iCepts

Supply Chain Management Best Practices

6 Mistakes Distributors Make that Impact Profits

" If you want to drive net profit improvements, then everyone needs to become part of the mission."-Jason Bader. Owner and Senior Consultant at The Distribution Team.

Introduction:

This paper explains 6 mistakes that Wholesale Distributors make that impact their bottom lines and how to address these mistakes. Content provided by Jason Bader, Owner and Senior Consultant at The Distribution Team. Jason brings over 30 years of experience working in the distribution field.

1. Understanding who your Most Profitable Customers are:

When we look at the breadth of our customer base, are they really all equal? I love it when I hear an order desk guy say that every customer is the same or I treat them all special. Really? Then why do we have different prices for some? The fact of the matter is that not all customers are the same. Some are more valuable to us than others. If we can all assume that this is basically true, how do we differentiate the good ones from the bad ones?

Here is a great exercise to do with your team. Gather everyone together and ask them to list the company's top ten customers on a sheet of paper. More often than not, volume will be the criteria used to determine status on the list. Some will go the extra mile and rank the customers by gross profit dollars. It is good to know where the mindset is currently. A couple of weeks later gather everyone again and ask them to list the top ten most profitable customers. There may be a few raised eyebrows and whispered suggestions that your memory isn't too sharp. Many people will think that you just asked them the same question and their list will be identical. If this is the case, it may be time for a quick discussion about the relationship between sales and net profit.

If you want to drive net profit improvement through the organization, then everyone needs to become part of the mission. By understanding who our most profitable customers are, the sales teams can make better decisions on how to allocate company resources. They don't have the authority to allocate company resources? I beg to differ. When a customer requests an item that needs to be transferred in from another location, the order taker is about to make a decision. The outcome of that decision can directly affect your bottom line. Is this customer worthy of the transfer? Are they a positive contributor to the bottom line, or do they string us out on payment? Chances are we have not armed our order taker with the customer information necessary to make a good net profit decision.

As I have discussed in previous articles, distributors tend to utilize only a fraction of their distribution software packages. Understanding the reporting capabilities and manipulating data can increase your return on this substantial investment. The customer profitability analysis report is simply a spreadsheet using data that your system captures on a daily basis. The magic occurs when you share the data with, and develop policies for, your front line decision makers. This report will rank your customers by contribution to net profit. It is important that we are only looking at customers who have done business with us for at least 12 months.

New customers should always be treated special until they prove themselves less than worthy. Here are the columns on the spreadsheet:

1. Customer Name
2. Annual Gross Sales
3. Annual Cost of Goods Sold
4. Annual Gross Margin Dollars
5. Annual Number of Orders Processed for Customer
6. Cost of Processing an Order
7. Annual Cost of Processing Customer Orders
8. Contribution to Net Profit

The first question usually occurs with the 6th column. How do we determine the cost of processing an order? There are fancy ways to do it, usually involving additional software and cost accounting, and there is an easy way to do it. The more precise way to determine the actual cost of processing an order is to use something called Activity Based Costing (ABC). Using “ABC Tools”, a cost is attached to each function associated with processing the order. Sometimes conflicts can occur between departments as to their relative value in the process. But, you will eventually get down to a fairly precise number. For those of you who are more interested in the getting a solid ballpark number, here is a quick method. Divide your annual operating expenses by the number of orders the company processed last year. Are there a few extraneous costs, like the twin engine floating delivery truck at the end of the dock that get lumped in? Sure. As you will see, precision is not all that critical here. Depending on your vertical market, most distributors tend to come in between $35 - $65 per order. Plug the number in your spreadsheet as a constant.

The rest of the math in the spreadsheet is fairly simple. Multiply column 5 (number of orders) by column 6 (cost of processing an order) to get your answer for column 7 (annual cost to process customer’s orders). Column 8 (contribution to net) is determined by subtracting column 7 (annual cost to process customer’s orders) from column 4 (annual gross margin dollars). This contribution to net profit will either be positive or

negative. Sort the spreadsheet by column 8 (contribution to net profit) in descending order. The result is a ranking of your customers by their contribution to your net profit. Once you have created your ranking, you may need to take a step back and allow for a few deep breaths. This is not the time to panic. One of the more troubling observations for first time viewers is that a majority of your customers fall below the zero line. Stated another way, their contribution to net is a negative number. It isn't quite as bad as the old 80/20 rule, but most distributors find that 70-75% of their customers are in the negative territory. So what now? Do we just cut off everyone below the line? Of course not. The majority of these folks help us with volume purchasing and give us economies of scale. Our next task is to determine our threshold for pain.

About 25% of the way up from the bottom of the list, I like to draw a red line. I like to refer to them as blood suckers or bottom feeders. Behind closed doors you may be able to come up with more colorful names. Anyone below this line is a candidate for termination. Firing a customer is not something that most distributors relish. It's kind of against our sales code of conduct. The fact of the matter is that it really isn't the fault of the customer. We have done it to ourselves. In the name of customer service, we have given away company resources to those who are not deserving of our gifts. If you need a little more convincing that this bottom group is taking you for a ride, just lay down an accounts receivable aging report next to your list. There is a strong correlation between slow pay and negative contribution to net.

