

## Understanding the Inventory Metrics

We have previously discussed the importance of the key financial metrics and ratios, such as net profit before income taxes, gross margin and the major expense components, of a retail furniture store. In addition to these critical profit and operational measurements, furniture retail store management must have a thorough understanding of the relationship of the most significant business asset, “inventory”, towards profitability.

Typically, there is no other controllable facet of the business, which can impact profits, to the same degree as inventory. A well managed merchandise inventory requires not merely product knowledge, but an in-depth understanding of the key inventory metrics, which can be used to assist the making of those all important decisions, which ultimately result in either high profits or mediocre results.

Just as the key financial ratios and percentages can be easily compared to specific retail furniture industry statistics, so also can the fundamental inventory metrics be employed, to determine how your company compares to other similar retail furniture operations? The ability to use this information to improve the efficiency and profitability of your business will result from the understanding of these inventory metrics.

Some of the most important inventory metrics are:

- Inventory to sales ratio
- Gross margin return on inventory (commonly called GMROI)
- Inventory turns
- Inventory aging percentages
- Best sellers in stock days

The inventory to annual sales ratio of high profit stores is normally in the 15% range, while the average furniture store will have a 20% ratio. A direct relationship exists between inventory levels and profitability. Those stores, which exceed the 15 to 20% ratio of inventory to sales, will almost always have significantly less profits than those operations, with excellent inventory management. The importance of maintaining a proper inventory level cannot be overstated. Typically a furniture store has about 50% of its asset value, tied up in the form of inventory. This dollar value does not appreciate or age like fine wine – it comes with significant costs. Overstock is by far the most costly problem facing furniture retailers everywhere, because of the three types of costs that are associated with inventory overstock:

1. Carrying costs, the annual out of pocket expenses of carrying inventory, amount to 20 to 30% of the inventory’s original landed cost – and this may be the smallest of the three.
2. Excess inventory leads to high markdowns. If there is a lack of a systematic clearance of slow moving items, a loss in gross margin of up to 33% may be incurred.



3. Stock-outs, whereby sales and gross margin are missed due to out of stock best sellers, can cost even more in lost profits than carrying costs and excessive markdowns combined.

**Keep your Inventory to Sales ratio under 20% and preferably close to 15%!**

Now let's look at gross margin return on inventory:

GMROI is perhaps the most widely used inventory efficiency tool in the retail furniture industry. It takes into account both gross margin and turns. That is to say that there are 2 sides to the coin that must be examined. Gross margin tells you how much money you are making from the sales of your inventory while turns tell you how often you sell it. The key lies in relationship of the mix of the two. GMROI is typically expressed as a dollar amount and can be thought of as how many dollars do you make per dollar of inventory currently invested. The GMROI of your entire business, your categories, your vendors, and your specific items are all-important in implementing strategies to maximize your return on investment. A simple formula for the calculation of GMROI is:

ANNUALIZED GROSS MARGIN DOLLARS DIVIDED BY  
AVERAGE INVENTORY DOLLARS

While GMROI does vary by product category, the typical store achieves a GMROI of \$2.30, while a high profit store will probably be in the \$3.00 plus range.

**You should target your GMROI for the \$3.00 range to achieve strong net profits!**

One of the key factors of GMROI is the inventory turn rate, which is achieved.

Inventory turns are the number of times that sell the value of your inventory on an annual basis. Turns are calculated by taking your annualized cost of goods sold and dividing it by your inventory. As your turns increase, the average cost of your inventory, at least proportionate to sales, decreases. The result is a decrease in the carrying costs of your inventory, which we have already seen can be 30% or more per year. The positive impact on net profits, of achieving greater inventory turns, is enormous. Studies have shown that an increase of one turn per year can be the equivalent of an additional 7 to 8% of gross margin. That's huge!

**The targeted annual inventory turns of a retail furniture store should approach the 3 to 3.5 range. The successful result will be strong profitability.**

To obtain high profits, a low Inventory to Sales ratio, a high GMROI and high inventory turns, a retail store cannot afford the luxury of sitting on inventory, which is not moving. The costs are so significant of carrying "dogs" that profits are reduced tremendously, cash flow can be tightened



to the danger point and the life of the business can be put into jeopardy. How can the aging of current and dormant inventory be measured? By determining the elapsed time and the sales activity (or inactivity) of an inventory item from the received date to the current date, the inactive products or “dogs” can be determined. If an item has not had sales activity, within 60 days of its’ receipt, it likely will be a dog, not a best seller. Sometimes, better merchandising or the determination of a more appropriate selling price can reverse the trend, but most often the non-moving item needs to be cleared, in the shortest possible timeframe, but at the greatest possible selling price. Get emotions and personal preferences out of the equation and move these “dogs”.

What then is a reasonable ratio of current inventory to “dogs”?

**Strive to achieve at least a ratio of 75% of current inventory to 25% of dogs or slow-moving items; in order to obtain the desired GMROI and inventory turns.**

How can sales and gross margin dollars be improved, to result in the higher profits, which are measured by these important inventory-related performance indicators?

Most gross margin dollars (in fact, 80%) are generated by 20% of your inventory items. If you allow your best sellers to get frequently out of stock, you are losing significant sales and gross margin dollars. You can’t sell what you don’t show! The high profit stores keep their best sellers in stock 95% of the time.

**To maximize your Sales and Gross Margin dollars, ensure that your best sellers are in stock at least 90% of the time.**

If you plan and monitor these important inventory ratios to ensure that they are better than those attained by the average furniture retailer and are approaching those of the high profit stores, you too will be taking the steps, which can result in double-digit net profits.

For information on how you can gain a better understanding of the inventory metrics of your business, please contact Wayne McMahon at 800-888-5564 or by e-mail: [wayne@profitsystems.net](mailto:wayne@profitsystems.net).