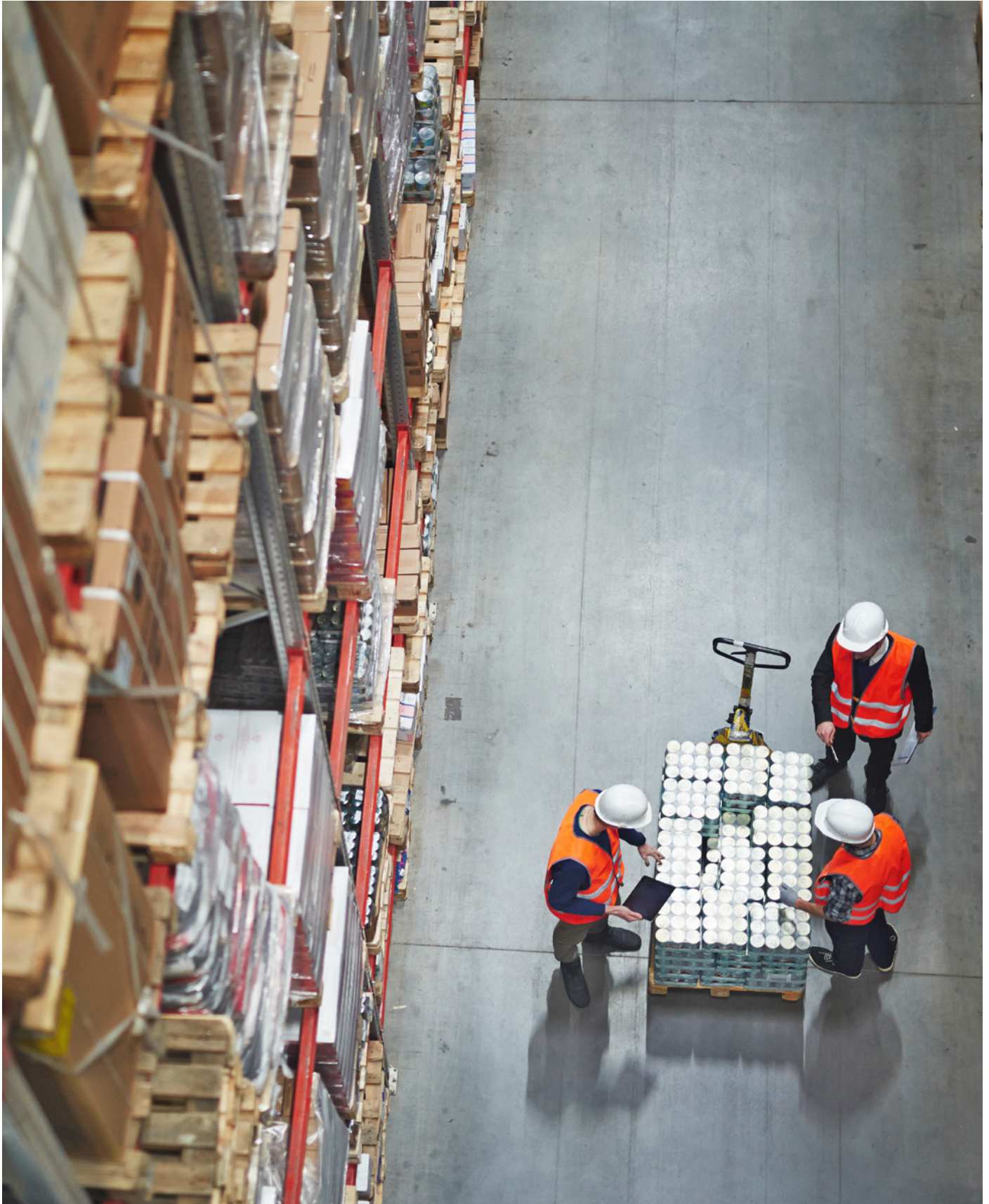


Three Steps to Reduce Unproductive Stock

Optimizing inventory in your distribution business



Optimizing Inventory in Your Distribution Business



Introduction

In the supply chain, distributors fulfill the role of buying, holding and combining stock from several manufacturers. Therefore, they have thousands of inventory SKUs to manage, track, replenish and analyze. In spite of the technology tools designed to assist them, we find that many distributors are still manually updating complex inventory data in spreadsheets or outdated enterprise resource planning systems. Identifying areas of opportunities and weaknesses in their inventory mix thus becomes a painfully inefficient endeavor.

