Consumer in practice

A consumer products and retail playbook series

Issue 3: Three ways inventory precision can boost retail profit

EY
Building a better working world

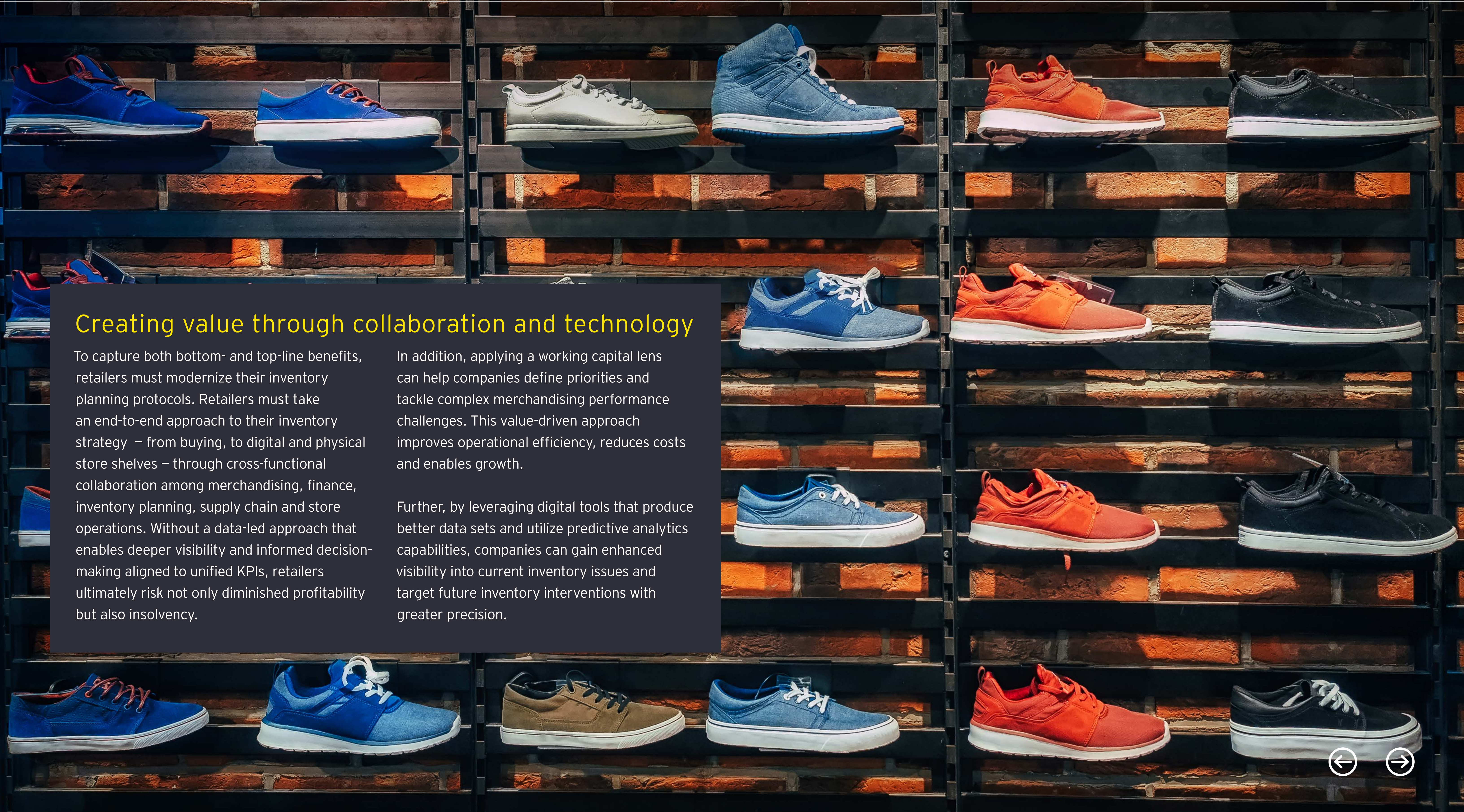
THE CHALLENGE

While merchandising and planning is the core of traditional retail operating models, it is ironically also an area that today's retailers often struggle to get right. The ripple effects of costly overstock and out-of-stock inventory scenarios can be significant, often impacting nearly every function across a retail business. But even amid today's margin pressures, evolving consumer demands and increasingly complex supply chains, many retailers continue to bring a siloed, business-as-usual mindset to their merchandising and inventory planning functions.

