Not All C and D Items are the Same!

Inventory Management Best Practices for Wholesale/Distributors

Written by Tom Birdwell and John Mansfield
5/31/2016

Contents

Introduction

As a distributor, you know that inventory represents a major investment. Minimizing the number of slow-moving items held in inventory is important. You need to free up cash to purchase productive, fast-moving items that contribute more to your distribution business' bottom-line profits.

Frequently, distributors use alpha systems to rank their inventory items as A, B, C or D (where A is most productive and D is least productive). The fear of getting stuck with obsolete inventory serves as a motivator to lessen the exposure to C and D inventory items.

Not all customers are the same – some are more profitable to you than others. You need to know which specific inventory items matter to your most important customers. For that reason, it follows that not all C and D items are the same.

It would be a mistake to indiscriminately remove C and D items from inventory simply because they are slow-moving. To do so is to risk customer service levels to those valuable customers who depend on you to supply those critically important items to them.

By categorizing customers into four groups, Customer Stratification provides a powerful tool to more critically assess the importance of your company's C and D inventory items. Customer Stratification can ensure that inventory investments are minimized even as you continue delivering exceptional service levels to your most profitable customers.

Inventory Management Issues

Imagine for a moment that you are a wholesale/distributor and one of your D inventory items is a widget. Stocking these slow-moving widgets ties up dollars that could be more profitably allocated to other items. However, the decision to stock widgets depends upon which of your customers value these particular items the most.

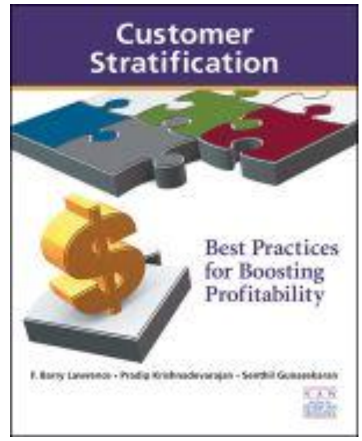
If the Customer Stratification analysis proves that undesirable 'Marginal' and 'Service Drain' customers are the primary buyers of widgets, then it probably doesn't make sense for you to continue stocking widgets. You are committing dollars to servicing customers who don't contribute much to your company's profitability. Going forward, it might be better to sell widgets as non-stock items, if at all.

On the other hand, if the Customer Stratification analysis finds that valuable 'Core' and 'Opportunistic' customers tend to buy widgets from you, then your company should definitely commit to stocking widgets. Customer service levels will deteriorate if you fail to keep widgets in stock. You want to keep your most profitable customers happy, even if widgets comprise a relatively small amount of the customer's business.

Of course, the widget's status as an underperforming D item may indicate untapped sales potential. Logically, if you are serving an industry that values widgets, then the other Core customers you support should want to buy widgets from you, too. It might be the case that widgets are relatively new to inventory and need to be marketed more aggressively. Perhaps you are selling low-margin substitute items that have detracted from widget sales to date. Or there might be another explanation.

The case study below shares how a leading distributor leveraged its Customer Stratification analysis to optimize its inventory management practices.

Case Study: Boosting Inventory Profitability with Customer Stratification



"Customer Stratification: Best Practices for Boosting Profitability"

"Customer Stratification: Best Practices for Boosting Profitability" published by The National Association of Wholesaler-Distributors (NAW) has defined best practices in Customer Stratification.[1] As a methodology, Customer stratification analyzes key dimensions including buying power, cost-to-serve, loyalty and margins. Empowered with this information, distributors can implement more effective sales, marketing, inventory management and customer service strategies than otherwise possible.

John Mansfield is a wholesale/distribution industry expert who has led a number of successful Customer Stratification projects. John says that the mountains of data created by the typical wholesale/distribution enterprise can often make it difficult to identify money-losing customers. A methodical approach is the best path towards aligning inventory purchases with the needs of the distributor's most profitable customers.

On that point, John shared his experiences implementing the E&A/StratMax Customer Stratification solution at a major wholesale/distributor located in the eastern United States. Throughout the implementation, John worked closely with the company's sales team including its sales manager, 'Tom' and sales rep, 'Walter'.

John presented a high-level overview of the distributor's customer data to the sales team. One of the takeaways was that the company was losing money on most of their Marginal customer accounts. John subsequently followed up this general presentation with a number of breakout meetings with individual members of the distributor's sales team, including Tom and Walter.

