

# Managing The High Cost Of Inventory In Today's Challenging Economy

**WITH THE ECONOMY SLOWING AND THE COST OF CAPITAL TO HOLD INVENTORY RISING, MULTI-CHANNEL RETAILERS ARE LOOKING TO SUPPLIER-DIRECT FULFILLMENT TO REDUCE INVENTORY CARRYING COSTS AND OPERATIONAL EXPENSES**

- The more product inventory a retailer finances the more the cost of funds takes out of the bottom line. Most retailers get a loan to purchase inventory, financing costs that were as low as 4-5% are now up to 10-12% or more.
- Standard "rule of thumb" for inventory carrying cost is 25% of the annual inventory value held. The cost of capital is a leading factor in the carrying cost of inventory, and can typically range from 4% to 12%.

## THE ISSUE

In the midst of an international financial crisis and an economy sliding into recession, sales are slowing drastically. With sales down and consumers spending less, the last thing a merchant needs is a credit crisis.

Funding markets are locked up, lending rates are high, and many merchants are finding it hard to get cash and forced to pay much higher rates for the cash they need. Many major retailers are finding their lines of credit being greatly reduced, or even canceled, as funding sources cut back on inventory financing.

For many retailers, the primary purpose of capital funding is financing inventory, especially to meet seasonal demands. With shipping rates spiking and letters of credit hard to come by, many are facing substantial increases in the cost of goods and are hesitant to tie up additional capital on the balance sheet.

As governments consider emergency measures to address the credit crisis and support the commercial paper

market, retailers need to address the high cost of carrying inventory, and ways to control its impact on operating costs.

## THE IMPACT ON GROSS MARGIN

The economic slow down and financial crisis is having direct impact on retailers large and small. To manage through economic crisis, experts recommend focusing on some of the biggest cost drivers: inventory, shipping and marketing. While many question the long term effectiveness of cutting marketing funds during a down economy, reducing the cost of inventory provides an immediate return in improved margins. Elements to consider in the high cost of inventory are;

### Cost of Capital

Inventory financing charges are directly impacting the balance sheet as rates rise and letters of credit become more difficult to secure.

### Cost of Insurance and Taxes

Directly proportionate to amount and value of inventory held, excess inventory is particularly costly at fiscal quarter and year-end.

### Cost of Inventory Service

While considered a basic cost of doing business, the more inventory ordered, received, stocked and processed, the greater the operational cost.

### Cost of Storage

The overhead cost of warehousing and distribution centers are directly related to the number of SKUs and turnover cycles of inventory held.

### Cost of Risk

The more inventories held and processed the more shrink, damage, overstocking, obsolescence and liquidation will impact the bottom line.

The cost of inventory is often the largest asset on a retailer's balance sheet.

Carefully managed inventory is a key metric to profitable margins in the

best of times, in the current down economy, the impact on COGS is critical. In a recession-based economy it is important to lower operating costs and increase productivity wherever possible.

### SUPPLIER-DIRECT FULFILLMENT (SDF)

Reduce inventory and associated expenses by using a Supplier-Direct Fulfillment strategy.

The growing eCommerce channel has proven the effectiveness of creating virtual warehouses by using SDF instead of buying, storing, and shipping product to customers. With SDF orders are sent directly to suppliers, manufacturers and distributors, who fulfill and ship the merchandise directly to customers. The retailer never holds the inventory on their balance sheet and typically only purchases it after receiving payment from the customer.

Implementing or expanding a Supplier-Direct Fulfillment strategy to control the high cost of inventory and logistics is an effective way to reduce operating costs.

*Tim Cook, Apple COO, views inventory as "fundamentally evil" that declines in value 1%-2% a week in normal times, faster in tough times like the present. As a result Apple's inventory, as measured by the amount of time it sat on the company's balance sheet, was cut from months to days.*  
– Fortune, Nov08.

The SDF strategy to control the cost of inventory and logistics will:

- Lower capital cost for inventory held
- Eliminate excessive finance charges
- Reduce inventory insurance and tax costs
- Reduce warehouse space requirements
- Reduce inbound shipping costs
- Reduce warehouse inventory costs
- Reduce reverse logistics handling and expenses
- Limit damage and shrinkage costs
- Improve customer delivery cycle time

For multi-channel retailers, Supplier-Direct Fulfillment offers the opportunity to maintain and increase product SKUs while reducing the levels of inventory held. Many are using SDF to control expenses, expand operational capacity and drive incremental growth across all channels.

### The SDF Capital Float — an additional revenue stream

Instead of paying interest on capital invested in inventory, Retailers realize revenue on up-front payments for Supplier-Direct goods sold. Depending on net-payable terms with suppliers, they can realize 30 – 60 – 90 days interest on capital received and held for goods sold.

