Turning Buyers into Investors

By Jason Bader, Principal

Does anyone remember a time when the guy with a mop and an enormous ring of keys was called a janitor? It seemed like all of a sudden they went off to a convention and came back as custodians. Some made it to the elevated status of "custodial engineer"; but that probably required a few more years of schooling. The word janitor refers to someone who cleans and maintains a building; but the word custodian refers to a caretaker, someone in charge. Although the name change was a simple swipe of the pen, the perception of the job responsibilities changed drastically. No longer were the men and women of this profession cleaning up after someone else. They were the caretaker of the facility. It became their baby. The mindset had changed to one of ownership. Isn't that something we strive for in our distribution businesses?

In this article, I want to focus on a name change that will produce significant results in the way your team of purchasing agents perceive their job. In a distribution company, who do you think spends the most money? Hands down it is the folks who generate the purchase orders. Each buy is an investment of company money. We don't just buy items to fill our warehouse. The idea is that we are going to create a return on that investment of company funds. The timing of the buy, how much we pay and the quantity we purchase all determine the return on investment. I have a good friend who once told me, "The art of purchasing is a thousand small decisions done right every day". Done right, we can maximize our return on the dollars we invest in inventory. Done wrong, these investments can take a company to its knees in a heartbeat. Years ago, I visited a company that recognized the significance this role. In order to change the mindset of the purchasing team, the term "Investor" replaced the traditional title of "Purchasing Agent". Anyone can purchase a product; but an investor expects a return on those purchases.

Changing the name is a good start, but changing the behavior requires some education about return on investment in a distribution company. There are several ways to measure inventory performance, but I am a huge fan of GMROII. This acronym refers to the gross margin return on inventory investment. Essentially, we are trying to determine how many gross margin dollars are produced for each dollar we invest in inventory. Here is the formula:

$$\frac{\text{12 months gross margin dollars from stock sales}}{\text{12 month average inventory value}}$$

It is important to note that we are only looking at stock sales, those sales being generated from items in our warehouse, versus those sales generated by sourcing product from another company. Direct ship orders and non-stock sales should be excluded from the numerator. The resulting formula will produce a number that represents gross margin dollars. Let's look at one vendor example.

12 months stock sales: $100,000
12 months cost of goods sold: $70,000
12 months gross margin dollars: $30,000
12 months average inventory value: $15,000

$30,000 / $15,000 = 2.00

What this example is telling us is that over the course of 12 months, we are able to produce 2 dollars of gross margin for every dollar we have invested in inventory. Since we fund our operations through gross margin dollars, it is important that we attempt to maximize these funds.

The next step in the process is to determine GMROII for all of your vendors. Once you have completed this task, I would like you to create a simple four column spreadsheet. This will help you determine areas for improvement.

Vendor Name	Inventory Turn	Average GM %	GMROII
Vendor A			
Vendor B			
Vendor C			
Vendor D			

Once you have created this spreadsheet, rank the vendors by GMROII. Determine what your median GMROII is. The top half of your ranking are the solid performers in your portfolio of vendors. Yes, I want your investors to start speaking the language of traders. The bottom half of your ranking are the underperforming vendors in your portfolio. These represent opportunities for change. I am not advocating changing vendors here. I am simply stating that these vendors should be analyzed further so that we can determine why they are underperforming.

There are generally two reasons for an underperforming vendor line. It is either an inventory turn problem or a problem with the average gross margin percentage in the line. It could be a combination of both, but one usually is more glaring than the other. If our investors are going to be successful, they need to learn how to find the root cause of the poor performance and then concentrate on fixing the problem. This spreadsheet tool makes it easier to them to achieve this goal.

Creating this spreadsheet will take some effort. Data extraction, from a distribution software package can be tricky. Software providers often confuse GMROII with the old Turn and Earn ratio (Turns x GM%). Make sure that you calculate GMROII using the formula I provided above. As you can see, I utilize the elements of Turn and Earn in the spreadsheet tool. I tend to think that GMROII and T/E work better in tandem than separately.

When using this tool to compare suppliers, or review competitive lines, make sure to give credit for rebates and special payment terms. These should both be added into the gross margin side of our analysis. Rebate percentages can be added directly to the average gross margin percentage in our spreadsheet. Use this new percentage to calculate the gross margin dollars in numerator of

our GMROII formula. With respect to special payment terms, or dating, I generally add another ½ percent for every 30 days of additional dating. So if the manufacturer has offered you 90 day payment terms, I would add 1% to the gross margin percentage. This really provides a fair evaluation.

Ultimately, I want to see this type of analysis and system maintenance become a much greater percentage of our investor's daily workload. The cutting of purchase orders should be a system driven task. In the companies I coach, I challenge them to reduce the physical buying to no more than 2 hours per day. Of course the actual number of hours depends on the number of people you have working in the team, but I think you see the direction.

You may be asking yourself – I found the root cause of the problem, now what do we do about it? For those answers, I would recommend that you read a couple of my other articles: *Improving Gross Margins* and *Improving Inventory Turns*. Both can be found at my website www.thedistributionteam.com. Good luck and know that I am always here to help.

About the Author:

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