BUSINESS GUIDE

6 Steps to Increase Working Capital By Reducing Carrying Costs

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6 Steps to Increase Working Capital By Reducing Carrying Costs

As supply chain disruptions continue to plague businesses, many are seeking to shift from temporary fixes to strategic long-term changes that will help them minimize the impact of supplier backorders, shipping delays and labor shortages. At the same time, many businesses are trying to increase their working capital as they continue to deal with pandemic aftershocks and a lingering sense of uncertainty.

With some challenges out of their control, most businesses have turned their attention to factors they can control, namely profitability, especially as they face limited inventory and therefore fewer sales opportunities. Business leaders are pursuing price increases, which also carries the risk of driving customers and prospects to competitors. Simultaneously, businesses are increasing their focus on lowering expenses by examining variable costs.

That's where carrying costs come in. They're one of the hidden, variable expenses that can have a significant impact on available working capital.

Carrying costs arise from keeping products shelved at a warehouse, distribution center or store and include storage, labor, transportation, handling, insurance, taxes, item replacement, shrinkage and depreciation.

Typical holding costs, another name for inventory carrying costs, vary by industry and business size but often comprise 20% to 30% of total inventory value, and that number increases the longer you store an item before selling it. Despite this, many companies don't give holding costs the attention they deserve. That's because the expenses that go into carrying costs are easy to overlook and they're seen as a mostly immovable "cost of doing business."

But taking steps to reduce carrying costs can help businesses increase available capital. We'll examine carrying costs, how they can impinge on profits and outline the steps you can take to optimize inventory levels and reduce these costs.

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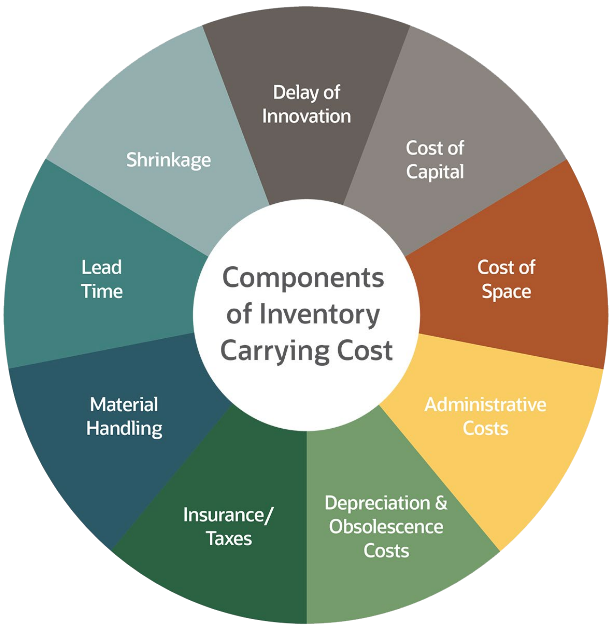
CHAPTER 1

What Are Carrying Costs and How Do They Impact Businesses?

Carrying costs can be sorted into four categories: capital costs, storage costs, service costs and inventory risk costs. Capital costs are funds spent on products and any interest and fees incurred if the company took out a loan to pay for the goods. Storage costs can be fixed, like a mortgage for a store or warehouse, or variable, like labor, utility and administrative expenses. Taxes, insurance and inventory management software are all examples of service costs. Inventory risk includes shrinkage, depreciation and product obsolescence.

Opportunity cost—the investment possibilities a company must decline because its resources are tied up in inventory—is also a factor, though it can be harder to calculate.



Because holding costs often make up 25% of all inventory spend, they can affect a business's overall financial health. Other ways these expenses can impact business operations include:

- Production planning. Once a company understands how much it spends to store inventory, it may rethink its production schedule. In particular, if a certain product can be manufactured quickly and has a lower turnover rate, the business may want to keep only a small quantity in stock. On the other hand, it makes sense to dedicate more warehouse space to an item that's a big seller and has a low carrying cost.
- Profitability of existing inventory. By calculating inventory carrying costs and tracking the value of each product, an organization can better estimate how much profit it can expect to earn from existing inventory. Once carrying costs are deducted, it's easier to measure profit by item.
- Inventory accounting. Inventory is one of the biggest expenses for many companies, so it's important to accurately calculate the cost of holding that inventory, as well as the value of those products. The accounting team needs this data to produce accurate financial statements.

CHAPTER 2

How to Control Carrying Costs

Carrying costs clearly warrant closer inspection and doing so will help reveal the ways you can prevent those costs from quietly escalating. It's not so much about running lean as being smart about the inventory you do keep on hand. Even if your organization takes more of a just-in-case inventory approach, these six strategies can lower inventory-related expenses.

1. Diversify Your Supplier Base

Building supply chain resilience has become a priority for many companies, and finding more suppliers in different geographies for key materials, parts and finished goods is a key component of bolstering that resilience. Sourcing the same product from multiple upstream partners gives you options if you encounter a problem with one. Alternative suppliers can also help with carrying costs: you can carry less inventory because you're not relying on one vendor for an item or worried about running out, giving you the freedom to wait until the typical reorder point instead of stocking up.

Once a business has established relationships with multiple suppliers, it can then monitor their performance with vendor scorecards, which purchasing managers can use to determine who they should order from based on what they need and when they need it. That can also reduce over-purchasing.

