COVER STORY

ELIMINATING STOCK OUTS

Making Sure Customers Don't Leave Empty-Handed

BY WALTER E. JOHNSON

Nothing brings a sale to a more abrupt halt than having nothing to sell.

While few would doubt this statement, many retailers allow customers to walk out of their stores unable to buy everything they wanted because the merchant was out of stock. Few retailers realize how great an impact even a small number of out of stocks can have on their overall profitability.

If a typical store has 20,000 SKUs and is out of stock on just one, random item, the chance that a shopper will be unable to find the product he or she is looking for is rather slim. In fact, in this scenario there is only a 0.02 percent chance that the next shopper coming through the door will be looking for a product that is out of stock—pretty low odds by almost any standard.

Throughout the course of an average year, regularly being out of stock on only one product would disappoint less than a handful of customers. And most of these shoppers would be willing to buy a substitute item if it would solve their immediate problem anyway.

Naturally, home improvement stores are not out of just one item, but instead they are typically out of hundreds of products. And what is individually a low-percentage problem adds up quickly. A recent investigation by *Do-It-Yourself Retailing* suggests that many do-it-yourself retailers are regularly out of stock on about 10 percent or more of their items on any given day.

What's the impact of this type of out-of-stock position? Our case studies suggest that typical retailers could increase sales by about 3 percent if they concentrated on reducing their out of stocks.

Our analysis also suggests that many retailers would have to boost their inventory investment by only 15 percent to 20 percent to ensure that they seldom ran out of any products.

For the average hardware store, this kind of commitment would mean a $50,000 increase in inventory and would generate $30,000 in additional annual sales and more than $11,000 in additional profit. A return of 22 percent is clearly a good investment.

In fact, it appears adding safety stock to a store will continue to pay for itself, even at extreme levels. While stock turns and gross margin return on inventory would continue to drop as safety stock is added, the store's overall profitability would not suffer. The increased sales generated by a reduction in out of stocks would cover a 10 percent carrying cost on the additional inventory.

This conclusion is based on the number of times customers would be unable to purchase a product they had intended to purchase and whether they would accept a substitute or go elsewhere for their purchase. See page 56 for a complete analysis.

Establishing a consistent in-stock position would require an average store to turn its merchandise less than 1.5 times a year and stock $55 of inventory per square foot.

Two factors, however, make this radical approach impractical. The first of these limiting factors is that space limitations on a retailer's saleflooor would make it difficult to stock $55 of inventory per square foot. Bill Round, owner of Round True Value in Stoneham, Mass., says he once had inventory levels above $50 per square foot, but found this approach unproductive. He says merchandise high on shelves or stored elsewhere, out of customers' reach, might as well have been in his wholesaler's warehouse, because "you will never sell it like that."

The second problem with extreme levels of safety stock is that a retailer could potentially sell even more merchandise if he used the additional inventory dollars to expand into additional product categories. While that approach takes more commitment and risk, our analysis of safety stock sidestepped this issue. Our focus is on the impact of out of stocks on a retailer's current inventory mix and assumes that retailers have already explored their other merchandising options.

Thomas Blischok, chairman and ceo of MindMeld.com, says being out of stock continues to be the biggest problem at retail.

Still, d-i-y retailers may not want to boost inventory to extreme levels based soley on our case studies. Blischok notes that the second biggest problem is having too much stock. But our investigation suggests retailers may want to experiment by slowly increasing their inventory investment.

NO EXCUSE

Despite the apparent obstacles involved with increasing safety stock and driving up inventory levels, Florida retailer Walter Toole embraces this general strategy.

"There's no acceptable reason for us to be out of stock on anything," says Toole, who operates three Ace Hardware stores in the Orlando market. "That's what customers say, so retailers need to accept this as reality."

As a general rule, Ace Hardware Corp. recommends that retailers stock $40 of inventory per square foot— the same number indirectly suggested by our recent investigation. This analysis recommends stocking enough inventory to annually generate about two stock turns, which means the average store would boost inventory from $34 per square foot to $40 per square foot.

Toole's approach has pushed this number even higher, often over the disagreements of his store managers and Ace's corporate advisers.

Many stores reorder products based on their velocity codes. "A" items are the fastest products, while "B", "C", "D" and "X" items move more slowly. A typical hardware store may reorder "A" items whenever its on-hand inventory drops below three weeks supply. "B" items are reordered when the number on hand drops below a two-week supply and "C" and "D" items when they fall below one week.

At Toole's stores, it is not uncommon for him to have a minimum of three months supply on hand. But Toole does not have standard reorder points. Instead, he uses an old-fashioned strategy.

Whenever his store runs out of an item, he and his staff review the reason for the out of stock.

He and his employees identify these out of stocks in a number of ways. First, they are constantly looking for empty pegs or shelves. Secondly, the store's computer generates a report twice a week noting any items that have an inventory level of zero. The worst way he finds out about an out of stock, though, is if a customer is looking for the product and he can't supply it.

There are three main reasons that an item is out of stock at his stores, accord-

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