A Low Gross Margin Customer is Revealed

The goal of Customer Stratification is to improve the bottom line profitability of the distributor. John believes it is important to identify those Marginal customers whose demand for services outweighs their contributions to revenues. The challenge includes reducing the distributor's exposure to those specific inventory items associated with Marginal customers.

John met to discuss these issues with Tom and Walter. "We worked closely with Tom and Walter because the analysis indicated that Walter, like other reps at the company, had a significant number of Marginal customers," said John. "To help isolate Walter's Marginal customers, we used the Quadrant dashboard to sort his customers by gross margin percentages."

Below is an illustration of Walter's Quadrant dashboard. The top red arrow indicates that Walter's Marginal customers have been selected for reporting. The center red arrow points to a scatterplot of Walter's Marginal customers.

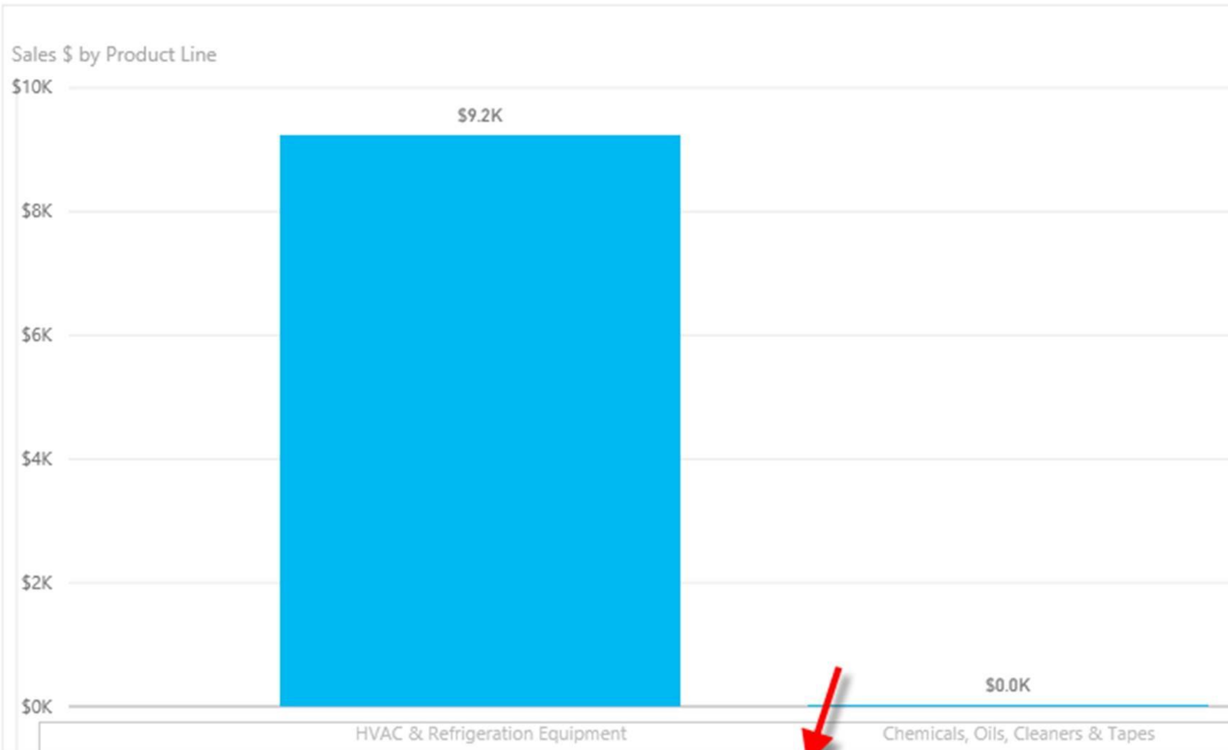
Cust Name	Fiscal YrQtr	Cust Strat Type	Sales Vol	Average of GM Pct
KRISTEL CORP - 12805	2015Q3	Marginal	$13,973	4.7 %
COMMERCIAL HARDWARE & IND SPLY - 13365	2015Q3	Marginal	$5,044	17.5 %
BLUE RIDGE GYPSY STUDIO - 12554	2015Q3	Marginal	$18,775	19.4 %
CALVARY INDUSTRIES - 14123	2015Q3	Marginal	$8,617	21.4 %
ASHLAND CHEMICAL WAREHOUSE - 12723	2015Q3	Marginal	$7,170	24.0 %
FARMERS PRIDE CO OP - 13559	2015Q3	Marginal	$7,495	25.7 %
ENGOV MIDWEST INC - 12948	2015Q3	Marginal	$16,291	27.3 %
HYDRITE CHEMICAL CO - 11842	2015Q3	Marginal	$12,594	29.5 %
RX SYSTEMS INC - 12187	2015Q3	Marginal	$15,405	31.2 %
VANGUARD SAFECO LLC - 12472	2015Q3	Marginal	$5,856	33.0 %
OCE NA - 12218	2015Q3	Marginal	$9,360	33.1 %
HOMESTEAD MATERIAL HNDLG CO - 13002	2015Q3	Marginal	$5,295	33.2 %

