The Distribution Team

We wrote THE BOOK on Distribution Inventory Management

Using ROI to Reduce Vendor Duplication
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If you are like most distributors, duplication of vendor lines is a thorn in your side. The sales folks love it. When we carry duplicate lines, we make it far easier to say yes to the customer. Our ability to take an order, rather than sell, is increased dramatically. Aren't we in the "give the customer what they want" business? I was recently working with a safety supply company. In our conversation, the practice of carrying several different lines that represent essentially the same product was referred to as the Baskin-Robins approach to vendor selection. Carry 31 flavors and let the customer make the decision. Just how many brands of safety glasses do we really need?

Unfortunately, this practice leads to difficulty in making vendor purchasing requirements. Meeting freight minimums can lead to inflated orders and result in lower performance over the entire category. When the strain on the credit line becomes painful enough, the edict comes down "reduce vendor line duplication". Now the inventory manager is caught in a difficult position. How do you choose between several lines of product? Who has the cool trip at the end of the year? Ok, that probably isn't the best way to make a decision; but, I'd be lying to you if I said that it has been used once or twice.

If you want to justify a decision, and your name isn't on the front door, prove it mathematically. When you run the numbers, all the emotion is taken out of the decision. When faced with this particular dilemma, I like to utilize a return on investment tool known as the Turn and Earn Index. Some folks prefer to use Gross Margin Return on Investment (GMROI) to analyze their vendor lines. This is another strong tool; but I like the way that Turn / Earn exposes the weaknesses in underperforming lines. This open exposure makes it easier to get to the root problems causing the line to produce poor returns.

To find the Turn and Earn, sometimes referred to as the T/E, simply multiply the inventory turn of the vendor by the average gross margin produced by the vendor line. Before all you purists start screaming, I want to acknowledge that T/E was originally taught using markup on cost in the "earn" side of the equation. We use gross margin primarily because most system software thinks in these terms. Gross margin is a much easier number to extract. When we are using T/E as an index, gross margin works very well. For example, if a vendor line has a turn rate of 4, and an average gross margin of 25%, the T/E would be 1.00. It should also be noted that T/E is usually stated by dropping the decimal point. In our example, the T/E would be 100. The next step is to rank all of our duplicate product lines by their corresponding T/E number.

For example:

Vendor	Turns	Gross Margin	T/E
Brand 1	5.5	30%	165
Brand 2	6	27%	162
Brand 3	5	30%	150
Brand 4	4	25%	100

From this table, it is clear that we would want to eliminate Brand 4 if we are basing our decision solely on our return. Take a look at Brand 2 versus brand 3. Without running the math, what would be the probable outcome of a decision to eliminate one of the lines? From a sales perspective, the gross margin percentage is lower on Brand 2 and it would probably get the ax due to most distributors' compensation methods. In actuality, Brand 2 is a better investment for the company because it will yield a better return on investment. This is powerful stuff. Savvy distributors have actually used this information to change their sales compensation programs. They give a higher commission percentage on the lines that yield the highest return on investment. How can you implement this strategy in your business?

If we are just using the T/E calculation for inventory performance analysis, the tool gives us direction on where to find the root of the problem. Assuming that the vendors are not duplicates, let's go back to the table. If I felt that Brand 2 was an underperforming line, I would take a look at improving the gross margin side of the equation. The turn rate, in this case 6, is pretty strong. In order to improve gross margins, we have some options. We could go back to the vendor and ask for better pricing. In a tiered pricing vendor, are we able to justify buying at the next discount level? My favorite place to look is the pricing matrix. In a recent article, I discussed the power of using your pricing matrix. To paraphrase, a good strategy is to increase your pricing on the slower moving items in a vendor line. This pricing by velocity strategy can usually bump the overall line by 1 or 2 percentage points. By slightly manipulating the price, we can significantly increase our return on investment.

When we look at Brand 3, the obvious point of attack is on the turn's side. Most distributors wouldn't be too upset with 5 turns; but for sake of example, let's consider it sub par. How do we affect inventory turns? The best way is to reduce average inventory value in the line. I will typically look for any dead or slow moving stock in the line. I would actively pursue returning material to the vendor or liquidating the material through sales channels. In addition, I would look at a HITS report to identify items to drop from an active stock status. A HITS report tells us which items show up most often, regardless of quantity, on sales orders. It is kind of like an items popularity contest. Items with fewer than 4 hits annually are candidates for non-stock status. Once these are bled out, overall inventory value will reduce. As a result, turns will increase and so will the return on investment.

Here are a couple of pitfalls to avoid when calculating the T/E. As a negotiating strategy, I would often share the T/E calculation with underperforming vendors. I was presenting a rather low T/E to a vendor, getting ready to launch into a plea for better pricing, when the manufacturer asked, "How do you account for rebates, and dating terms?" Since this vendor provided generously in both categories, he had a valid point. Unfortunately, I did not have a stellar response. Something to the effect of, "Uh, I dunno…" These two common practices, rebates and terms, provide significant value. Although I was a bit embarrassed at the time, I am grateful to this gentleman for pointing this out. Both of these practices need to be accounted for in the gross margin side of the equation. Rebates aren't too difficult to figure out; but dating terms tend to trip some folks up. My rule of thumb is: for each 30 days in additional dating, add ½% to the gross margin. I figure that this is the amount of interest savings you will receive by taking advantage of the dating. We want to get everyone on the same playing field when we are making comparisons between lines.

Whether you are using the Turn and Earn Index to compare duplicate vendors or simply to identify underperforming lines, doing the math will go a long way toward solidifying your argument. Consider this just another powerful arrow in your quiver. Good luck.

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