Let's go back to the goal of this exercise. We are trying to drive decision making based on contribution to net profit. The key to getting the most out of the information we just extracted is to share this with our front line decision makers. Additionally, we need to set some policies that help us align our resource expenditures with the customers that help contribute to our financial success.

The first group I would tackle is the "blood sucker". For ease of use, let's refer to them as group C. We are giving everything, they are giving nothing. The sad part is that we just learned this. They have known for years. It is a sad fact that your worst customers know it. They take pride in their ability to beat you up on price, run you all over town, and string out your money. We clearly need to level the playing field when it comes to this group.

The first thing I would do is quit being their bank. Convert the slow payers to COD. If you have cash discounts, get rid of them. This goes for all customers, but that is for another discussion. Now that we are out of the finance business, it's time to raise prices. These folks won a prize. Give them all list price. Whoa, Jason, you are being too harsh. Au contraire, it's time these folks paid their way. Will some of them leave you? Absolutely. In fact, give them a road map to your competitor's place. Let them be someone else's worst customer. The funny ones are the customers that stay. This is one of those forehead slapping moments where you rethink your whole pricing strategy.

Let's take a look at the services we provide. Do we provide free deliveries to this group? Do we have minimum orders? Are we transferring product at our own expense? Have I hit a nerve yet? Good. We have a finite amount of resources in the company. We should not waste them on customers who are not contributing. A good strategy is to require minimum orders for both credit purchases and delivered product. Do not order in special products for C customers. They get to buy what we have on the shelf. Above all, we do not transfer product at our own expense.

One of the final suggestions is to quit spending sales dollars on them. For those of you with an outside sales force, quit calling on these customers. Remove commissions on these customers, and make them house accounts. By removing the commissions, you remove the favorite word in the sales vocabulary used to describe an underperforming customer – potential.

The middle group, let's call them B customers, is a different animal. They do have a negative contribution to net profit, but I wouldn't want to lose them. As mentioned earlier, they provide us the volume to purchase more efficiently and allow us to enjoy certain economies of scale. Some slight adjustments to how we handle this customer group will allow many of them to rise up to positive contribution.

Most of these customers have a decent gross profit volume. The real trouble occurs in the frequency of order. We may find ourselves processing several low dollar orders in a single day. If we could get them to consolidate orders to once a day, they would slide up the profitability scale. This type of discussion will need to come from someone senior in the organization. They can speak in terms of reduction in the clerical costs of PO generation and payment processing.

Another strategy is to look at how we handle special orders and transfers for this customer group. I would ask this customer to bear the cost of expedited handling. In addition, I would be more apt to suggest the customer to accept a substitute rather than ordering in a special item. While we are talking about specials, make sure that we are getting a high margin on the product. We are spending company resources to bring this in. Be strict with your return policies and be mindful of internal costs. Finally, I would look at modest price increases. This where a good pricing matrix guru can come in handy. Look for subtle increases to less popular items. You should be able to raise your overall margin by 1-2%.

Now we arrive at our best customers. To stay consistent, and a bit boring, let's call them A customers. These are the folks that make a positive contribution to our net profit. We love them. We need to tell them we love them. I'm serious here. If we lose one of these customers, it will often be the next most expensive sale we will ever make. We will throw all kinds of deals at them in order to woo them back. Unfortunately the cash impact of these deals will be felt for many years to come. Let's not lose them in the first place.

My brother and I discuss this all the time. Get close to the A customers. My brother is the heir apparent to my family business because yours truly has chosen to write articles and speak at trade shows. Note to self, ask mother if I was fond of paint chips as a child. The point is that I want the owners of companies to become close to this group of customers. Do not leave the relationship to your sales manager or salesperson. At least once a year, meet with the owner of each of these companies. Talk about what you are doing for them. They need to be reminded. Incidentally, this is an excellent utilization of sports tickets or that golf club membership. People still do business with people they know, like and trust.

Is it easier to go get new customers or sell deeper into your existing customer base? Nothing fancy here. We already have them on the books; let's sell them more product categories. It is always a blow to the ego when a long standing customer says, "I didn't know you carried that." Most sales managers I know would love to be able to analyze each customer and figure out where we are not selling them. The problem is that the task is just too daunting. There are just too many customers to really look at. Why not use the ranking report to help us?

Why would we want to sell more into companies that produce a negative contribution to net profit? Doesn't make a whole lot of sense to me. Let's focus on selling deeper into group A. I was presenting this in a private seminar recently. Fortunately, the sales manager was in the room and a grin spread across his face. At the break, he shared with me that he had been told to create a sales opportunity analysis for all the customers in the company. He was really sweating this assignment. I just cut his workload dramatically. It's better to work smarter than harder.

