organic growth. But it has brought with it greater manufacturing and portfolio complexity driven by an increasing number of flavors and package sizes, as well as supplier/procurement complexity (i.e., more suppliers and vendors that need to be managed). In other words, that complexity stretches from end to end, from the customer all the way back to the supply chain.

## Key levers CPG manufacturers can pull

To ease margin pressure, lessen supplier complexity and, in the process, reduce labor concerns, CPG manufacturers can implement:

- **Portfolio optimization** — This involves eliminating the SKUs that are less productive, difficult or time-consuming to produce, duplicative of other SKUs, or not profitable
- **Packaging optimization** — Harmonizing packaging types, materials, price packs, etc. across multiple SKUs/product lines will optimize their packaging
- **Procurement optimization** — A review of suppliers and formulations will enable manufacturers to consolidate suppliers and achieve procurement synergies, as will harmonizing ingredients

Each of these steps will help the organization, and its management, focus on "core" SKUs and return to profitable, operationally sound innovation.

From an operational standpoint, reducing SKU complexity and short runs will limit the time/machinery required for packaging and increase uptime but reduce changeovers. Procurement efficiency will improve due to the reduction in supplier count and order complexity combined with the benefit of additional volume discounts.

Logistics and inventory management costs will also fall due to the reduction in storage complexity, having fewer low-velocity SKUs in the warehouse, and the improved ease of shipping. And because there will be fewer SKUs to keep track of, CPG manufacturers will be able to improve resilience and service levels, resulting in improved levels of customer service.

## Steps CPG leaders have taken

The portfolio optimization programs undertaken by some of the largest CPG companies demonstrate just how impactful such optimization can be. For example, in 2020 Kraft Heinz reduced some 20% of its SKU count to focus on high-growth SKUs, simplify its supply chain and increase its service levels. In 2021, Smucker's set out to eliminate the 30% of SKUs that generated just 3% of revenue so it could focus on retail rather than foodservice and, in the process, better orient the organization toward its strategic goals. And most recently, in 2023, Hain embarked on a program to increase organizational focus, shelf space and brand awareness for its core SKUs by cutting 50% of its SKU count "long tail."

In an analysis of the portfolio optimization efforts of more than 20 public CPGs, three core themes emerge:

1. Driving distribution of core SKUs is the goal
2. Operational efficiency is a key focus
3. Systematic strategic optimization processes drive meaningful cost savings on an ongoing basis

CPG companies should start by taking a holistic look at their portfolio, doing rigorous activity-based costing to identify the "true profitability" of each SKU and assessing whether SKUs that are less profitable have a strategic role to play in the broader portfolio.

They can take a number of steps to bolster their portfolios — namely, increase the price of less profitable SKUs, consolidate them with other SKUs, increase minimum order quantities and reduce related service levels. But as a last — or perhaps best — option, they could optimize their portfolio by discontinuing those SKUs (see Figure 1).

**Figure 1**
Strategies to optimize SKU portfolio

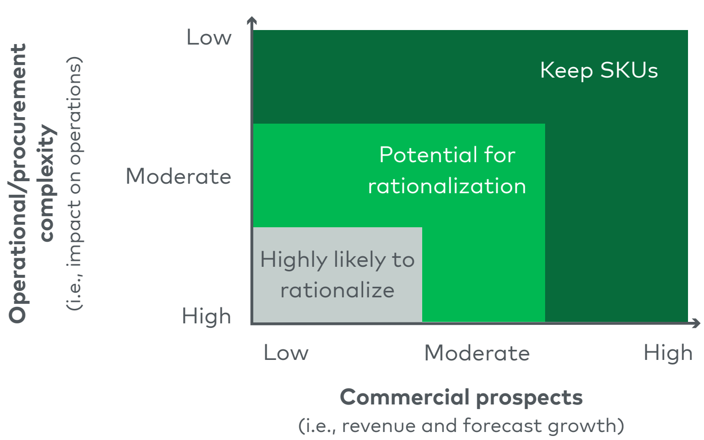
**For a less profitable SKU, manufacturers could…**

| | | |
|---|---|---|
| If not, | **Increase price** | To offset margin dilution and/or increase profitability compared to the rest of the portfolio |
| If not, | **Consolidate with other SKUs** | For example, when nonstandard sizes or formulas can be combined |
| If not, | **Increase minimum order quantities** | To leverage scale (e.g., longer production runs, distribution efficiencies) |
| If not, | **Reduce service levels** | Where the product could be made to order rather than stocked, could employ longer lead times, etc. |
| | **Discontinue/rationalize** | As a final remedy |

Note: SKU=stock-keeping unit
Source: L.E.K. research and analysis

In order to minimize operational/procurement complexity and maximize the potential for revenue and forecast growth, CPG manufacturers should consider eliminating SKUs with low or moderate commercial prospects, depending on their operational impact, whereas SKUs with high commercial prospects should rarely be considered for elimination, irrespective of the resulting operational impact (see Figure 2).

