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Controlling your inventory costs

By Jim Morphey
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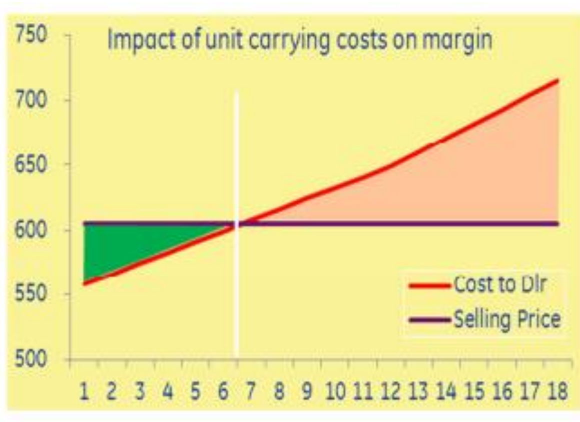
In previous articles the importance of maintaining an inventory balance based on matching inventory payment terms with inventory turn was highlighted. A big benefit to using inventory financing or floorplan programs is the ability to stock inventory for sale at little to no expense. Proper control of floorplan inventory can have a big impact on the profitability of a dealer's overall business.

A good business practice is to avoid carrying inventory for too long. It could tie up capital, incur interest charges, take up space, and eventually become obsolete – losing even more value. Dealers that try to match their turns – the frequency in which they sell a unit – with the terms of the finance program can avoid this trap.

In cases where inventory does not turn quickly enough, it is best to pay down the value of the investment in the inventory and price it accordingly. This will help avoid any long-term loss in value. From our observations, consistently struggling dealers may not have priced their aging inventory in accordance with ongoing market conditions. The carrying cost of inventory held too long can erase any profits anticipated from its sale.

Consider the exercise below:



For example, a unit's cost is $550. The annual interest rate for the unit is 18 percent for the first 12 months, and 24 percent thereafter with a sale price of $605. That's an initial margin of 10 percent. In this example after the third month the potential profit is less than half of what it would have been if the unit was sold in the first month. By the sixth month, the entire margin is erased and becomes a liability the longer it remains unsold.

There are other real-world considerations to take into account including storage costs, insurance, and competition from next season's product lines. Also the actual interest rate may be higher. This simple exercise helps illustrate the expense of carrying a unit for too long.

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Tips to Help Control Your Inventory Costs:

- Review documents and financing terms carefully. Make sure you are familiar with the timeframe for when unsold inventory becomes a liability. Do not let inventory age beyond the point of profitability.
- Know your terms and due dates. Keep current with each inventory item.
- Exercise prompt payment habits.
- Interest should be paid within the month billed or earlier if required.
- Make sure to pay for inventory as it is sold. Delays in paying for items can generate additional interest expenses and cost.
- Use the online Customer Online Management System (COMS) as a fast, efficient way to monitor inventory and make payments. Set up electronic payments (ACH) within COMS to avoid delays in check processing.
- Know that interest does not stop accruing on the date you put the check in the mail. Using ACH as a payment method can help minimize delays in posting payments.
- Avoid paying additional interest by selling and paying for aged equipment.

One of the by-products of old and/or obsolete inventory is that it often goes unnoticed by a business owner. Before you know it you could have 10 to 20 percent of your inventory reaching its second or third year on the floor. When appliance inventory ages, it becomes difficult to sell and eats into overall collateral value. Since inventory collateral value is often a major component of what you need to be able to borrow fresh funds, aged product will eventually be discounted heavily by lenders. This in turn reduces your capacity to borrow. We frequently see this type of liquidity crisis where there is no metrics established to regularly monitor inventory. It is also common among dealer failures.

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.

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