From product selection, to assortment, distribution, storage and eventual placement, managing inventory in a disparate manner drives billions in excess inventory and related costs across the retail value chain each year, with products often ending up in the wrong place at the wrong time. This approach makes it difficult for retailers to establish unified key performance indicators (KPIs) and milestones that can unlock efficiency, mitigate risk and drive overall performance. It also presents challenges when companies need to leverage flexibility and liquidity in addressing fast-moving inventory that performs well. Moreover, inventory mismanagement often leads to a fragmented customer experience that erodes brand loyalty.

On top of that, additional inventory-related operating challenges include inefficient product mixes, lack of operational consistency across regions, ineffective store layouts and pricing structures, lack of customer segmentation and high-quality data sets, and reliance on outdated technologies.

These pain points share the same root cause: a preventable but all-too-common lack of precision and rigor around inventory management.



Creating value through collaboration and technology

To capture both bottom- and top-line benefits, retailers must modernize their inventory planning protocols. Retailers must take an end-to-end approach to their inventory strategy – from buying, to digital and physical store shelves – through cross-functional collaboration among merchandising, finance, inventory planning, supply chain and store operations. Without a data-led approach that enables deeper visibility and informed decision-making aligned to unified KPIs, retailers ultimately risk not only diminished profitability but also insolvency.

In addition, applying a working capital lens can help companies define priorities and tackle complex merchandising performance challenges. This value-driven approach improves operational efficiency, reduces costs and enables growth.

Further, by leveraging digital tools that produce better data sets and utilize predictive analytics capabilities, companies can gain enhanced visibility into current inventory issues and target future inventory interventions with greater precision.

TAKE ACTION

Retail companies that are looking to reduce merchandising and planning inefficiencies, enable growth and become more profitable should consider moving swiftly to activate three unified initiatives:

1

Align decision-making across the organization.

Begin by enabling better collaboration among merchandising, finance, inventory planning, supply chain and store operations teams. Key actions include defining common profitability-driven KPIs, such as gross margin ROI, reduction in days outstanding inventory, increased forecast accuracy and consumer satisfaction, and implementing guardrails around excess and out-of-stock inventory that tie to top- and bottom-line results, working capital and other financial metrics. This step will help identify and resolve operational alignment issues that are impacting performance. It also helps retailers validate what products have truly “earned” a spot on their shelves, which can mitigate costly inventory-related missteps.

2

Move from reactive to predictive by leveraging unified data, supported by advanced analytics.

Next, perform a diagnostic assessment of inventory challenges to identify root causes around overstock and out-of-stock inventory (see Figure 1) and inform key decision points. Machine learning coupled with AI can improve foresight into inventory misalignments by enhancing visibility into multiple data inputs, such as historical, internal and external data. Additionally, data-driven digital tools can help retailers detect the probability of excess or out-of-stock scenarios and identify key drivers across the supply chain.