**Figure 2**
Operational/procurement complexity (i.e., impact on operations)




SKUs with high commercial prospects should rarely be considered, regardless of operational impact; other remedies potentially exist

SKUs with low or moderate commercial prospects may be considered for rationalization depending on their impact on operations

Note: SKU=stock-keeping unit
Source: L.E.K. research and analysis

Indeed, for CPG companies seeking to boost efficiency and increase their products' alignment with consumer preferences, portfolio optimization plays a crucial role (see Figure 3).

**Figure 3**
Benefits of portfolio optimization

1. Portfolio optimization allows CPG companies to prioritize their high-velocity SKUs and new product development tailored to consumer preferences
2. A reduced SKU count can buoy profit margins by reducing equipment downtime related to changeovers and can allow for longer manufacturing runs
3. More-focused scope of SKUs improves procurement efficiency by reducing the number of suppliers, leading to streamlined supplier management and decreased procurement risk
4. Simplified product variety lowers shipping complexity, reducing logistics cost and inventory management
5. Fewer SKUs simplify operations, allowing companies to meet and exceed customer service level agreements and rapidly address customer needs

Note: CPG=consumer packaged goods; SKU=stock-keeping unit
Source: L.E.K. research and analysis

## How to kick off a portfolio optimization program

While every CPG company could benefit from a portfolio optimization program, before embarking on one, companies need to ask themselves the following questions:

- Who are our consumers and what is our category? Where is the puck going, and how should we focus our company for sustainable growth?
- What is our true SKU-level profitability in terms of activity-based costing? Which SKUs are margin dilutive?
- How will our customers react? Will they still feel special?
- What will the implications be in terms of operational complexity/throughput?
- What will the implications be for the organization overall, i.e., Can we do this? How will it impact our various stakeholders?

Answers to those questions will help CPG companies move to the next set of considerations, which are focused on creating value (see Figure 4).

**Figure 4**
Key considerations for portfolio optimization


Note: SKU=stock-keeping unit
Source: L.E.K. research and analysis

But there can still be barriers to executing on portfolio optimization, among them conflicting priorities across company functions, a proliferation of SKUs resulting from small differences in product specifications and a "be everything to all customers" mindset. In that case, CPG manufacturers can draw on the examples of their peers to apply best practice solutions (see Figure 5).

**Figure 5**
Overview of challenges and best practices

| Common challenges | | Best practices |
|---|---|---|
| **Too many SKUs create operational inefficiencies** (e.g., frequent changeovers), which weakens the EBIT margin<br><br>This conflicts with sales and marketing's view that the SKUs are necessary to win and retain customers | **Conflicting cross-functional priorities** | **Quantify and objectively evaluate the trade-offs** to decide on the best outcome for the enterprise<br><br>For example, are there SKUs that can be rationalized to generate $1M in cost savings, while facing <$100K in revenue impact? |
| **Small differences in product specifications create SKU proliferation**<br><br>(e.g., packaging, labels, colors, dimensions) | **SKU proliferation** | **Assess the cost savings value of SKU consolidations** vs. importance to customers<br><br>Consider commercial options to nudge customers toward standard/high-volume products by category (e.g., volume-based pricing) |
| **Lack of focus on customer segmentation** creates a "be everything to all customers" culture<br><br>SKU portfolio continues to proliferate; inventory grows; DCs become full and inefficient | **"Be-everything-to-all-customers" mindset** | **Align the SKU portfolio to serve the business strategy**<br><br>Determine the priority channels and customers, and ensure the SKU portfolio is built to their needs with good performance across both revenue and margin |

Note: SKU=stock-keeping unit; EBIT=earnings before interest and taxes; DC=distribution centers
Source: L.E.K. research and analysis

## How we can help

There are a variety of ways that CPG companies can realize the revenue and margin benefits of a more professionalized portfolio optimization process, including performing consumer and market research to understand priority SKUs, improving net profitability visibility via in-depth financial and operational analysis, and improving organizational capabilities. CPG companies must strike a delicate balance with their brand portfolios and must be ready to adjust their portfolio to account for shifting consumer tastes, labor challenges and all the complexities that come with manufacturing. One of the most impactful steps manufacturers can take is to optimize their SKU assortments. When done properly, an optimized SKU portfolio will minimize headaches — and maximize profits.

For more information, please **contact us**.

## About the Authors

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