

How To Optimise Profit With A Business Intelligence System

The power of a business intelligence system, writes BiPredict director Steve Corbett, is its ability to link a business's financial drivers to its operational drivers...

The power of, and the rationale for, a business intelligence system is that it provides decision makers within an organisation with the capability to link and optimise financial drivers with operational drivers.

Shareholder value is derived from these financial drivers: revenue growth, less operating costs, less taxes, less investment in working capital and capex, and less cost of capital.

Taking a retail business as an example, the operational drivers for revenue growth in a business are: merchandise management (including predicted demand, price analysis, supply on hand), store operations, and market analysis.

Every decision taken at the operational level has an impact on the financial drivers in the business. The most important person to have on the team when implementing a business intelligence system is the person who understands the business – and this person is not usually from the IT department!

To demonstrate the power of BI, here is an example of using a business intelligence system for retail price optimisation (an operational

driver) which, of course, will also impact on the working capital (a financial driver).

Pricing strategy in retail can be a complex process. There is much to contemplate when considering how to price goods, including inter alia market forces, competitive pricing and so on. And even more so when developing and implementing a pricing strategy which will provide management with an assurance that the strategy can optimize the company's gross profit returns, while at the same time also ensuring that the investment in inventory is managed appropriately.

A key point to note with retail pricing is that gross profit does not track with sales.

What this means is that the relationship between the gross profit and price for price elastic products is not (usually) a linear relationship (ie. a relationship that is illustrated by a straight line).

Understanding how gross profit changes with a change in price and/or quantity demand is the most critical knowledge set that a company can build.

The formula for Gross Profit is: $GP = (\text{Price} - \text{Cost}) \times \text{Quantity}$.

As the cost is normally fixed, only two

other variables, ie. price and quantity, can affect gross profit, and as most products display varying degrees of price elasticity (where quantity demand is directly related to price), we can see how important price is as a driver of gross profit.

The example graph shows there is an optimum point (top of the gross profit curve) which is where customer demand and the price point (in this case \$22-\$23) provide the optimum gross profit for the company.

The information provided in the gross profit curve is the most valuable for strategic and tactical price setting.


Once this optimal price is established the company can then plan its pricing strategy accordingly, taking into account all the other factors that need to be considered.

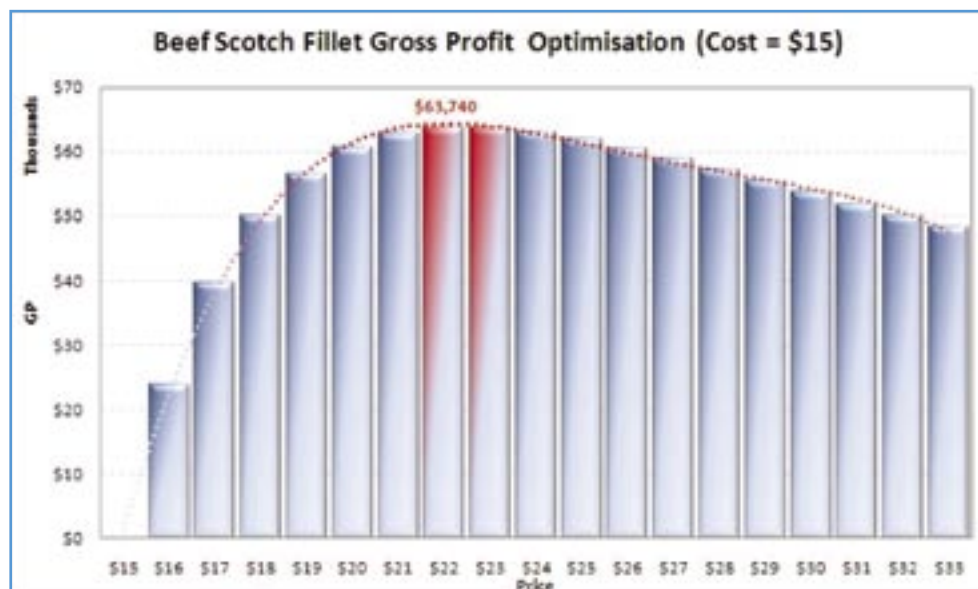
Let's demonstrate how the strategist would use the curve.

Current Price	Proposed Discount	Sales Price After Discount	Impact on GP Dollars
\$28	15%	\$23.80	increase
\$28	20%	\$22.40	increase
\$24	15%	\$20.40	decrease
\$24	20%	\$19.20	decrease

As can be seen the business has ended up with a significantly different profit (and cash) result for the same discount strategy.

Also the pricing strategy can have a major impact on inventory planning. With price elastic products the product demand increases at the lower price points and the business would need to plan for and be capable of holding higher inventories to avoid stock outs, etc.

This example demonstrates not only the power that a BI system offers to a company but also the alignment between operational decision making and management planning for the financial impact on the business. Working together they can create significant shareholder value. 



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