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A primer on dead stock

by Doug Levin

Executive summary: This article, part 1 of a two part series, provides a good dead stock primer and overview of the negative impact it has on cash flow and profitability. It also presents some of the solutions that have been tried to reduce dead stock in a channel.

Dead stock. Obsolete inventory. Surplus stock. Excess inventory. Regardless of what you call it, dead stock exists and each year negatively impacts distributors' cash flow and bottom line.

Each distributor defines dead stock differently. For this article, dead stock is defined as any stock that sits on a distributor's warehouse shelves, usually collecting dust, for a year or more. On average, 30-40 percent of a distributor's inventory falls into this category and is contradictory to the basic premise of what makes a distributor successful – turning around inventory quickly and for a profit. Distributors' main focus in life is to buy a product, mark it up a certain amount (margin), and resell the product. Of course, distributors also offer value-added services, but for the purposes of this article we will keep the model simple.

For example, a distributor has $1,000 in capital. He purchases 100 widgets at $10.00 each and sells them for $15.00 each over a one-month period for a total of $1,500. This is a 50-percent return on investment (ROI) in just one month. Naturally, there were a lot of expenses tied to the logistics of purchasing and selling 100 widgets that affect the ROI, but from an inventory standpoint, he got a 50-percent return on his investment in that one month.

Let's say the following month the distributor buys another 100 widgets at $10.00 each. But instead of selling all 100 widgets, he sells none. In fact, the customer that bought the widgets the previous month closed down and moved to another state. As the only factory in that region that used those particular widgets, they are now doomed to sit on the shelf for a very long time. Now we have a situation where the distributor invested $1,000 in inventory and at the end of the month has that same $1,000 in inventory. From a profit and loss standpoint, there is no affect, but cash flow has come to a complete halt, leaving the distributor without cash to reinvest in inventory that will sell.

Enter *carrying cost*. Carrying cost is the amount of money it costs to carry inventory over time. It includes the cost to own and operate a warehouse to store the inventory, payroll expense to count and manage the inventory, and, in some areas of the country, asset taxes on the inventory. Most people agree that carrying cost is between 25 and 35 percent of the inventory value. For our purposes, it does not really matter what number you want to use; what matters is that you agree it costs money to carry inventory.

So for our example above, if the distributor got stuck with the 100 widgets for a year and his carrying costs equal 30 percent of the widgets' value, his carrying cost would be $333.00 or 30 percent of his original $1,000 investment. By calculating the carrying cost, we see that dead inventory does not just impact cash flow, but also negatively affects the bottom line.

In our example, we assumed that the distributor could not sell the widgets. Another scenario might be that he sells the widgets, but at a much slower rate then expected. Perhaps a new factory opens in the region and buys five widgets every month, now the 100 widgets in stock amount to a 20-month supply. Despite having a long-term buyer, the distributor might be better off selling the inventory quickly at some factor below cost rather then holding it and paying the carrying cost.

Dead stock exists for many different reasons – some under the control of the distributor and some not.

The factors that distributors control are based around inventory or sales management.

- Many times a manufacturer/supplier gives incentives to distributors to buy more stock than they need, such as offering additional discounts on extra inventory or improved payment terms.
- A distributor's sales force may push to get more inventory with the promise of selling it, but are unable to follow through.

Factors outside distributors' control include:

- The sudden loss of a customer either by plant closing or switching distributors.
- A customer might change the products they use.
- The manufacturer/supplier may change or drop a product line.

In some cases the manufacturer/supplier will allow the distributor to return dead stock, but this is usually based on how long the distributor has had the product and how much new inventory they buy. Normally there is a restocking fee that can run as high as 20 percent.

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The issue of dead stock has been around since the beginning of the distribution industry. With the average distributor carrying 30-40 percent of their inventory in dead stock at a 25-35 percent carrying cost, you can clearly see that dead stock can mean the difference between profit and loss.

Looking for solutions

When it comes to dead stock, most people seem to think that everybody wants to sell dead stock, but no one wants to buy it.

Well, not exactly "no one." There are people who want to buy dead stock, but only for deep discounts – sometimes as much as 50-75 percent of cost – and then the inverse holds true: "Everyone wants to *buy* dead stock, but no one wants to *sell* it."

Let's look at some of the solutions that have been developed over the years. The first — and fairly obvious — solution to the dead-stock problem is to simply give it away. The best bet is to find a non-profit organization, such as a school or Habitat for Humanity, which might be able to use the products. In return for your gift, you get a tax write-off, which should help you recover some of the loss of having dead stock.

Another option is to have a fire sale. This can be as simple as setting up a table in your show room to display all your inventory you consider dead at marked-down prices. Or you fax, e-mail, or mail a flyer to your customers with a list of "special items" (i.e., dead stock) at great discounts. Either way, prices can be discounted as much as 70 percent.

Technology solutions

While giving away or discounting dead stock will eliminate the problem, the solution isn't much better than throwing the inventory into the dumpster.