Figure 1. The Quadrant dashboard can sort Marginal customers by Gross Margin percent

The Low Gross Margin Customer is Connected to a Specific Inventory Item

To understand the source of the customer's low Gross Margins, John directed Tom and Walter's attention to the Buying Power dashboard. A review of the data made it very obvious that one particular inventory item was at fault. "The part had a high volume for the customer but a low Gross Margin rate," said John. "Plus, the customer was not buying many other items which otherwise might have helped push margins higher for Walter."

Walter's Buying Power dashboard for the low Gross Margin customer is illustrated below. The highlighted row indicates the low Gross Margin item purchased by the customer. The customer is defined as Marginal partly because the low Gross Margin item comprises nearly all (99.7%) of the customer's total purchases.



Item Num	Sales Amt	Ship Qty	GM %	Count of It...	% of Total
MDT5N25W-1J - SCOTSMAN DISPENSER ICE & WATER	$9,245	2	0.05	1	99.7 %
4371-88 - NU-CALGON TRI-POWER	$15	1	0.38	1	0.2 %
440/55/5R - RUN CAPACITOR TRCFD555	$8	1	0.44	1	0.1 %
Total	**$9,268**	**4**	**0.05**	**3**	**100.0 %**

Figure 2. The Buying Power dashboard can display sales by product line for specific customers.

Inventory Management Implications

John’s inquiry turned next to inventory management. Should the distributor continue to stock this particularly low Gross Margin item? A review of the Inventory Dashboard proved useful.

“We looked at the Inventory Dashboard to see the movement velocity of this low Gross Margin item,” explained John. “We could clearly see that this item had a C/D ranking but was only sold to Walter’s Marginal customer. The item had never been sold to any of the distributor’s other, more profitable customers. As you can imagine, Tom was very concerned about the company stocking and selling a slow-moving, low-margin item for the sole benefit of an unprofitable customer,” John continued.

The screenshot below proved that the low Gross Margin item was being sold exclusively to Walter’s Marginal customer.

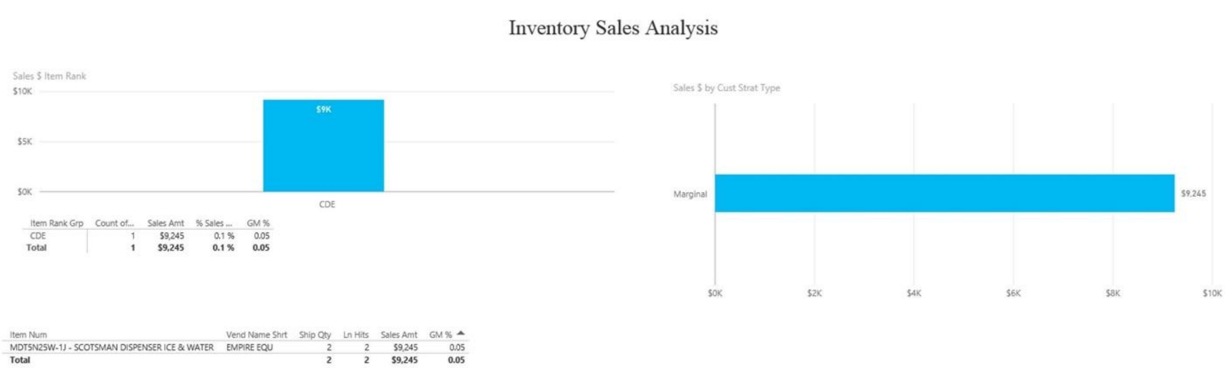


Figure 3. The Inventory Dashboard can display a Sales Analysis for individual inventory items.

