Case #6

Company: McKinsey (Round 1)

Topic: Profitability

Industry: Direct Mail Clothing Retailer

About the Case

This is a profitability case where candidate is required to evaluate the feasibility of a change in the cost structure of the product. The candidate should use a framework and walk the interviewer through it. A profitability analysis should follow.

Defining the Problem

Your client is a direct mail garment retailer that sells clothing for women. The primary selling tool for the business is the product catalog. The postage costs of your client's catalog have just increased by 0.40 cents per catalog.

How can your client decide whether this new cost is feasible for his current business model?

Information Gathering

Read this information well before you administer the case. Share the information in each bullet only if the candidate asks for it in a clear and deliberate way.

Prompt 1: Revenue and cost structure - *The Interviewee should ask for revenue and cost information in order to infer profit margin.*

Information to be given if asked:

- Profit margin on catalog orders: 15%, excluding new mailing costs
- Postage costs: $40 for each 100-catalog bundle mailed (100 x 0.40 cents)
- **Exhibit 1**

*The candidate should be able to deduce the following information from **Exhibit 1**.*

- Average response rate: 2%, i.e., two orders placed for every 100 catalogs mailed in 2001. This number has increased slightly over time to 3% in 2005
- Average order size: Decreased over time from $150 to 66.67 (= 400,000/6000)
- Percentage of customers who reorder within six months: Hovering over time between 20% and 25%, on average
- Revenue and profit calculations for 2005
    - Total orders generated per 100 catalogs = orders received + reorders i.e. (100 X 6000)/200000 + 3*(1,500/6,000) = 3.75 orders placed per 100 catalogs mailed.
    - Revenue per 100 catalogs = orders per 100 catalogs X avg. sales order = 3.75 * 66.67 or $250.00 in revenues.
- Cost calculations
    - Given profit margin of 15% means approximately $250 in sales will return a profit before postage cost of $37.50
    - This is insufficient to cover the mailing cost of $40

Prompt 2: Revenue per catalog – *Ask the candidate how the client might improve the revenue per catalog metric. This is an open-ended question where the candidate is expected to brainstorm possibilities given the above analysis*

Answer: The best answer might have the candidate take some time to come up with a structured response. Examine the various aspects that affect the catalog revenue; think of a MECE solution.

One example might be modifying the product i.e. the catalog itself (bigger pictures, layout, more product selection, print in color, etc.). Client could also consider tweaking the marketing strategy through better-targeted advertising or by offering a pre-holiday sale to spur volume.

Conclusion: Given the present profit margin of $37.50 per 100 catalogs, it is not feasible for the client to accept the cost increase in postage of 0.40 cents.

Exhibit 1: Mail Retailer Revenue Data (2001 – 05)

Year	No. of Catalogs Mailed	No. of Orders Received	Sales	No. of Reorders (within six months)
2001	50,000	1,000	$150,000	200
2002	100,000	2,000	$150,000	600
2003	200,000	3,000	$300,000	1000
2004	150,000	3,000	$300,000	600
2005	200,000	6,000	$400,000	1500