Best-in-class inventory management involves identifying these opportunities and weaknesses, including unproductive stock. Unproductive stock may include :

- ▶ **Dead inventory**—inventory that hasn't sold in a certain amount of time
- ▶ **Dying inventory**—inventory that is trending towards dead inventory
- ▶ **Excess inventory**—having too much of an item
- ▶ **Any other unprofitable item**

These items typically do nothing to help the bottom line and the hidden costs associated with carrying these items can be harmful to the bottom line. Some of the hidden costs that come along with unproductive inventory include: wasted warehouse space, movement of product in the warehouse, insurance, utilities, depreciation, decay and damage. Distributors may experience customer dissatisfaction by holding irrelevant inventory and spending unnecessary customer service hours to find up-to-date inventory from other suppliers when it should be on location already. All these factors reduce business cash flow. Eliminating this type of stock and freeing up prime warehouse space will help to mitigate those hidden carrying costs and/or shift your inventory investment to the right items.

Distributors should ideally be able to manage inventory turnover but many know that determining the right amount of inventory to have on hand is tricky and requires accurate inventory forecasting. Industry averages show that dead inventory accounts for 10 to 30 percent of distributors' inventory. Even at 10 percent, for every \$500,000 in inventory, it's a good possibility that \$50,000 is dead. Storage, labor, utilities and insurance costs can make up 20 to 30 percent of the cost of the unproductive stock. That's another \$10,000 eroding your bottom line on products that won't sell. Additionally, consideration must be given to the impact on customer service of potentially having the wrong product mix. This white paper outlines the ways in which you may improve your balance sheet and operations by reducing unproductive stock.

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Item	X
Annual Sales	\$100,000
Cost of Goods Sold (COGS)	\$80,000
Gross Margin Percentage	20,000
Average Inventory	20%

Reducing Unproductive Stock

A solid inventory system backed by data that can help you easily identify your most and least productive items—both in terms of profit and volume—is an integral part of your operations. If you don't have a ready-made way to identify these items, consider the following three:

1. Determine a metric to use

There are several metrics you can use to identify your unproductive items, including: turns, turn and earn, or gross margin return on investment (GMROI)—just to name a few. The chart to the left contains information we'll use to illustrate these examples in the following paragraphs.

"Turns" measures the number of times you sell or turn the average inventory. The calculation is COGS divided by the average inventory over a given time period. Another way of looking at turns is the number of opportunities you had at earning margin.

For Item-X, with annual COGS of \$80,000 and average inventory of \$20,000, the number of turns is four— $80,000 \div 20,000 = 4$. In other words, there were four opportunities to earn margin on the inventory investment. While this information is valuable and it allows you to compare items, it does not take into consideration the margin you actually earned. To factor in margin, consider turn and earn or GMROI.

"Turn and earn" helps you balance turns and gross margin. The calculation is number of turns multiplied by the gross margin percentage. Using Item-X as an example, with turns of four and the average gross margin of 20 percent, the calculated turn and earn would be 0.80 ($0.20 \times 4 = 0.8$). This metric takes turns to another level, and enables you to easily compare items with low turns and high margin against items with high turns and low margin.

GMROI is similar to turn and earn in that it balances turns and gross margin, but the formula is different. The calculation is gross margin dollars divided by average inventory. Using Item-X again, with gross margin of \$20,000—sales less COGS—and average inventory of \$20,000, the calculated GMROI would be 1.

Both turn and earn and GMROI—which factor in both turns and gross margin—provide the most accurate view of underperforming inventory items. However, turns alone will also allow you to identify underperforming items. Ideally, you'll have multiple metrics available to analyze inventory, as two items with the same low GMROI or turn and earn can have wildly different reasons for the low mark.

2. Identify underperforming items

Now that you have a metric or metrics in place, you can start identifying underperforming items. This can be a combination of science, art, and gut feeling, as the definition of an underperforming item is nebulous.

The easiest place to start is by looking for dead stock, but the definition of what is "dead" is always debatable. We would all agree that dead stock is an item with zero sales. The question is, what is the timeframe for zero sales? Is it 3, 6, 9, or even 12 months? An easy way to avoid the debate is to rank items by the time it's been since the last sale, and focus on items with the oldest sale date. You may consider that items with no sales in 12 months are completely dead, while items with no sales in 6 months are mostly dead.

The next step is to identify dying stock. Dying stock is inventory that is still selling but is trending towards dead inventory. It is important to identify dying stock before it becomes dead—otherwise, you could be stuck with large amounts of stock that you need to discount heavily or donate. The trick is finding a dying item at the right time. Typically,

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you're looking for an item where the metrics are trending down. The item's turn and earn could be satisfactory at present, but you need to examine what it's been in the past. Additionally, you can look at the item's usage and identify any downward trends. You might even go one step further and try to determine the number of unique customers buying the item. The fewer customers purchasing the item, the more at risk the item is to becoming completely dead.