The customer profitability analysis is one of the most powerful tools in any distributor's arsenal. From an inventory management perspective, you will find several wins. A big part of inventory management is the allocation of resources. We have a finite amount of cash to invest in inventory. As good asset managers, we are charged investing our resources where we will receive maximum customer benefit and a strong financial return.

When we use this customer ranking, it is easy to see where we want to invest our money. We need to make sure that our A customers are satisfied. One of the scarier outcomes of this analysis is realizing how much inventory dollars we are wasting on group C. Sometimes we carry entire lines of product for C customers. If I aim really hard, I can probably just shoot off my middle toe.

After all is said and done, the biggest win comes from educating the front line decision makers. At a customer service level, they have ability to make a tremendous impact on our bottom line. One of the final challenges is to make sure that everyone knows who the A, B, and C customers are. This is where our software can help us. Some of the more sophisticated pieces can actually have the customer code appear in a different

color during the order entry process. Some user defined fields in the customer record can help; but they are not always seen. I ran across one distributor who came up with a simple code. He just added asterisks to the end of the customer name in the database. This worked well because the codes also appeared on the pick tickets. Because he chose to include the material handling team into the process, they understood the significance of the star codes. Customers with 3 stars were given special treatment. The key is to find a communication vehicle that works for you. Understanding customer profitability will go a long way toward improving your bottom line. As you can see, this simple data extraction will provide several avenues to look for cash. Don’t be afraid to lose some of your C customers. You have already given them enough of your money.

When I work with clients, one of their greatest concerns is the turning of inventory. This seems to be the prevailing metric associated with a healthy organization. The conventional wisdom appears to say that the faster you turn the inventory, the better you are. In fact, many organizations have developed incentives based solely on turning the product. While turns should be part of a compensation strategy, it can’t be the only thing we measure.

2. Balancing Inventory Turns and Customer Service:

When I work with clients, one of their greatest concerns is the turning of inventory. This seems to be the prevailing metric associated with a healthy organization. The conventional wisdom appears to say that the faster you turn the inventory, the better you are. In fact, many organizations have developed incentives based solely on turning the product. While turns should be part of a compensation strategy, it can’t be the only thing we measure.

Just so we are all on the same page, here is a quick clarification of the inventory turn ratio. Inventory turn is a measure of how well your inventory investment is performing financially. To determine the inventory turn in your business, take the annual cost of goods sold from stock sales and divide it by the average inventory value. One of the most important words in that formula is “STOCK” from “stock sales”. This is where I see the greatest confusion when distributors calculate this metric. They tend to throw all sales in the numerator of the equation. When you include a drop ship into the measurement, are you really measuring the performance of your money? Did you invest your money to hold that item in inventory? Of course not. The inventory was held at the supplier’s facility. This logic holds true for non-stock specials that you buy for a customer. Transfers to fulfill a customer order are often included in the inventory turn calculation for the selling location. Should they be? When you are determining the performance of inventory in a certain branch, they should be excluded. Again, we are not using the inventory of the selling branch, we are capitalizing on the assets of the

shipping branch. You can see how the numbers can be fairly skewed. This is why I am very skeptical when I see industry averages. How sure are we that the other guy did the math right?

If my compensation was based solely on inventory turns, I could easily achieve the goal. The fastest way to increase inventory turns is to reduce the average inventory value. If you want to reduce inventory, quit cutting purchase orders. Believe me, you would bring that average down in short order. Unfortunately, it would also have severe consequences on your sales figures – but that isn't what we are measuring. Can anyone see the danger? I am very concerned that distributors may be leaning toward a wholesale slashing of inventory values in order to preserve the cash. Things like buying budgets and buying after the 25th of the month might be coming out of the closet. Folks, these are dangerous practices that focus on short term gains and create long term problems.

If you want to reduce inventory value, take a hard look at the dead and dying inventory. Get rid of the inventory that no one seems to be interested in. Be very cautious when a supplier suggests that you need to carry the whole breadth of the line. Look at your safety stock levels on the least popular items. Breadth of line is ok, but don't allow depth in the less popular items. As I mentioned earlier, the wholesale reduction of purchase orders will have negative consequences. Without inventory on hand, your customers will see you as an unreliable supplier. This is why we must measure our customer service level in conjunction with the inventory turns. It is not good enough to just put inventory in our warehouse. We need to bring in the products our customers want. More importantly, we need to bring the products in when our customers want them. Meeting our customer needs is what the customer service metric is all about.

The formula for measuring customer service is this: take the number of lines (on customer orders) shipped complete divided by the number of lines ordered. This is a fairly strict measurement of how well we met the customer's' needs. If a customer orders 10 grinders and you have 8 in stock. You ship the 8 and back order the other 2. What is the customer service level on this line of the order? Many would argue that it is 80%. Wrong. It is 0%. You failed to meet request of the customer. The customer wanted 10 and you gave them 8. If they wanted 8, they would have ordered 8. Think of measuring the customer service performance by the order. For example, if there were 10 lines on a customer order, and we were able to ship 8 of those lines complete, we would achieve an 80% customer service level for that order. Seems a bit harsh, doesn't it?

