Raising Prices and Gross Margins with Inventory Replenishment

In 2006 we met with the President of a national retailer of fashion clothing and accessories. During the meeting he disclosed the following information about his company.

- They had close to 100 stores, 1 distribution centre and hundreds of overseas suppliers.
- They sourced from China and India primarily to lower product cost.
- Sales were about $120M with inventory of about $12M.
- Inventory turned approximately 6 times per year.
- On average, garments sold at approximately 75% of the full list price.
- They had about 4,000 active skus.
- The company's primary strategies were to 1) open new stores in new and existing geographic markets; 2) convert old stores to new, larger formats; 3) expand their product breadth by offering more complementary product lines.

After providing us with this brief bit of information, the President asked us if there was anything we would do differently. Naturally, before answering, we continued the meeting by asking some more good questions and discovered that:

- Due to the long lead times from their sources of supply, most purchase orders had to be sent to the suppliers 4 to 6 months in advance of the season.
- To ensure that costs were kept low, only one production run was ordered and product was sent in only one shipment.
- Stock was shipped direct to their DC and, when ready for release to the stores, at least 80% was distributed to the stores in the first shipment - based on the forecast.
- Each store received enough stock of an item to fill its allocated shelf space and to cover at least the first 2 to 3 weeks of forecasted sales.
- Each store received about 2 shipments per week of new stock.
- Each store received approximately 20 to 25 new styles per week.
- New items on display at the stores were listed at 100% of the selling price for the first 2 weeks, discounted for the next 2 weeks (through 3 progressive discount levels) and then moved to either the store discount rack (at the front of the store) or shipped to the corporate discount store location.
- Re-distribution shipments (from the store back to the DC and between stores) happened very frequently.

At this point, the President, being smart enough to know that he might learn from us, said, "Enough – now tell me what I should do differently!" We started the dialogue by first making a strong claim. We said that, "He was lowering his selling price (and therefore gross margin) and increasing his transportation costs, unnecessarily, because he didn't understand the Theory of Constraints approach to Demand Driven Replenishment". We instantly caught his attention. It must have been because our

first focus was on price when he thought it would have been on efficiency or inventory.

We elaborated on our claim. We told him we believed that, just like every other distributor and retailer we have met, he was trying to maximize his gross margin per square foot of shelf space in each of the stores (whether they owned the stores or not). Since he readily agreed with our statement, we continued. We told him that from what we could see, he was using three primary strategies to maximize the rate at which product profitably moved through his shelf space:

- He was pricing to move the product;
- He was placing most of the product in the store (available to customers); and,
- He was maintaining a constant stream of new styles for each shelf space location.

We told him that we see a lot of companies doing the same thing and they all have the same negative outcomes that accompany these strategies:

- The company is too often forced to discount its prices.
- The company is too often forced to re-ship and re-process product back to the warehouse and out to the stores.
- The company is forced to overly rely on the accuracy of the forecast as they require each store-level forecast for each SKU to be accurate over the first 3 weeks.

Now that we had gained his interest, we chose to explain the Theory of Constraints' approach to Distribution.

- Distribution used to be based on the wisdom of holding inventories close to the consumption points (the retail shops).
- The Theory of Constraints suggests that the more reliable place in the distribution system is the supply points; the further from the end consumption, the more reliable the forecast.
- Holding inventories closer to the supply point increases the in-stock position at the distribution warehouses and retail shops, if and only if, the replenishment frequency is increased.

The solution we described for him was simple because it only involved two major changes:

- Initial store inventories need to be sized according to the forecasted consumption over the re-supply time (not over the first 2 or 3 weeks) in relation to the shelf space. Since the stores were already supplied twice per week, this amount should be no more than 1 week's worth of expected demand.
- Consumption needs to be communicated to the warehouse, and re-supply (replenishment) needs to occur as frequently as possible.

The biggest visible change is that rather than send approx. 80% of the stock to the stores, much more would wait at the DC for a replenishment call. The benefits of such a simple strategy would be:

- Increased sales at full prices in the first 2 to 3 weeks of product introduction – due to having the right product (style, colour & size) in the right store, at the right time – creating much less requirement for discounting;
- Less inventory in the stores – freeing up space – for either additional product offerings or greater store appeal (especially in smaller foot print stores);

- Reinforce brand image by reducing the amount of discounted items;
- Less obsolescence of un-saleable products, and,
- Less re-distribution shipments back to the warehouse – freeing up capacity to focus on replenishment and lowering transportation costs.

Looking a little bit skeptical, the President leaned over his desk and looked at us and said, “Convince me, using some of my own data.”

“Gladly”, we replied.

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