# Increasing Profits by Lowering the Cost of Goods Sold

*"In spite of the cost of living, it's still popular."*

Kathleen Norris

The inflation rate in the U.S. has been trending sharply upward. If the trend continues we could be on track to experience the highest rate of inflation so far this century. This is not news to consumers who are faced with inflation daily as they go to the gas station or shop for groceries. They know full well that non-discretionary items like gasoline, dairy and grain-related products have steadily gotten more expensive. Wholesale and retail companies across the board report receiving price increase notices from their suppliers at an increasing rate.

Wholesale distributors and retailers get squeezed as consumer price competition makes it difficult to just apply the cost increases to the selling price. One way to hedge against ever tightening profit margins is to take advantage of investment buy opportunities based on pre-announced price increases from suppliers. In other words forward buy on the current cost just before the cost increase takes effect. While selling generates revenue, better buying generates better profit.

There are inherent costs associated with buying and reselling inventory, for example inventory carrying costs. There are also several points that must be considered when taking advantage of an investment buy opportunity including:

**Return target rate** – Return target rate is the return you want to achieve on the last piece of forward bought inventory. You don't want to forward buy more inventory than you can profitably sell through in a reasonable amount of time because it costs you to hold inventory.

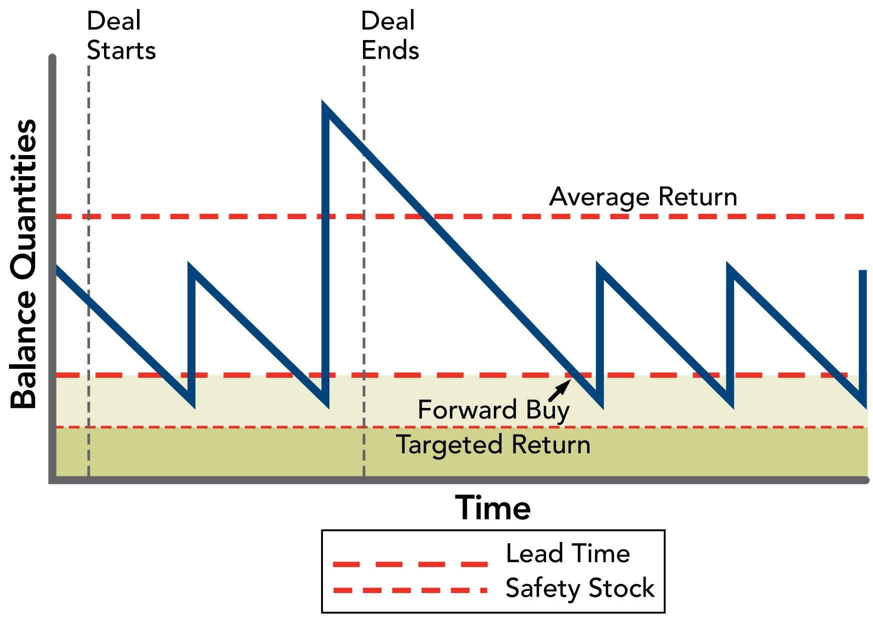
**Cost of money** – How much to forward buy should be governed by the point when incremental profit on the forward buy is balanced with the incremental costs of carrying the extra inventory.

**Cash requirements** – Forward buys usually require more cash. This may involve consultation with your CFO and needs to take into account your cash strategy, cost of money and liquidity. Sometimes this can be mitigated by additional dating terms by extending the time you have to pay the invoice.

**Investment alternatives** – Another consideration before entering into a forward buy is any investment alternatives. What else would your company invest this capital in if it was not for inventory? Opening new facilities, etc.

*It is important to have an inventory optimization application that can do the heavy lifting for calculating the additional investment buy quantity while still harmonizing it with normal replenishment buying.*

While we have previously referenced the profit potential by doing an investment buy ahead of pre-announced prices increases, other investment buying opportunities are often found in other types of deals including buying incentives from your suppliers like temporary discounts, Rebate/Bill Back and Extra Days Dating.




The graph above illustrates how at the beginning of a deal, the proper aspect of inventory optimization is to hold back from ordering additional quantities until the deal is about to expire. After the respective forward buy has been made and you enter into the sell-down period, assuming a robust investment buy algorithm was used, the aim is to achieve the targeted return on the last unit of investment inventory sold just in time to return to normal replenishment buying patterns.

It is important to have an inventory optimization application that can do the heavy lifting for calculating the additional investment buy quantity while still harmonizing it with normal replenishment buying. You also need reasonably accurate values in targeted return and cost of money inputs enabling your application to assist you in calculating how aggressive you can be in the investment buy. An added bonus is you also receive a service level benefit during the period in which you are selling down the investment buy inventory because you are carrying more inventory than normal (above your average of safety stock and half of cycle stock) but within reasonable and profitable limits while not adding to or changing your safety stock investment.

Finally it all comes down to balancing the risk of investment buying. A forward buy usually takes extra cash, depending on the merchandise itself it may require extra space and your demand forecasts need to be reasonably accurate.

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