3

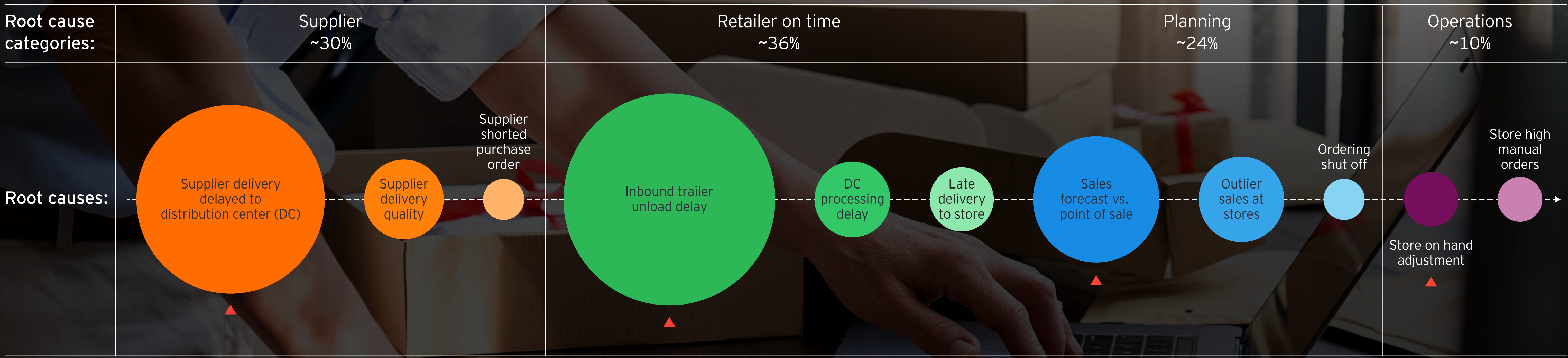
Prioritize interventions that enhance profitability and respond to consumer demand.

Lastly, deploy data-driven insights across company functions through strategic decisioning that drives performance and reduces inventory mismanagement. Example interventions include enhancing assortment and SKU rationalization for more accurate buying, implementing dynamic pricing and promotions to address excess inventory, optimizing supply chain agility through flexible supplier agreements and leveraging inventory management systems to identify and address stranded goods.

Retailers often need to transform their organizations' culture to see measurable performance improvements. The chief operating officer, chief merchant and chief supply chain officer all play a crucial role in establishing clear guardrails and oversight for buyers who purchase excess inventory and expand assortments due to a lack of end-to-end inventory visibility. Additionally, the chief operating officer and chief merchant should implement effective inventory management practices and incentives that foster collaboration between buyers and other stakeholders that have differing KPIs, which serves to minimize both costs and the impact of inventory-related missteps on profitability.

Figure 1

Diagnostic example of out-of-stock (OOS) root causes and associated value for each, to prioritize interventions



▲ Top drivers of OOS, represented by sales lost (in $)

IN PRACTICE

A lack of inventory precision and rigor is a common issue for retailers of all sizes; compounding issues not remedied at their root cause can impede success and growth. The following is one example of our work with a major retailer we helped realize that a "business-as-usual" approach was no longer fit to serve. By helping to streamline its inventory management processes and amplify its supply chain visibility, the retailer reduced inefficiencies needed to thrive.

A lifestyle apparel retailer was experiencing tremendous growth and popularity but needed to address its increasing inventory levels and service challenges. The CFO recognized that the company's inventory growth was not sustainable, but merchandising decisions historically were driven by sales targets, with minimal consideration for inventory impact.

Additional challenges included a lack of formal training for new employees, leading to an individualized approach to forecasting and planning; gaps in metrics and reporting tools, limiting management's visibility into supply chain performance; and key supplier data stored and maintained in multiple systems, causing information inaccuracies.

We worked closely with the retailer, leveraging process and data improvements to identify more than $100 million in sustainable inventory reductions. Further, our team helped this client achieve hundreds of thousands of dollars in cost savings related to excess storage expenditure. Our data analytics tools supported by machine learning enabled leadership to gain deeper visibility into its supply chain, deploy more effective inventory planning and enhance internal accountability across key functions. These organizational culture improvements were also supported by enhanced documentation and a formal training initiative.

While the retail landscape has changed significantly over the last few years, retailers must refocus on the fundamentals of merchandising and planning through a profitability, growth and performance optimization lens. This means enhancing operational alignment and modernizing digital and data analytics capabilities to overcome inventory-related challenges and drive overall business success.

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