### FACTORS IN SUPPLIER-DIRECT FULFILLMENT

There are many factors to consider in utilizing SDF as an inventory and logistics strategy. What channels and SKU's does it apply to, what technical capabilities are required, and the impact on customer experience all factor in the evaluation.

### MULTI-CHANNEL APPLICATIONS

SDF is well established in eCommerce, where customers place orders online and expect the product to be shipped to them. In a process transparent to the customer, orders placed online are fulfilled by drop-shippers who deliver the merchandise with packing slips and packaging bearing the retailers name and logo.

SDF works well in direct sales for large products that customers expect to be delivered anyway, such as furniture, appliances and big-screen TVs. Retailers can carry floor models only, eliminating inventory carrying costs and reducing staffing requirements by having supplier-direct fulfillment for these large product SKUs.

SDF has proven to be effective in reducing cycle time, staff and warehouse space for very high-turn in-store inventory that literally flows through the channel, like jewelry,

CDs and DVDs. Here SDF allows stores to bypass distribution centers, directly ordering exactly what they need in a just-in-time supply model.

### SKU TURNOVER

When using Supplier-Direct Fulfillment, retailers pay for items on an as-ordered basis. While realizing a savings in inventory cost, they also may lose significant pricing discounts offered for bulk buying. The impact on margin is a matter of inventory turnover.



Inventory turnover (INVT) reflects the management of inventory and is typically computed by dividing COGS by the average inventory on hand. The resulting calculation indicates how many times inventory "turns" (is sold) during a period of time, usually over a year period to ensure seasonal differences are reflected.

Typical stock turn for many retail product categories is four to eight turns a year, meaning many retailers are carrying at least three months of inventory on their balance sheet. The cost of slower turning inventory is much greater than the cost of faster turning inventory because the capital required to finance and manage the inventory is locked up that much longer.

Inventory Turn – If a product sells 50,000 units in a year with 10 turns, the warehouse needs to carry 5,000 units. At 4 turns the warehouse needs to carry 12,500, with much higher carrying costs.

The ROI model to determine which SKUs to hold in inventory and which to direct-ship balances turnover rate, cost of inventory and bulk-buy discounts against the cost to direct ship. SDF costs will typically decrease margin somewhat, but these costs are offset by reduction in the expenses to warehouse and carry inventory. Building the ROI model requires analysis of specific product/channel inventory and logistic metrics.

As the economy slows and consumers pull back on their spending, high volume products will experience a decrease in their inventory turns. Retailers need to regularly assess product turns, cost of direct shipping, and bulk buying discounts to determine which products to warehouse, and which to direct ship.

### SDF IMPLEMENTATION

Implementing SDF can be challenging. Open communication, process visibility, and clearly defined business processes and rules are critical to successfully processing orders and meeting customer expectations. Developing and managing a network of drop-ship suppliers can be technically challenging for retailers because there are multiple communication protocols and file formats in existence.

With SDF, the merchant places brand identity and customer satisfaction in the hands of third parties, risking fulfillment experience and process control. It requires communication and process technology that must be carefully planned and executed.

Whether managed internally, or outsourced to a third party, the benefits of SDF are enticing: ability to offer products without additional inventory cost risk, zero warehouse and carrying costs, and direct impact on net income and the balance sheet.



### CommerceHub, the ONE Connection

The CommerceHub Supply-on-Demand Platform is a single connection that enables Supplier-Direct Fulfillment for any supply chain:

- 100% Any-to-Many Integration — unified supply chain integration and fulfillment
- Multiple communication protocol support, including VPN, VAN, FTP, HTTP, and AS2
- Multiple file format support including XML, EDI, and flat file
- Virtual Warehousing with drop-ship fulfillment management that eliminates inventory carrying costs and warehousing expenses

- Bi-Directional visibility and process control for end to end performance management
- More than 8,000 drop-ship suppliers, manufacturers & carriers currently connected to the platform, and growing
- Over 10 million unique SKUs represented by platform suppliers
- Over 20 million drop-ship orders processed in 2010.

The CommerceHub Supply-On-Demand platform rapidly integrates new trading partners or connections to the more than 8,000 drop-shippers, manufacturers and carriers currently in network. It provides comprehensive tools to manage order processing, drop-ship fulfillment, supply chain visibility, branding, trading partner performance, inventory synchronization, returns processing, carrier tracking, and reverse logistics.

With the CommerceHub One-Connection you have the power and flexibility to leverage Supplier-Direct Fulfillment in controlling your inventory cost issues.