Let's put this another way. Say you stick your ATM card in the bank machine and request $100. The machine spits out $80 and tells you to come back tomorrow for the other $20. 80% isn't bad, right? You only have to wait a day for the remainder. Are you

satisfied with this transaction? I have a feeling that some of you would let your frustration be known to the little camera in the ATM.

Now that we are measuring customer service percentages, what is the goal? We typically like to see our clients shoot for an overall percentage of 90 – 95%. Anything higher than 95% would force us to invest a ridiculous sum of money in our inventory. We probably wouldn't have the space to achieve a 96% or higher. This is an overall inventory percentage. Some items will be higher than 95% and others will be lower than 90%. Here is a great way to use this measurement. Make sure that your most popular items, the top 5% your customers expect you to have, are in the 99-100% range. This will give you the appearance of having everything when they need it. As the popularity drops, the customer service percentage can drop with it. When you are measuring a vendor line, watch out for an overall service level in the low 80%. This means that you are carrying too little inventory or you may simply be carrying the wrong inventory. Go back and review the hits ranking to see which items are most and least popular. Adjust your levels to get the customer service percentages in line

Turns and customer service is the balancing act that all inventory managers must face. If we try to spin the inventory too quickly, we will develop holes in stock. Backorders will occur and our customer service will deteriorate. Let it deteriorate too far and the phone will stop ringing. Conversely, when we tip the scales too far toward the customer service side, our turns will reduce and we will be forced to borrow more. One side can not exist independent of the other. In uncertain economic times, the distributor who balances their inventory asset will be in better shape long term that the organizations who panic and make short terms decisions

3. Skipping Cash Discounts:

Don't you just love running across some information that supports a practice you have always just assumed to be true? I found myself in this position recently. One of the best pieces of advice I ever received was, "if you ever want to get your point across, prove it mathematically." Numbers don't lie. Now some folks apply numbers in a way that is far from the truth; but, that isn't the numbers fault. Up until recently, I have always just accepted the general theory that it is a good idea to take cash discounts, when possible, when you pay your suppliers. In my experience, most distributors take cash discounts in times of strong revenues and solid cash flow; but when the business starts slowing down we tend to opt for extended dating. What recently hit me like a 2 x 4 across the backside of the noggin was this: If we don't take advantage of the cash discounts presented by our suppliers, we are essentially borrowing money at the highest interest rate most of us will ever experience.

Let's look at a common set of terms for a supplier. The supplier will offer us a 2% discount off of a particular invoice if we pay it within the first 10 days of the due date. The due date of the invoice is actually 30 days. You will see these terms printed somewhere on the invoice in this fashion: 2% 10th, net 30. The supplier is giving us a reward of 2% of the total invoice value for paying 20 days early. If we choose not to take the discount and pay within the 30 days, we are actually paying 2% more for the product than we have to. Stated another way, we are paying a 2% interest charge for the privilege of holding our money an additional 20 days. Roll that interest charge out on an annual basis and we are talking about an interest rate around 36%- quite expensive.

Let's take a look at one more set of terms. Many of our suppliers like to be paid in 25 days, not 30. Some folks will offer 1% for paying in 10 days on an invoice due in 25 days. The terms will be stated: 1% 10th , net 25. Again, this is a very common set of terms in wholesale distribution. Let's analyze this scenario. If we choose to hold on to our cash and pay in 25 days, we have essentially borrowed money for 15 days at an interest rate of 1%. If we push this out to an annual percentage rate, we just signed up for a 25% interest rate loan; again very expensive.

Annual Interest Rates When We Don't Take Discounts

Early Pay Discount	Borrowing 20 Days (Net 30)	Borrowing 15 Days (Net 25)
1%	18.43%	24.58%
2%	37.24%	49.66%
3%	56.44%	75.26%
4%	76.04%	100.39%
5%	96.05%	128.07%

Looking at this table is enough to make me grab the extra strength Maalox. I can't tell you how many times I chose to forego the cash discount just to hang on to my cash for a few extra days. When I realized the penalty here, I was literally blown away. Could you imagine admitting to the owner of your business that you just signed up for 50% interest rate loan? If you are the business owner, could you admit it to your spouse? This is what you just did if you avoided the cash discount option of 2% 10, net 25.

We can all pretty much agree that the interest rates stated in the table are pretty substantial and should be avoided if possible. I do understand that cash can get very tight at times. Sometimes it just isn't possible to pay in 10 days. This is where a solid line of credit comes into play. Using a lower interest business line of credit in order to take advantage of early payment discounts is a sound business practice.

