THE EXCESS OF EVIL

Lurking in the dusty recesses of your warehouse could well be the seeds of your profit destruction.

You can work hard to accumulate profit but one mistake can dash all your hard work. Assume that you sell a product for $10 and that you make a 30 percent gross margin. Let's also assume that you have an expense to revenue ratio of 20 percent to cover admin, overheads and carrying costs, so that would mean you would make one dollar for each sale. If you sell three units a year, it would take you three years to accumulate nine dollars in profits.

If then, however, you fail to sell the tenth unit, you have to write off the full cost of that unit and also perhaps a year or more of stock carrying cost and some extra admin and process time – you can easily wipe out all your accumulated profits.

What can you do to avoid this sort of profit destruction?

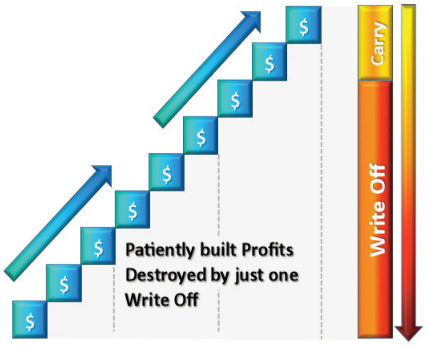
Find the Causes – the Secret to the Solutions

It would be too easy to play with the numbers in the above example and then dismiss the issue. For example, raising the gross margin to 50+ percent would put more money in the bank before the write off of the tenth unit. The problem is that this sort of thinking tends to hide the real issues and stops you thinking through the ways to avoid the excess and the damage it can do.

So what are some of the reasons why you have excess and how can it affect you?

- You had to sell ten units because you had an MOQ of 10. You have to ask what was the expectation of sales when the original purchase of ten units was made? What does that say about your forecast at the time of purchase? Your risk management?
- You were able to take advantage of a 10 percent discount if you bought ten. Was it worth it?
- Why did it take 3-4 years to recognise that you had excess? By the time you recognise that you have 1-2 years of excess you could easily be several years too late. Driving via the rear vision mirror is not the way to manage your excess inventory.

There will be times when a competitor's action or a customer's cancellation will leave you holding too much stock. Even then you can better position yourself to play the probabilities of what might happen. But if you look at each cause they usually relate to a decision, the disciplines applied, the information available, the people taking them and the support from systems. Make a bad decision at any time and you tend to set yourself up to have excess. So let's look at some of those decisions.



Policy for Participation, Pricing and Positioning

You have to start with three key strategic policy decisions.

Do you even stock the product? If you cannot turn it over at least twice a year, you may decide to only buy it in if ordered, rather than stock it. Importantly as the product's demand falls off over time, you have to be prepared to not restock it when it no longer meets your turnover criteria. You need to have clearly stated and understood participation and exit criteria. Of course you have to link this with your overall strategy. Do you want to be known as the supplier of first choice and command an overall price premium? Is the product part of a strategic product range?

The normally accepted behaviour for retailers is to write down the price if turnover falls. That sort of thinking often contributes to profit destruction for replacement and repair parts. Be prepared to raise the price as the part becomes rarer. Again this requires discipline.

As demand falls off, do you stop ranging in every branch? Do you just stock in the main DC? When you first introduce a product how big an investment do you make? Too much and you can easily regret it. A stocking culture will put a couple in each branch and see what happens. A marketing and sales culture will establish the demand and then position the stock to match.

Optimum Decisions need to be Common Place

Once you have introduced a product you need to optimally manage the supply and purchasing decisions on an ongoing basis. What does that mean?

- If there is an MOQ that is too high do you elect to use an alternative supplier that might ask a higher price but not impose an MOQ?
- If there is a price break or a value incentive to what extent do you take advantage for different products?
- If you make a higher gross margin then you can err to stock a bit more.
- Holding costs need to be higher for lower demand products to reflect the higher risk of obsolescence.
- You need to know when to add value to a forecast and when to recognise that variability is best estimated by rigorous forecasting techniques.
- You have to manage the whole product portfolio so you make right decisions more often, and then stick to them. There will be times when you will wish you had the stock and times when you know you have too much – but you must be prepared to be disciplined and play the percentages.

Ideally each of the above decisions should be made automatically, by the system where possible. There are simply too many variables to consider in your head. If the system can do as much as possible for you, then you can be freed, for example, to negotiate better sourcing arrangements or find ways to reduce supplier lead times.

Early Warning of Excess

Of course no matter how disciplined you are things will go wrong. You have to have a system that recognises quickly when you have too much. It needs to tell you early and ideally evaluate business cases to position stock so it is best placed to be sold. Prevention is far better than cure, but ongoing vigilance is still essential.

You can take the Evil out of Excess Management

Top performers in the aftermarket have great systems supporting them. They also know that they need the right goals, policies, strategies, processes, information and people.

If you can put all this together then you too can keep the evil out of your excess and maximise your profits.

For further information consult www.horizoninventory.com.au or email info@horizoninventory.com.au