



Web of Excess Inventory – Why 20% Inventory to Sales is Too Much

Carrying too much inventory creates a host of web-like costs in your business. If you get stuck in this web, it slows down your efficiency and produces a precarious situation that is difficult to escape. You could become immobilized, just like a fly waiting to get eaten.

The first step in avoiding this trap and escaping, before you become too entangled, is to know why so many companies get caught. Then, you should evaluate your current situation and understand all of the intertwined impacts that excess merchandise has on your sales, cash, and profitability.

The best retail furniture operations in the world run their businesses continuously at around a 15% inventory to sales ratio. This fact has been published year after year by the NHFA and I have witnessed it in my 10 years of traveling to stores around the globe. There are no double digit profitability stores that carry over 20% for any extended period of time.

Why is it then that the majority of operations run at inventory levels higher than this? It is common to see stores over 20% and some even over 30% inventory to sales. Store owners and managers fail to take action, because they historically have not seen inventory as a problem. They only see it as a solution believing that they can buy themselves into profitability. Some say, “If we just buy the right merchandise, our sales will increase”. Then, when sales stay the same or increase slightly and the next market rolls around they say, “I think if we just try this new group; our sales will increase more”. They need to realize that new buying is necessary, but also a gamble, and should only be done when fewer than 20% inventory to sales. Buying new at the wrong time leads to getting stuck in the web!

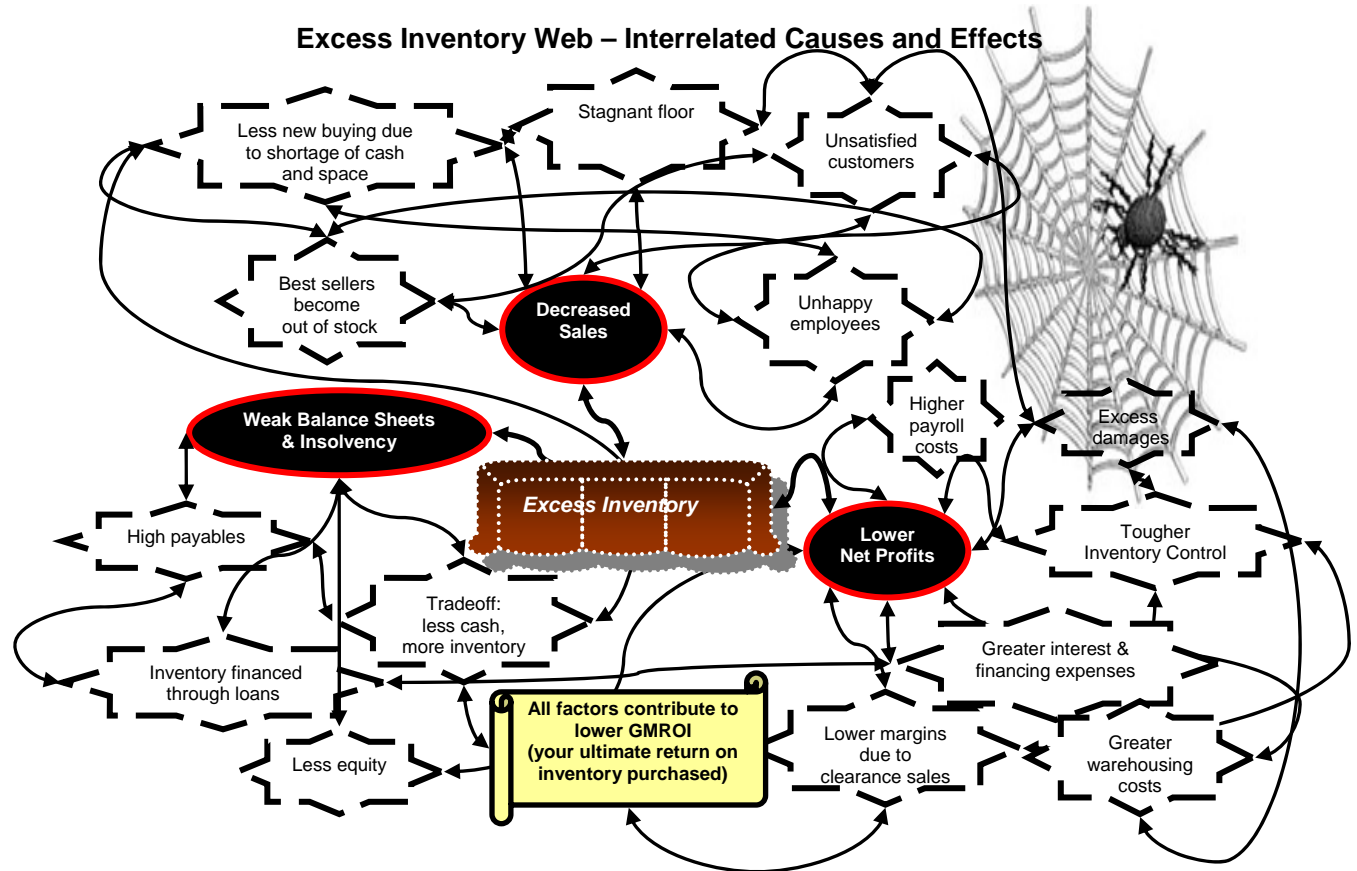
Traditionally, some people have seen inventory as an asset with a lot of liquidity. They believe that because they have always run at a certain level that they can maintain it indefinitely. Although it is an asset, it is not equal to cash. Cash, with prudent investment, appreciates with time and is liquid. Inventory depreciates and only best sellers are liquid. In fact, smart financiers don't even consider inventory when looking at the solvency of a business. They look at the quick ratio only. This is the ability to cover short term debt with current assets, excluding inventory and long term receivables. Inventory is not part of this solvency equation.