I have only stated a few examples of possible terms from our supplier partners. Special extended dating terms are very common in our business. Many of us have negotiated Net 60 and Net 90 terms. While it may sound great to hold on to our money for an

additional couple of months, we need to be able to prove our position beyond the old gut feeling analysis. Remember, if you ever want to justify your actions, prove it mathematically. Fortunately, we have a secret formula.

If you want to determine what the annual interest rate would be if you chose to skip the cash discount, use this calculation:

Discount % / (1 – Discount %) x (365 / Number of Borrowing Days)

Just because I really like this formula, let's run through an example. The supplier gives a 2% discount for payment in 10 days. The invoice is due in 30 days. Let's say that you are a pretty savvy negotiator and you have convinced the supplier to extend the due date out to 90 days. The question is: Should I pay in 10 and grab the 2% or should I hold my cash for an additional 80 days.

Run the math.

2% / (1 – 2%) x (365 / 80)

.02 / (1 - .02) x (365 / 80)

.02 / (.98) x (4.56)

.0204 x 4.56 = .0931 or 9.31%

Should I take the discount and borrow on my line of credit? Let me give you a true consulting answer: it depends. It really depends on the interest rate for your line of credit and your borrowing capacity. In some cases, 9.31% might not be such a bad rate. The most important thing here is that we can justify our actions. Being able to prove our business decisions mathematically goes a long way toward improving the bottom line.

Here is one more log on the fire. Many of us offer cash discounts to our customers. The same formula can be applied to determine the interest rate on the loan we just picked up from our customer. By offering 2% 10th Net 25 terms, we just borrowed money from any customer who chose to take the cash discount – at the same outrageous rate stated in the table above. Some industries require cash discounts as a matter of tradition. Giving cash terms should be avoided if at all possible because once you start it can be really difficult to get rid of them. Early in my distribution career, I remember hearing some very sound advice on cash discounts from Dr. Don Rice, former head of the School of Industrial Distribution at Texas A&M, “Always take ‘em, never give ‘em.”

4. Making Picking a Scavenger Hunt:

You have heard many times that inventory accuracy is the key to managing a successful operation. There are many ways that we skirt the rules and create inventory inaccuracy. We do it by not issuing the proper documentation for products, we take

things from stock for Will Call that never get picked up and we take items as samples that are never recorded. Unfortunately, there are many ways to increase our inventory inaccuracy. One thing we can control very easily is making sure our picking processes are done with a high degree of accuracy.

When you have a new warehouse (I call it a vault) person, there is always the dilemma of what to have them do in those early days. Should they just watch the more experienced personnel? Should they clean the place up? Should they receive product? The answer is simple THEY SHOULD PICK! The reason you want your new vault personnel to pick items is because you already have someone checking the order before it is shipped. You have a built in safety net for the new person. They will make mistakes just because they are new.

If you want to help your new vault personnel learn your products and system quicker, try sitting down with them every night for one week and go through the orders they picked that day. These are the ones that were corrected at the shipping table. You want to talk to them about why they picked the items they did and why some items were picked wrong. You are not grilling them for inaccuracy, but you are trying to determine why matching up the pick ticket with the product location and product did not go as smoothly as you might have imagined.

The answers you get might surprise you. It is usually not because the person is new and does not know squat about your products. That will come over time. It is often because the pick ticket, the item location and the product descriptions do not match up very well.

I suggest that everyone take a pick ticket and go pick some products from time to time. Even if you are very familiar with the products, this little exercise will point out just what you are hoping your new person points out in that first week. With all the activity, changes and vault shuffling over they years, the pick ticket (your roadmap to finding items) does not match up very well with your street signs (bin locations).

Labeling your vault can be done in many different ways. Some choose to have everything bar coded and use a Warehouse Management System to help with put away, picking and shipping. Some use hand made labels that are easily changed when required. Some use the old method of just walking around to find items or become familiar with where things might be TODAY. In an effort to increase your inventory accuracy and getting your personnel to increase their overall efficiency, I suggest you go through your vault and make sure everything is labeled clearly.

Some of you might be saying this right now Bob the vault manager knows where everything is so we do not need to label the vault. You might be right, Bob does know where everything is, but will your next new vault person? How long will it take for Bob to get that knowledge transferred to the new person's head? What happens if some but

not all of the knowledge comes across? How many mistakes will others in the vault make when Bob is not around? What happens when Bob gets sick, leaves or retires?

Labeling your vault is critical to inventory success. I suggest you use colors as much as possible. Big color charts, poster boards or aisle markers help people learn quickly where certain products are kept. Row labels, shelf labels and even bin labels can be color coded to enhance the learning process. Open floor space should also be labeled. This is critical because at certain times of the year, product is moved in and out of that space but the label can be used to identify product location.

Step one should be to go through your vault and make sure every inch of space has a label or address. Be creative. If you can use colors to identify certain vendor lines or product categories, use them. If you can use colors to help identify slight variances in the product (width, texture, thickness or voltage) then do it. For example, I have seen distributors with racks and racks of pipe. To the naked eye, it looks all the same. But at receipt, they put different colored tape on the end to help quickly identify the length and width of the pipe. This made a huge impact on their overall inventory accuracy. Picking and subsequently cutting the wrong pipe was virtually eliminated. A simple color chart was clearly displayed next to the pipe racking for easy reference.

