WELLS FARGO

Wells Fargo
Commercial Distribution Finance
500 W. Monroe Street
Chicago, IL 60661-3671

wellsfargo.com/cdf

How much should I invest in inventory?

By Jim Morphey
Vice president of corporate development, Wells Fargo Commercial Distribution Finance

The inventory on your floor is an asset and the goal is to sell the assets at a profit. Your inventory can be thought of as investments. You buy them at one price and aim to sell them higher. Knowing how much to invest in inventory is very much like other investments. If we only had a crystal ball to predict the future…

Accurately predicting the future is next to impossible. But a good place to start is to understand the expected return on an inventory investment based on historical data. Inventory return is closely related to gross margin and inventory turns. Generally speaking, the lower a gross margin, the faster the inventory turn needs to be to maximize profit – your Return on Investment.

Two tools to help determine inventory investments are the Inventory to Sales Ratio and the Target Inventory Investment formulas.

Inventory sales ratio = Average inventory sales for the period

Target inventory = Projected annual cost of goods sold target inventory turnover

The Inventory to Sales Ratio identifies the potential growth of your investment. The closer the numbers, the better your investment performance. This ratio is useful if calculated on a monthly basis over an extended period of time. It is also best to exclude any inventory that is being held for display purposes since those items typically turn only once a year.

The ratio also can be calculated by manufacturer or product category if your inventory system breaks out by inventory and sales. The Target Inventory Investment Formula can help create a budget for the following year by identifying the projected investment needed based on past costs and inventory turns. The target inventory turnover, the denominator, should match your average terms provided by your inventory finance provider or your vendor's open account to maintain optimal cashflow. To obtain your projected annual cost of goods sold, the numerator, take your prior year's cost of goods sold and adjust for:

- +/- For expected change category mix
- +/- For anticipated vendor price changes
- +/- For expected gross margin movement
- +/- For displays[1]

© 2016 Wells Fargo Bank, N.A. All rights reserved.

Jim Morphey is the vice president of corporate development for Wells Fargo Commercial Distribution Finance (CDF). Morphey has more than 40 years of management experience in consumer finance, trade credit, and most recently with domestic and international inventory financing, as well as factoring. Morphey's career has been devoted almost entirely to the domestic consumer electronic, appliance, and outdoor power industries. His background includes executive assignments in operations, credit, and relationship management at the national level with Whirlpool, Whirlpool Financial Corporation, Transamerica Distribution Finance, and senior relationship assignments at GE Capital.

Morphey received a Bachelor of Science in Management from Northern Illinois University. He was a member of the Association for Finance Professionals (AFP). He earned professional certifications from The National Association of Credit Management/Credit Research Foundation (NACM/CRF) Graduate School of Credit & Financial Management held at Dartmouth College, and also from The Finance, Credit, and International Business Association (FCIB). Morphey has published many articles on the topics of inventory management as well as cashflow. He also helped produce a six part video series on a variety of cashflow topics which may be found at www.cdf.wf.com/learningcenter. Morphey and his family reside in southwestern Michigan.

Questions about this article can be directed to james.a.morphey@wellsfargo.com

[1] If displays sponsored by vendors are a large factor in your total inventory investment, it may be necessary to calculate your Target Inventory Investment for display inventory separate from non-display inventory.

© 2016 Wells Fargo Commercial Distribution Finance. All rights reserved. Products and services require credit approval.

Wells Fargo Commercial Distribution Finance is the trade name for certain inventory financing (floor planning) services of Wells Fargo & Company and its subsidiaries.

This article has been prepared by Wells Fargo Commercial Distribution Finance (CDF) for informational purposes only and does not constitute nor should it be taken as financial, business, tax, accounting, legal and other advice, or relied upon in substitution for the exercise of your independent judgment. Readers should not act upon nor rely on this information without seeking advice from the appropriate professional advisors. No representation or warranty, expressed or implied, of any kind is made by Wells Fargo CDF or any of its affiliates as to the accuracy or completeness of the information set forth

herein. Neither Wells Fargo CDF nor any of its affiliates accepts any liability of any kind for a loss arising from the use of the information provided herein.