Next, you can look for items with excess inventory. On one hand, you could argue that as long as an item is selling, having too much of it isn't a problem. However, considering you have limited inventory dollars and space, too much of Item-Y could mean too little of Item-Z. Also, like dead stock, the merit of excess inventory is debatable—exactly how much is too much of an item? It can depend on your purchasing process and whether you use static purchasing methods—like min./max.—or dynamic purchasing methods—like order point, economy order quantity (EOQ), line point, etc. The trick is to determine the metric that makes sense for your business and avoids creating more work. For instance, some people treat excess stock as any on-hand-balance greater than the order point or minimum. The problem with this method, however, is that every time you eliminate that excess, you fall below order point or minimum and repurchase the item. A better method would be to look for inventory that is greater than maximum, or order point + EOQ, or line point.

Lastly, you can look at any other unproductive items—items that aren't dead, dying, or simply have excess

inventory. Many times these are items with low margin that result in low turn and earn or GMROI. The low margin could be completely justified. Maybe it's a commodity item sold by many competitors that requires a low margin. Maybe it's an item that's important to a product line or another product—where not having the item in stock would have a negative impact on sales of other items or customer service. Sometimes, you'll find it's a new item where the price was set too low initially and never adjusted. In any case, while these items can be the lowest priority for your examination of underperforming items, they should be periodically reviewed to identify outliers.

3. Identify and execute a strategy to offload unproductive stock

Once you have identified underperforming items, you can start working on a strategy to deal with those items. What you do with those items will depend on many factors—including whether the item is dead, dying, overstock, or just unprofitable.

The best solution with dead stock is to get rid of it as soon as possible. It's typical for distributors to run a promotion for dead stock that includes deep discounts. This can be done via a list of promotional items that sales can query from your order entry program, via your website, or even eBay. Another method is to market these items to customers who have purchased them in the past via emails or outbound phone calls. While this is more work, it can be more effective—if a customer bought it once, maybe they'll buy it again. If these methods don't work, many distributors resort to donating the items to take the tax break.

Once you have dealt with dead stock, you can move on to dying stock. Identifying and addressing a dying item before the entire customer base has moved on to another

product is important. As long as there are enough customers still buying the item, you can move it out before it becomes dead. Similar to dead stock, a marketing or promotional campaign can be very effective in selling these items.

Like dead and dying items, marketing campaigns and outbound calling are great ways to unload excess stock. Highlighting these SKUs on your eCommerce site with relevant promotions when customers log in to purchase can also help move them off your warehouse shelves. Keep in mind that you need to determine why you have too much of these items to help prevent the situation from repeating itself. In some instances, the excess may have resulted from purchasing too much of these items to meet vendor minimums in spite of declining customer demand. For instance, when trying to meet vendor minimums, buyers sometimes buy extra of A-Items. This can result in huge overstocks on top items after just a few purchasing cycles. Ideally, you should look at purchasing as a point in time instead of an order point—the point in time you need to purchase an item. When trying to meet vendor minimums, instead of thinking of buying more of certain items, think instead about your buying needs for tomorrow, the next day, or next week. Determine what items will be at order point or minimum in the near future that you can buy early.

Lastly, you can focus on other unproductive items. As previously mentioned, these items often have low gross margin that pulls down the turn and earn and GMROI calculations. For these items, you need to understand if the low margin is appropriate or not. If the former, it's best to find a way to identify this item in the system to prevent it from consuming your time in future analysis. If the latter, a best practice is to examine and potentially change the item's pricing structure.

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Software That Enables Success—and Inventory Optimization

In today's highly competitive marketplace, it's important for you to optimize your inventory following the methods outlined in this white paper. If you've never performed these exercises, starting this process from scratch can overwhelm businesses and ultimately lead to paralysis by analysis. It's important to gain actionable insights quickly that may be enacted without consuming a lot of resources.

One way to achieve this is by utilizing the tools already available in your ERP system. However, not all ERP systems are created equally. Inventory management software built into Epicor® distribution ERP systems allows you to minimize excess or obsolete inventory and improve cash flow, while capturing inventory changes that allow you to make more accurate purchasing decisions.

Epicor's end-to-end, fit-for-purpose ERP software is designed specifically for distributors, because you need a business system that supports the unique processes of a wholesale distributor. No other software provider can support your needs like Epicor. For over five decades, Epicor software solutions have enabled distributors to master their inventory with advanced demand forecasting, lot billing and traceability tools, and more.



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