With the widespread adoption of technology in the distribution industry over the last five to 10 years, people have been looking for technological solutions to helping distributors get rid of dead stock. Most of them focus on a central database that allows distributors to post their dead stock on the Internet. This allows distributors to go to a specific site and browse through what is posted to see if they need some of the inventory. Many buying/marketing groups and trade associations have centered on this concept as a solution for their members.

While these bulletin boards, as they are called, have met with some success, it has not been widespread and distributors have not seen material results, basically because there are several flaws to this model.

The first relates to the adage we mentioned earlier: Everybody wants to sell dead stock, but no one wants to buy it, unless of course it's priced right and is easy to find. Let's think about this. I am out of stock of a particular product for a customer. I know my supplier has it. Do I really want to spend time searching a bulletin board for a particular item, and, if I find it, not really know what shape it is in? As a purchasing agent the return would have to be high to take that kind of risk. The time I spend searching might eat up the savings I would receive buying the discounted product.

The next issue is the reliability of the data. These bulletin boards are static – once the distributor posts the stock, the information will not change (even if the distributor sells the product) until the distributor does another post. A buyer may find exactly what they need, only to find when they go to buy it that it was sold.

Another issue is time. If the system is not quick and easy to use, the time a buyer spends looking on the bulletin board can quickly eat up any saving gained by buying the product at a better price.

Finally, there is the issue of consistency in item codes or uniform product codes (UPC). Some industries, such as electrical, have done a great job of defining UPC, but others have not. Even in industries with standardized UPC, many distributors have failed to adopt them. This causes a major problem for distributors using bulletin boards because there is no common key to use as they search for the items they need. It is like looking for a needle in a haystack.

All of the above contribute to the reason why these technology solutions have not made a material impact on the dead stock issue.

In the next issue we will discuss a new initiative that promises to overcome these issues and solve the problem of dead stock.

A trading network approach

Remember the distributor who ended up with dead stock because his customer moved out of the region? What is now dead stock to him probably will be quite valuable to a distributor in the new territory the customer moved to.

Think about distributors who carry seasonal products. Often, seasons differ depending on geographical area. Roofing materials, for instance, are used heavily from April to October in the Northeast, but these products are most in demand from September to May in the Southeast. It's likely that a distributor in the Northeast in November might have some dead inventory that a distributor in the Southeast is buying as an active item.

Instead of, "Everybody wants to sell dead stock, but nobody wants to buy it," the real axiom of dead stock should be: "One man's trash is another man's cash."

Of course, this raises a few questions. First, logistically, can distributors afford to buy inventory

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from each other rather than manufacturers/suppliers? And second, just what is the correct ratio of cash to trash?

Before a distributor can sell dead stock to another distributor he needs to sort through all the logistics involved – freight, cash collection, transaction costs, etc. Remember carrying costs? Distributors understand that every day they do not sell dead inventory is a day of spending money to keep the inventory around. In general, distributors agree they would gladly sell dead inventory for cost minus 50 percent.

Now we need to look at the distributor buying the dead stock. The buyer is under pressure from their customers to get the right inventory and get it quickly. They know the quality and the responsiveness of their normal supplier and need an added incentive to buy from an unknown source where the quality and responsiveness are also unknown. Most distributors agree that they would expect as much as a 20-percent discount of cost.

With the seller willing to sell at cost minus 50 percent and the seller willing to buy at cost minus 20 percent, there is a 30-percent gap left to cover transaction and logistic costs. Since logistics and transaction fees should never be 30 percent, the buyer should be able to get better than cost minus 50 percent, and the buyer should be able to get a price better than cost minus 20 percent. This means both the buyer and seller will be motivated to make these transactions.

Now the tougher question: How to match the cash to the trash? While most solutions for dead stock have focused on identifying dead stock and then posting it either on a fire-sale rack, or on some type of electronic bulletin board, up to this point none had focused on identifying *buyers* of this dead stock. While the seller is the one motivated to make the transaction, it is very difficult to make the sale without knowing who the buyers are.

Enter Internet trading networks, which connect distributors together through an electronic network (the Internet). All of the connections go through one central hub.

Enterprise software solutions contain many pieces of data, with the best systems updating and reporting changes in a real-time, but for this article, two pieces that are critical for matching the cash to the trash is usage (the cash), and dead stock (the trash). By connecting distributors together, a well-managed Internet trading network can match distributors that are buying a particular item with distributors that have the item as dead stock. Once a match is made, the next time the buyer goes online to purchase the item, he is notified what distributors have that item as dead stock and what they are willing to sell it to them for. Since this is a real-time process, the buyer only sees distributors who have the item in stock right at that time.

The seller can also request a list of distributors that have a need for the items he has in dead stock; this way he can proactively sell these items to distributors that have, or will have, a need for them.

Editor's note: The second and final part of this article — a case study of how a group of distributors are attacking dead stock using their P21 network — will appear in the next MDM.

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