

# Retailers as 'Stock' Investors

Finding a balance between the cost of inventory and lost sales is key

**B**ob Buchanan of A.G. Edwards recently asked me to speak at its Retail Investment Conference on the topic of helping retailers profit-optimize inventory and supply chains. While the primary focus of the annual conference is for public retailers to brief the investment community on their businesses, the A.G. Edwards Conference is unique in that it emphasizes the role of technology in improving a retailer's business and, ultimately, value.

Optimization has received significant attention as a way for retailers to improve profitability. In particular, there's been a lot of markdown optimization activity recently. In fact, it often seems that when people talk about "optimization" they often mean markdown. In fact, optimization can be applied to many different problems that retailers face.

As I presented real-world results in profit-optimizing retailer inventories and supply chains, the

cost of positioning inventory. However, as we save money on inventory, we incur a certain amount of lost sales and margin.

In profit-optimizing inventory, the cost of positioning inventory is balanced against the cost of lost sales to find the most profitable inventory level. Basically, a P&L is calculated for every level of inventory for every item in each store for each period and, by selecting the inventory level that yields the greatest profit, the inventory is aligned for profitability.

Retailers that do this can increase profitability by 200+ basis points. In addition, by significantly reducing lost sales, they can provide customers with better service. This also translates to more equity with consumers. The retail financial analysts recognized that profit-optimizing inventory aligns a retailer to deliver better customer service—cost-effectively and profitably—while building their consumer franchise.

So, is it better to optimize markdowns or inventory?

They both help you improve profits. Given that, I'd propose that optimized markdown is a good tactic, but optimizing inventory is a great strategy.

While markdown optimization has helped improve profitability, it comes with a number of liabilities and questions. If consumers expect markdowns and see that they are reliably available, will they wait for them? Do markdowns effectively set a de facto price? Do they take us to a "buy high, sell low" business? Do we think that is sustainable? In the end, it's a loss-mitigation approach to get as much cash out of an overbought position.

Comparatively, profit-optimizing inventory drives a better match of supply and demand within a profit framework. By having a "stock investment" model, retailers can make more efficient investments in their inventory portfolio. To be clear, this doesn't eliminate markdowns but it does reduce their need, accounts for the costs of markdown and guides us to the best overall company profitability.

Ultimately, the retailers that better invest in their "stock" may very well be better stock investments.

## Retailers can more profitably invest in their 'stock' by practicing approaches first used by Wall Street

retail financial analysts quickly grasped not just the approach but also the opportunity. They understand the approach, as Wall Street has applied very similar methods over the last 25 years to improve the performance of stock portfolios. The analogy is strong as, just like Wall Street, Main Street retailers also invest in stock—their inventory.

Beyond the fact that optimizing retail inventory "stock" is similar to optimizing investments in the stock market, what is the opportunity for retailers to optimize their inventory and supply chain?

It's pretty clear that inventory is a key driver of sales. No inventory, no sales. And, as inventory is added, sales go up. The "first" units of inventory that are put into service are incredibly efficient—they sell reliably and quickly. As more inventory is added into service, it takes longer to sell and costs more to capture those sales.

Conversely, as we reduce inventory, we save the



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