Now let s go to step two. Take a look at the product master files and see what fields you can use to help the pickers make the right pick all the time? Are there fields that are not being used right now that you can use to identify a color scheme? How about the product description field? Is there an option to make it more descriptive from a picking standpoint? Would it make sense to print the entire product description on the pick ticket instead of just the short version? Look at the quantity fields to ensure that when we say pick one or an each , the pickers know if it is one piece, one pack or one case.

The location fields on the pick ticket might also be expanded. Maybe we need to revamp the pick ticket print routine to expand the field to more spaces. Maybe we can use the primary and secondary location fields in the inventory master file differently and have them guide our pickers better.

When it comes to picking, there is no set way to make it happen. But there are many ways to help the accuracy of our picks. Your goal is to make the directions you are giving the picker (the pick ticket) match up as closely as possible with the streets signs (vault labels) as possible. You might want to add in the directions that you need to go to the green aisle instead of the red one because this product is in the green aisle. Enhancing the print routines for your pick tickets is rather easy to do. The more descriptive you can make your pick ticket, the better off you will be. Look at all opportunities to add information on the pick ticket (longer product descriptions, more exact location detail, more specific quantity descriptions and maybe even some color coded identifiers) can help. Winning a scavenger hunt isn’t all just luck, it is knowing which places to go to find the items on your scavenger hunt list.

5. Choosing the Right Supplier:

Are you a buyer of product or an investor of company money? This is the question I invite all purchasing professionals to ask themselves. Those of you who are familiar with my inventory management philosophy know that I am constantly asking buyers to look beyond the clerical function of the job. We buy sophisticated computers to handle those mind numbing tasks. The fact that many distributors do not use their software to free up the buyer's time is a whole other can of worms. When you make the move to investor of company money, don't be satisfied with price analysis alone. When did we develop this myopic view about the role of the inventory investor? If you are just focused on saving the net price nickels, you are missing the big dollars available in total return on inventory investment.

Total return on investment is achieved by working with suppliers who support your overall inventory replenishment goals. Do they ship complete? Do they have consistent lead times? Do you get the products you ordered? Do they help you manage your dead and slow moving inventory? When we choose suppliers that do not live up to these ideals, there is a cost. We invest money to cover up these substandard practices. This investment comes in the form of safety stock. Bear in mind, safety stock is an insurance policy designed to protect our customer service goals from poor performing suppliers. I sure hope our insurance premium is smaller than the percent we saved in net price. If you really go back and do the math, you will start to understand the value of those suppliers who give you a total return on investment.

I recently had the opportunity to spend some time with a supplier who exemplified what I am looking for in a total return on investment. This is a company that understood the cost structure of a distributor. Let me ask you something. When was the last time a manufacturer understood the terms: inventory turn, carrying cost and gross margin return on investment. When most of us mention relationship concerns in any of these areas, the majority of our suppliers look like a deer in the headlights. It just isn't where they are trained. Uh, I don't know about that, I just sell stuff.

One of the most frustrating things I experienced as a purchasing professional was erratic lead time. Early on, I was naïve enough to believe that I could guess on an arrival date by looking at the geographical distance between myself and the manufacturer. What I failed to understand was the time it took for my order to get out the door of the supplier. If my customer called at noon, they expected it to ship the same day. It was a customer service expectation. When a supplier doesn't ship quickly, what does it really cost us?

Let's say that I have two suppliers in Charlotte and I am located in Seattle. Supplier A ships in 24 hours. Supplier B ships in 3 days. Both have the same transit time to

Seattle. In order to meet my customer service obligations, I will need to order Supplier B 3 days sooner than Supplier A. I will have 3 days more inventory in my facility when I have to make the investment to Supplier B. What is the carrying cost on that 3 days of inventory? Do I really trust that they will get my order out the door in 3 days? Been burned enough times on that one. Since I can't trust Supplier B, I need to insure my customer service obligation. Let's add a couple of days of safety stock. Now I have 5 extra days of inventory accumulating carrying costs. Are you getting the picture here?

Just to make sure that we are on the same page, carrying costs are the dollars we invest to feed, clothe and shelter the products we bring into stock. It is usually represented as a percentage of overall inventory dollars. That percentage can fluctuate between 20-30% of inventory value. Some of the components include: rent, insurance, interest, labor, shrinkage and opportunity cost. The longer we hold on to something, or the more we have, carrying costs escalate. This is the hidden cost behind every inventory management decision.