One other reason why stores carry too much inventory to their sales volume is, because they fail to react quickly, when changing business conditions negatively impact their sales. Over the past few years, the housing market slowdown and the expansion of branded stores have taken a bite out of the independent's furniture retailers profit. Most dealers did not see this coming and continued to buy at the same levels. Many reacted by making cuts in operating expenses when inventory should have been cut first. The minority that recognized a slowdown and reacted fast were enabled to maintain high levels of cash flow and respectable profitability, even with declining sales.



Web of Excess Inventory – Why 20% Inventory to Sales is Too Much

This excess inventory is by far the costliest expense. 20% inventory to sales is too high and you should seek to operate at a 15% ratio. If you are an independent store, branded, or a top 100 retailer, the benefits of doing it right are too massive to ignore. Ask the Ashley Furniture Homestores! This is at the heart of their massive success. Maintaining efficiencies will be the primary factor in your long term survival as well as your success.



Impacts on cash, sales, and profit from carrying too much inventory:

Getting caught in the excess inventory web has three big negative repercussions. It causes:

1. Weak balance sheets leading to insolvency.
2. Declined sales.
3. Smaller net profits.



Web of Excess Inventory – Why 20% Inventory to Sales is Too Much

1. Balance Sheet Impact

The balance sheet becomes weak and the business becomes less solvent. Current assets become disproportioned. A high profit company typically has about 19% of it's assets in cash and 50% in inventory. An average store has around 12% in cash and 56% in inventory. Liabilities increase to fund the indulgence of the average and a greater amount of payables, short and long term loans are present.

The difference a high profit and average operation with \$10 million in total assets would be \$700,000 in extra cash. Another way to look at this solvency effect is via inventory's relation to sales. An operation doing \$10 million in sales running at 15% rather than 20% carries \$500,000 less in inventory.

2. Sales Impact

Excess inventory causes a drop in sales. There are many factors that participate in this affect. One is best seller out of stock days. Due to the strain on cash flow that is experienced, fewer funds are available to be allocated to properly buy your best items. These items account for the majority of your sales, so if you run out, you lose.

Is there anything more frustrating that not being able to order a container of goods that customers are lined up for because you have to make payroll or your current payables?

As well as not being able to purchase sufficient top merchandise, your floor will become stale, as you will eventually become unable to buy new merchandise and your existing merchandise will become old. The showroom stagnates and becomes clogged with dogs.

This leads to another issue: customer satisfaction. If you are not able to provide what your customers want, when they want it, they will not have the best experience in shopping your store and they may not return. Worst of all, they will tell their friends. Your store will be in danger of appearing unfashionable and old looking.

As with your customers, a stagnant floor affects the morale of your sales force that produces all your sales. They, just like customers, love the latest and the greatest. If you allow merchandise to sit, they will sit too. Motivation is the highest at fast moving, dynamic stores.

Think of clothing retailers who take action to recognize and move old stock out immediately. Competition is fierce, inventory is kept correct, customer service rules, and the best systems and procedures are implemented. The thought of being unstylish and old is not acceptable.



Web of Excess Inventory – Why 20% Inventory to Sales is Too Much

3. Profit Impact

Too much inventory results in a smaller gross margin because more dogs are carried. If dogs are not recognized fast and moved out, their accumulation eventually becomes overwhelming. This is why many operations hold semi-annual clearance sales, tent sales, and going out of business type promotions. What happens is that prices are slashed on a massive scale. GMROI is destroyed due to less gross margin and slower turns. To highlight this fact is that high profit and average stores are usually separated by three to five points in GM%.

Significant extra operating expenses are incurred as well. The following is a real example of the gain in profitability that was experienced by a store that decreased its' inventory to sales ratio from 25% to 15%:

- **Gross Margin: +3%; eliminated excessive markdowns.**
- **Salaries: +1%; reduced extra people to receive, transfer, inventory control.**
- **Warehouse: +1%; reduced costs of equipment, supplies, maintenance.**
- **Customer Service: +.5%; reduced occurrence of damages.**
- **Occupancy Costs: +2%; eliminated unnecessary additional storage space.**
- **Interest Expense: +2%; reduced cost of loans needed to finance inventory and pay vendors.**

Net Income Effect: +9.5%

The most profitable store that I have visited has a 10% inventory to sales. Their net income was 18%!

Unless you are an antique dealer, merchandise does not age like wine. It becomes more and more expensive to carry each day that it sits. Don't believe that, if you hang on to something long enough, someone will buy it and you will get your margin out of it. Realize that this product takes up valuable floor space. Your GMROI will improve by embracing the strategy of turning faster and then replacing with new items sooner.

Whatever your situation, remember; don't stop buying your best sellers and special order merchandise, that is your lifeblood. Controlling new purchases, along with other strategies will help you avoid and even escape the spider web.

In my next article, I will explain some strategies used to get your inventory down to 15% and maintain it there.