

Capital Corner

How Much Should I “Invest” in Inventory?

By Jim Morpheu, Vice President of Corporate Development, GE Capital, Commercial Distribution Finance

The inventory on your floor is an asset, and the goal is to sell these assets at a profit. In that sense, these assets can be thought of as investments – you buy them at one price and hope to sell them at a higher price in time. Knowing how much to “invest” in inventory is very much like other investments we make. If we only had a crystal ball it would be so easy.

Since predicting the future with accuracy is difficult, a good place to begin is to understand what “return” to expect on your inventory investment based on the data you have in your history. This inventory “return” is closely related to two things: Gross Margin and inventory turns. Generally speaking, the lower your Gross Margin the faster the inventory turn needs to be to maximize your profit... the return on your investment.

Two good tools that may be used to 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 will show the potential growth of your “investment”. The closer these numbers become, the better your investment performance. This ratio is most useful if it is calculated over time on a monthly basis and it is best to exclude any inventory that is held for display in this formula since displays, typically turn only once a year.

The ratio also can be calculated by manufacturer or product category, if your inventory system breaks out Inventory and Sales in this manner.

The Target Inventory Investment Formula can help create a budget for the next year by identifying the projected investment needed based on past costs and inventory turns. The Target Inventory Turnover (denominator) should match your average terms provided by your Inventory Finance Provider or your vendor’s open account to maintain optimal cash flow. To obtain your Projected Annual Cost of Goods Sold (numerator), take your prior year Cost of Goods Sold and adjust for:

- +/- For expected change category mix
- +/- For anticipated vendor price changes
- +/- For expected gross margin movement
- +/- For Displays *

* If Displays sponsored by vendors have become so large a factor in your total inventory investment, you may find it necessary to calculate your Target Inventory Investment of display inventory completely separate from non-display inventory.



Just remember to add both outcomes together when calculating your target for the entire business. You might also use 1 for your Target Inventory Turnover when calculating your target display inventory since most display programs run for 12 months.

Bringing it all together: if you determine your Target Inventory Investments at the beginning of the year, and use the Inventory to Sales Ratio regularly (i.e. monthly) you may be able to determine, with greater accuracy, how much to invest in your inventory.

Having a plan for your inventory and the discipline to stay on plan is another great way to keep your cash flow positive.

For more information, visit www.cshpi.com.



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