We are all familiar with Supplier B. The industry is littered with them. With ever tightening margin pressure, can you really afford to subsidize an erratic shipper? One of the things I really liked about this enlightened manufacturer is that they call penalties on themselves when they do not perform. If they do not meet their order fulfillment guarantees, they discount the invoice by 5%. In an industry where the margins tend to hang out in the low teens, this is a fairy stiff penalty. I am not sure how many times they have had to honor the discount, but it is nice to see a supplier put their money where their mouth is. Do any of your current suppliers guarantee their shipping commitments?

What is the biggest killer of inventory turns in a distribution company? Besides the gut level SWAG (i.e guessing) that many buyers substitute for purchasing logic, dead and slow inventory is like an anchor when it comes to spin. By the way, the SWAG method tends to breed large surpluses as well. Good investors of inventory understand that inventory turn is a key component in determining the return on investment. If you can turn the inventory faster, gross margin pressure is less critical. Remember, your gross margin is often dictated by the marketplace. A large portion is controlled outside of your four walls. Inventory turn is largely controlled by your company and the suppliers you choose to partner with.

How can a supplier affect inventory turn? Earlier in the article, we talked about their ability to get orders out the door quickly. This allows us to slim down the average investment in the line and inventory will turn more quickly. Again, the greatest inventory turn gains are achieved by removing dead and slow inventory from a line. What is the return policy of your current supplier? Do you have to jump through several hoops and pay a restocking charge? Do they run you around until you eventually get tired enough to quit asking? All of you have had these relationships. The company I spoke to takes responsibility for their products in a distributorship. They have a fairly simple policy – if

you can’t sell it, they can. Choose the folks that support your need to return unproductive inventory.

VMI or Vendor Managed Inventory is one of those concepts that many distributors shy away from. The basic concept behind VMI is simple. The supplier takes over the fulfillment function of the inventory management process. The distributor supplies the vendor basic sales transactional data. The supplier runs it through their purchasing algorithm. Inventory is fed to the distributor as needed. The theory looks good, but many distributors are scared to give up that much control. There is a fear that the supplier will just load them with more inventory in order to make their own sales goals. In order to combat this, most VMI relationships have very specific inventory turn goals. If you expect 6 or more turns, the supplier better be very cautious about loading you up.

Although most manufacturers have a relatively low percentage of customers using their VMI solution, it is really the next step in the relationship. This is the program that cements the partnership between distributor and manufacturer. Sure, it ties you to one brand in the marketplace. But let me ask you this, how many of your current lines turn 11-13 times per year? Some of you might know that I have been on a campaign for the last few years to teach manufacturers, particularly their sales representatives, how distributors really make money. I encourage them to be more consultative, rather than product focused. Start to look for those suppliers that support your need for total return on investment. Challenge your current suppliers to become more distributor driven in their approach. You will quickly separate the wheat from the chaff.

6. Liquidating Dead Inventory:

I recently spent some time with a large distributor in Florida. The original reason for my visit was to assess the company’s purchasing procedures and look for ways to improve the procurement process. After spending some time with the purchasing director, I happened to notice a report on his desk outlining the inventory turns for the last two years. Just like a good salesman, consultants learn to read upside down just in case there might be some important information residing on someone's desk. I asked about the report and indeed confirmed that it was a monthly turns history. Over the last 6 months, the turns had been dropping at an alarming rate. To give you a context of alarming, the turns had dropped from around 3.6 to 3.1 turns. Although I had not been originally hired to look at this trend specifically, it was apparent that this decline was causing more than its fair share of anxiety. This anxiety was compounded by the fact that my client, the purchasing manager, had just taken over the team 8 months ago. What had started out as a broad based task had now revealed a very specific goal: arrest the declining turns and reverse the trend.

Like many other indicators in our businesses, turns is simply a comparative ratio. In the numerator, we look at the cost of goods sold from stock sales for the past 12 months. We are diligent to make sure that we exclude any sales that may not be from our local stock inventory: direct ships, transfers to fill a back order, etc. Some software makes it difficult to filter out certain transactions, so we might have a little inflation in our numerator. But hey, we are benchmarking against ourselves. As long as we keep measuring it the same way, progress can be measured. While we are talking about benchmarking here, be sure to always measure against your own numbers. Be skeptical of the validity of "industry standards". I just mentioned a couple of ways that the ratio can be skewed. Besides, some of us tend to paint a slightly rosy picture when we respond to industry surveys. But I digress. The denominator of our turns ratio is the average inventory value. This is a far more stable value; but it can be slightly misleading due to the way our software calculates the average. By the way, the most pure way to find the average is to take 12 months of inventory values and divide by 12. Did I mention that consultants have a flare for stating the obvious; and then try to pass it off as something really profound?

In our situation, it was important to look at where we could make the most impact if the trend of declining turns was going to be corrected. Although the purchasing team does have some impact on our cost of goods sold number, through buying at a lower unit cost, the most logical area of focus was on the average inventory value side of our ratio. What are the factors that inflate our inventory? Overbuying is probably the largest contributor.