Towards Aligning Price with Value

John soon discovered there was a story behind the predicament. “Walter explained that he originally won this business in a competitive pricing situation,” said John.

“The customer agreed to the low price because the item was to be shipped directly from the manufacturer to the customer, thus avoiding inventory carrying costs.”

However, as is often the case in wholesale/distribution, the requirements of Walter’s customer changed over time. “In this instance, the customer found direct delivery to be inconvenient because the item had a long lead time, was large, yet was essential to avoiding business interruptions,” said John. “The customer asked Walter to stock the item locally so that it would be available on demand and deliverable within a preferred time window. Of course, as a customer-focused salesperson, Walter chose to add the item to stock - and he even helped schedule deliveries to the customer site. The problem is that Walter didn’t revise his pricing to account for the significant value-add his company was providing to the customer,” continued John.

Walter’s situation is not unusual. According to research by the National Association of Wholesaler-Distributors (NAW), most distributors have Marginal customers who are notorious for wanting to use all of the distributor’s services and not paying for them.[2] Identifying these problematic accounts and constructing win-win solutions is critical to the distributor’s long-term viability.

John is a student of NAW best practices who understands that distributors must learn to bring their pricing in line with the total value delivered to customers. “The natural question that Tom and I had was, ‘Aren't these services worth something to the customer that they would be willing to pay a little more?’ Walter admitted they were. He just hadn't demanded a higher price in exchange for the additional services,” said John.

Within only a few minutes of interacting with the Customer Stratification dashboards, Walter and Tom developed plans for improving both the profitability of their business and the quality of their inventory. Walter made arrangements to meet with the Marginal customer. He would explain that the extra services provided would require a higher price if the customer wanted him to keep this low Gross Margin item in stock locally. Alternatively, the customer could go back to the original deal to have the item direct shipped. Depending upon the outcome of the meeting, Tom will make a decision about whether to continue stocking this item for the customer, or not.

“With a comprehensive customer stratification solution, that decision will be made logically based upon the results of the efforts and results of the sales team,” observed John. “The end result is a plan to increase profitability for problematic C and D items. This is how distributors can continuously improve the quality of their inventories.”

Conclusion

Merging your inventory management and customer stratification systems has a synergistic effect. The short case study above illustrates how Customer Stratification ensures that your inventory investment is optimized towards serving the needs of your best customers. Simply put, Customer Stratification provides distributors with the tools to quickly, easily, and strategically manage their inventories and more profitably service their customers.

About the E&A/StratMax Solution

The E&A/StratMax Partnership

Instinctively, you know that not all of your customers are the same. Some are more profitable than others. Research has shown that typically 80% of a company's profitability is concentrated in 10% of their most profitable customers while 75% of customers represent less than 5% of their profitability. But how do you objectively determine which are the most and least profitable customers? And how should you treat them differently?

E&A and StratMax have partnered to help distributors answer these questions with its Customer Stratification solution. Adhering to industry best practices articulated by the National Association of Wholesaler-Distributors (NAW), the E&A/StratMax customer stratification solution allows businesspeople to implement strategies that drive more profitable growth.

How it Works

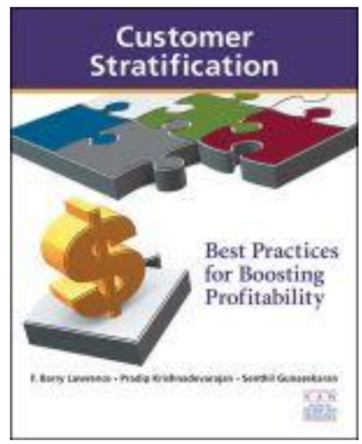
Leveraging your existing ERP investment, E&A and StratMax work with your management team to tailor the factors in the customer stratification model that are most relevant to your business. The E&A/StratMax solution leverages the quantifiable information within your ERP system. The customized model is delivered to you through a cloud-hosted solution that features easy-to-use, interactive dashboards. Gain unique insights into your business – and your customers – all in one place.

E&A has teamed with StratMax to turn your data into actionable information. StratMax business consultants will help ensure that you are doing the right things with the right customers to boost your bottom-line profitability. Over 30 years of sales and marketing experience has established StratMax as the leading practitioner of customer stratification strategies in the wholesale/distribution industry.

