



## **Solving The Costliest Problem – Overstock Part 1 of 2**

Most furniture retailers aren't aware of just how costly inventory overstock is, in out-of-pocket costs, excessive markdowns and lost sales... that's right, lost sales.

By Larry Stark

I never cease to be surprised how many furniture retailers think they are rich because they have a large warehouse full of merchandise that is all paid for. With no money borrowed, they think there is little or no cost associated with carrying that inventory. Nothing could be further from the truth. Inventory carrying costs are the costliest expenses associated with the furniture business... ranging from the 27% or so annually (of the original landed cost of the inventory) when interest rates are very low, as they have been recently, to as much as 40% or so when interest rates are very high as they have been a couple of times in my memory.

Why is there such a wide divergence between retailers' perception of these costs and reality? Well, first of all, these costs aren't grouped together and totaled on a P & L statement. They're scattered all over under several different expense classifications, so it's not readily apparent that these expenses are all associated with the cost of carrying inventory. I've got to admit that when I was in the retail furniture business myself, I wasn't fully aware of how much it was costing us to carry our inventory. I knew, as I think all retailers do, that getting my inventory down would increase my stock turns and improve my GMROI, but I didn't really buy into the idea that inventory carrying costs could possibly be anywhere near 30% annually of the original landed cost of the goods. I just didn't really believe it, even though Dun & Bradstreet has been saying that very thing for years.

It wasn't until we were in the furniture software business, and a user came up to me at one of our Users' Conferences and asked for my help, that I became so aware of how very costly it is to carry a furniture inventory. This retailer's situation was this: They had been in business for over 40 years. During most of that time, they had been quite profitable, but profitability had been declining steadily for over 10 years, and they had lost money every month for the past 2-½ years. The losses were increasing at an alarming rate, so that it was obvious that they couldn't continue down that road much longer. They had lost \$20,000 the first loss year, \$40,000 the second and had already lost \$40,000 in the first 6 months of the current year, so were on track to lose \$80,000 for the full year. They had borrowed \$50,000 from the bank recently, half of which was already gone, and the bank had told them that they wouldn't be able to lend them any more. Needless to say, the sense of urgency in his request for help could not have been higher.

I told him that we would be glad to help him, and asked that when he returned home after the conference, he immediately send me financial statements, both P & Ls and Balance Sheets going back as far as he had them available. I expected that I would receive 2 or 3 years worth. A few days later, here came a sizable Fed Ex package with 25 years of monthly financial statements. I was amazed at what turned out to be a real gold mine of information.



I started out by recording the 25 year end figures for sales, gross margin \$ and % of sales, net profit \$ and % of sales and inventory \$ and % of sales. That was a huge eye-opener, because it was immediately apparent that every year that inventory at landed cost was less than 25% of annual sales at retail, they had made money. And every year, without exception, that their inventory was 25% or more of annual sales, they had lost money. There was almost an exact inverse correlation between inventory and profit. The lower their inventory as a % of sales, the higher their profit, and vice versa. Their inventory had been going up for a number of years. It was over 33% at the previous year-end, and it had risen even higher at that point in the current year.

The story does have a happy ending. We helped them have probably the biggest clearance sale in their history. They paid off that bank loan and made a profit the next month for the first time in 2 ½ years. They continued working very hard on getting their inventory down and ended up the year in a profit position, which represented almost a \$100,000 profit swing from the past year, given that they had lost \$40,000 the previous year and were already in a \$40,000 loss position by the time they started on their inventory reduction program.

That experience motivated me to embark on a lengthy research project to: 1.) Identify all of the inventory carrying costs to get a firm handle on how costly inventory overstock really is, 2.) Determine the minimum inventory level that could be sustained without hurting sales, and 3.) Calculate how much effect would achieving that inventory reduction have on profitability.

Here are the results of that research: 1.) The costs of carrying an inventory fall into three categories, one of which is easily identified and quantified, while the other two can only be estimated, but all three are very costly:

1. Out-of-pocket carrying costs are easily identified and quantified from your P & L statement. Here they are, and they will total about 30% of your landed inventory cost annually:
  - Interest expense on money borrowed to invest in inventory, or the imputed interest on the money tied up in inventory if there is no money borrowed. (Even if you have no money borrowed, the money that is tied up in inventory isn't available for investment elsewhere, so you are losing the income that that money could produce.)
  - Contents insurance coverage on the inventory.
  - Warehouse occupancy expenses... not only the rent or depreciation, but also the building insurance, utilities, repairs, etc... ALL the warehouse occupancy expenses.
  - All the inventory-handling expenses... not only the salaries of the people doing the work, but also the merchandise repair costs, etc. These costs are always excessive when you're overstocked, because overstock always leads to overcrowding, which leads to excessive labor costs of constant re-arranging to make room for new shipments. And when there's excessive handling, there's also excessive damage which leads to excessive repair costs and the second category of inventory carrying costs, which, though not as easily quantifiable are very substantial nevertheless:



2. Excessive markdowns, both from excessive damage and because retailers intuitively know that they need to get rid of the overstock. The more serious the overstock problem, the more costly excessive markdowns tend to be.
  
3. The last cost of inventory overstock, and the most costly of all, is lost sales. It might seem incongruous that inventory overstock would lead to lost sales, but the reason is that the overstock isn't the result of too much buying of good sellers. Inventory overstock is always, Always, ALWAYS an accumulation of poor sellers that haven't been moved out in a timely manner. You can prove this to yourself. All you have to do is quit buying for a while. If the your overstock were just a little too much buying of winners, quitting buying for a while would solve the problem, but it never does. Anyone who's tried quitting buying (and almost all of us have) knows that what happens is that you quickly sell out of the winners, end up with a floor full of dogs (your overstock) and business goes into the soup. When you realize what's happened, the tendency is to hop on the phone, place a bunch of panic orders and soon the inventory is where it was before or higher. The end result is that inventory overstock inevitably leads to cash flow problems. When you've got your money tied up in a lot of bad stuff, you don't have the cash you need to buy all the good stuff you could sell, so sales are lost. Sales are the lifeblood of your business, so this is the most costly of the entire inventory carrying costs, and the hardest to survive if corrective action isn't taken.

So how do we solve this problem? Well, the short answer is we have to reduce our inventory. That's obvious, of course, but we all know that that's a lot easier to say than it is to accomplish. Moving merchandise that customers don't much want to buy is probably the most difficult part of retailing, and doing so without massacring gross margins in the process is a trick that the majority of retailers never quite get the hang of. That's why the average furniture retailer nets about 3% to sales, pretax, year after year. Retailers that have learned how to accomplish that trick are netting 10%, 12%, and 15% and even more, and as one of our clients told me, "Business is sure a lot more fun when you're netting 12% than when you're netting 2%."

If you haven't yet learned how to do that, and would like to increase your profitability by three to five times what it is today, don't miss Part 2 of this series about how to solve this most costly problem. In the meantime, do a little research of your own: Total up the out-of-pocket inventory carrying costs enumerated above from your last year-end statement, and calculate what percentage those costs represent of your year-end inventory at landed cost. When you see how very much it really is costing you to carry your overstock year after year, I'm sure that will give you the motivation to do what's necessary to solve the problem.

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