When we don't set our ordering controls properly, or base our purchases on gut feel, inventory inflation can often occur. Correcting the ordering controls will give us the greatest overall impact on our inventory value; but it takes a long time to realize significant gains. Sometimes, we will not achieve our inventory goals for 2 years. Since I have the patience of an average 4 year old taking a car trip, and most financial partners are not enthusiastic about waiting for a 2 year correction in a plummeting turn ratio, we need to find at a more immediate solution to our problem. If you want to make a quick correction in the average inventory value, attack the dead and slow moving inventory.

In the remainder of this article, I will focus my attention on one aspect of dead stock management: vendor returns. In order to set the context, I will explain a couple of steps that are required prior to liquidation of dead inventory. The most important thing to agree on is a time of death. As a company, we must have an agreed upon standard as to when something becomes dead in our system. The most common answer is no sales in 12 months. Some industries need to set their date at 3 months. But, for most hard goods distributors, 12 months is a good first start. Now this definition may produce a fairly significant number; but I challenge you to go one step further. Seek out those items that are nearly dead and add them to your list. Nearly dead items can be identified by using a hits report. A hits report simply tells us how many times a specific item

appears on a sales order, regardless of quantity ordered, in a calendar year. If you need help creating a hits report, give me a call. You can eliminate most items with fewer than 4 annual hits and have virtually no adverse reactions with your customers. When you run this report for the first time, you will be amazed at the number of items that fall below 4 hits. Again, I recommend that you change these items to a non-stock status. There may be a couple of exceptions; but try to keep these to a minimum.

Now that we have identified this large lump of dollars, it's time to convert this inventory back into its original form: cash. Dead stock is still money; it's just old money. There are several ways to convert dead stock to cash; but, I would like to focus on the vendor return solution. Pre-negotiated vendor returns can put a large dent in our dead stock pile. In a previous article, I mentioned that it was important to establish return policies prior to taking on any vendor line. A little footwork up front can make our dead stock liquidation easier. Without prior agreements, sometimes vendors can be rather reluctant to accept a return of goods. As distributors, we seem to be reluctant to process returns to our vendor partners. We are great at taking returns from customers; but for some reason, we don't follow through with pushing the materials back up the supply chain. One of the problems I run into most often is that we do not actually know what the return policies are. A great homework assignment is to have your buyers research and clarify the manufacturer's stated return policies. You will be amazed at the opportunities we do not utilize.

Many distributors tend to get derailed by vendor return policies that require a restocking fee. Is a 20% restocking fee too much to surrender? Let me ask you this. How much have we lost by holding on to this inventory for a full calendar year? The average carrying cost for a distributor is about 25% annually. Each additional day that we hold on to an item adds to that carrying cost tally. Would I rather have 80 cents in my hand versus a diminishing dollar cluttering up my shelves? Every day and twice on Sunday. With cash, I have the ability to invest in something that turns multiple times a year. I can recover my 20 cents in a few months.

In some cases, vendors give us a return allowance based on previous the year's purchases. Take advantage of this. Convert dead and nearly dead cash into turning inventory. At times this percentage can seem painfully low. This is where distributors have an opportunity to negotiate. Asking for a larger percentage will not always work. Sometimes we need to become creative. Offering a "one for one" return is a good way to start. This offer means that we are willing to cut a purchase order to the vendor for the same dollar value we wish to return. Consider offering a "1.5 for 1" return. Even a 2 for 1 return is acceptable. Remember, we are getting rid of inventory that occupies shelf space and ties up cash. By bringing in good saleable merchandise, we will recover our investment in a few months. There is a tendency for buyers to load up on their A items when putting together their offsetting orders. Be careful of this practice. You will wind up making it very difficult to make future target level purchases and find yourself running

out of your B and C items. Spread the investment evenly over the entire line. During the negotiation, try asking for special dating. An extra 30 days is not uncommon.

In the case of my client, we determined that approximately 10% of his inventory was eligible for return using the manufacturer's stated policies. By simply processing these returns, we would not only arrest the fall, but his turn ratio would jump ½ a point. If he was able to go the extra mile and negotiate returns on the items with less than 4 hits, he could actually move up another ½ point once he bled through any additional offsetting order surpluses. It is very rare to see turns jump by a whole point in 12 months. The important thing to remember is that dead stock management needs to become a continual process. You will find the many manufacturers are more willing to process 4 smaller returns spread out over the year rather than one large return at year end. Here is another little trick. Put together your returns during the first month of the quarter, rather than the last.

Let's review the action steps:

1. Determine a company deadstock definition

2. Go the extra mile and identify the items close to death

3. Research and review the stated return policies of all vendor partners

4. Maximize your ability to return product under these rules

5. Negotiate offsetting orders for additional return privileges

6. Continually cycle out dead products on a quarterly basis

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We hope you found this article of value. We have many additional articles on our website and we also can partner with your company if there is need to explore other supply chain management technology solutions. We can consult with you to give solid guidance on strategies and systems that have led to success from our vast industry experience. We look forward in hearing from you. Our contact information is below.

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