What it is

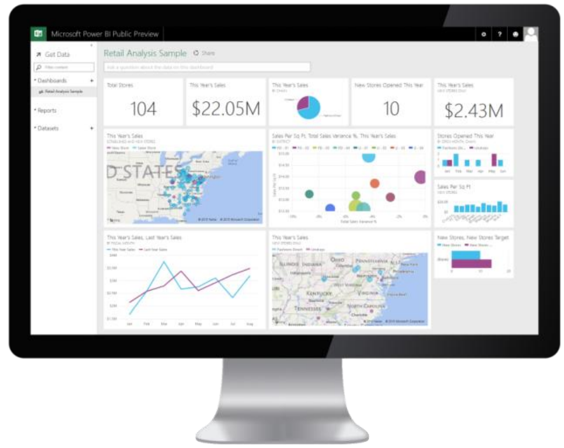
The E&A/StratMax customer stratification solution is a set of sophisticated yet easy-to-use tools that are customized to your business. Empower your sales team with strategies that have been proven to drive more sustainable, profitable growth.

Key Components



"Customer Stratification: Best Practices for Boosting Profitability"

- Groundbreaking industry research by the National Association of Wholesaler-Distributors (NAW) serves as the foundation of the E&A/StratMax solution. "Customer Stratification: Best Practices for Boosting Profitability"[1] is the definitive guide to Customer Stratification, a tool that can help distributors identify their most profitable customers. The book is published by the National Association of Wholesaler-Distributors (NAW) in collaboration with Texas A&M University.
    - Customer Stratification processes data in your enterprise resource planning (ERP) system through an algorithm that tests key customer profitability factors such as buying power, loyalty, profitability and cost-to-serve. The insights yielded can guide you to spend more time on profit-building customers; and less time on money-losing customers.
- The customer stratification model is customized to each client's unique business needs.
- Results are delivered using a powerful cloud-based, interactive dashboards built on the Microsoft Power BI platform.



Power BI Platform

- The comprehensive solution combines E&A's technical expertise with StratMax's hands-on customer stratification management.
- Creative strategies to 'stretch', 'develop', 'examine' and 'protect' your customers are provided by industry experts with deep industry knowledge.
- Model data is updated quarterly on an ongoing basis to help your business gain control of a rapidly changing competitive environment.
- No more sifting through reams of paper reports and complex spreadsheets to get the vital data you need to develop more effective sales and marketing strategies.
- Empower your sales and management team to collaborate and sell more effectively using the backbone of the Power BI cloud-based application, E&A's business intelligence tools and online access to StratMax consultants.
- Best practices, case studies of additional strategies, and personalized training and implementation services are included.
- A significant upfront capital investment is not required to get started.
- "Pays for itself" as license holders implement strategies that drive profitable growth and EBITDA improvement.

Benefits

- More Accurate Sales Force Deployment
- Improved Negotiations
- Identify New Growth Opportunities
- Understand Cost to Serve (CTS)
- Optimize Pricing for Greater Competitiveness and Profitability

- Better Inventory Management
- Better Marketing Communications
- Targeted Sales Force Compensation

Industry studies have demonstrated that Customer Stratification can significantly drive EBITDA improvement, with positive effects across the business enterprise.

What you get

- Copy of NAW Research book "Customer Stratification: Best Practices for Boosting Profitability"
- Full Day Onsite Modeling Workshop (Facilitated by StratMax)
- Full Day Onsite Management and Sales Team Workshop (Facilitated by StratMax)
- Daily Profitability Trends Updates – Business Intelligence
- Interactive Dashboards
- Over 60 Proven Best Practice Strategies in an Interactive Dashboard
- Model Updated Quarterly
- Best Practices Web Conferences
- E&A Online Learning Modules

Learn more

To learn how the E&A/StratMax sales collaboration solution featuring Customer Stratification can help grow your wholesale/distribution business, scan the QR code or go to www.earnestassoc.com/customer-stratification.

References and Acknowledgements

1. 'Customer Stratification: Best Practices for Boosting Profitability' by F. Barry Lawrence, Ph.D., Pradip Krishnadevarajan and Senthil Gunasekaran. The book is available at the National Association of Wholesaler-Distributors (NAW) website at http://www.naw.org/publications/pubs_item_view.php?pubs_itemid=145.
2. Ibid., page 2.

The author thanks John Mansfield at StratMax for his valuable input and suggestions.