2. Improve Inventory Forecasting

Poor demand forecasting is a common driver of high holding costs. With flawed data in its forecasts, a business may expect a spike in demand for a certain SKU and load up on inventory, only to see sales fall far short. Or it may falsely assume that because a specific product was a top seller in the second quarter, that item will continue to fly off the shelves for the next two quarters, or even in the second quarter of the following year.

Accurate forecasts limit excess inventory that consumes valuable space and ties up cash. Forecasts must be not only accurate, but specific.

Broad numbers about the total amount of product needed for a quarter won't cut it. Forecasts should be broken down by channel and item location to get the right inventory in the right place. As for getting that inventory at the right time, forecasts should factor in not only historical sales, but emerging trends.

Finally, you should review forecasts frequently to make any necessary adjustments to the plan, especially in unpredictable situations. All of this should keep holding costs under control, even in times of uncertainty.

3. Leverage Lot Tracking

Lot tracking can really help minimize waste, which is critical to limiting carrying costs. Assigning lot numbers to groups of items makes it much easier to closely monitor them and can be especially important for products that are perishable or have an expiration date. Companies that use the first expired, first out (FEFO) fulfillment method use lot numbers to ensure the items that will lose value or become obsolete soonest are the first shipped out.

In that way, lot tracking can prevent obsolete items with no value from taking up prized warehouse space and contributing to carrying costs. This item-level view can also keep you from losing track of products that have lingered for too long so you can find a way to move them before they lose all value and become obsolete.

4. Track Inventory Performance at the SKU Level

To make optimal decisions about what inventory to hold and how much, a business needs a way to constantly monitor the performance of products at the SKU level. You need to know not just how a certain item is selling, but how sales of it vary across different colors, sizes, geographies and sales channels. And you need access to the latest information at all times to know not only what to stock but where to keep it to minimize shipping costs. You also must know the up-to-date margins on each product to understand how each contributes to profitability and, in turn, working capital.

With all that information in hand, you can then make smarter purchasing and stocking decisions.

By knowing exactly what to stock when, you can limit the amount of unneeded inventory that sits in your facilities and contributes to carrying costs.

You'll have more of the fastest movers available to meet customer expectations but limit the on-hand supply of slow-moving products. It will also help you pinpoint items that should be discontinued due to consistently poor performance. That could delay the move to a bigger warehouse or adding to headcount, which will drive up your expenses. This data can also enable other improvements once products are within your four walls (more on that in the next point).

5. Optimize Warehouse Storage

Warehouse space is more expensive than ever, which means businesses must make the most of the space they have to minimize the impact on carrying costs. That's where warehouse optimization comes in. Companies must consider what they keep where and whether that location makes sense in fulfilling the greatest number of orders as quickly as possible. For instance, are the fastest-moving SKUs located near the staging and packing areas of the warehouse? Consider not just floor space but vertical space as well. When the seasons change and one category of items becomes less popular, it should be moved to a higher rack and replaced with something that is a big seller. A better warehouse layout can also make employees more productive, and labor is one of the primary contributors to carrying costs.

Automation in the warehouse—not necessarily robots and conveyors (though those can be helpful), but the automation of processes—can have a big impact too. Think through all the steps involved in each of your warehouse processes, from receiving to picking to fulfillment and shipping. What steps within each of those tasks are particularly slow and painful? Exploring other picking methods like zone or wave picking and giving warehouse workers mobile devices that guide them through processes can all provide a valuable efficiency boost.

There is almost always room for additional automation, increasing efficiency and thereby reducing labor costs. Technology you already use may have the ability to speed up some of those steps.

6. Keep Returns Out of the Warehouse

Reverse logistics is another discipline that impacts holding costs, so better returns management can lower these costs. For multi-channel businesses, a “return anywhere” model where they can process returns regardless of where the items were originally purchased (for example: an online purchase returned in-store), avoids unnecessarily sending items back to the warehouse. When products land back at the warehouse for returns processing, they also incur additional shipping charges, which get added to the carrying costs and ultimately the cost of goods sold (COGS).

A better approach for sellers with a physical presence is inspecting items at the point of return and, if they’re in good condition, immediately returning them to available inventory. Those goods can then be sold or used to fulfill an order.

By not routing all returned goods through a warehouse or returns processing center, you’re eliminating the carrying costs that would come with that step and making it available for sale faster. There is no need to store the goods in a warehouse for someone to handle them or for other administrative costs that all contribute to holding costs and eat away at working capital. Omnichannel returns present numerous advantages, and this is one of the less obvious benefits.

CHAPTER 3

Lower Carrying Costs With Inventory Management Software

Like with so many fundamental challenges businesses face, technology plays a key role in helping organizations control carrying costs. By providing a centralized view of inventory, suppliers and financials, NetSuite helps you employ the strategies covered here, driving down holding costs and increasing working capital.

An inventory management system is the most important technology for lowering carrying costs. NetSuite Inventory Management tracks individual items across multiple locations in real time.

Having all of that information at your fingertips makes it much more realistic to strike an ideal inventory balance, because it helps employees better time new orders and track metrics like inventory turn and sales volume by product category and individual SKU. NetSuite's solution also supports lot tracking, another way to limit carrying costs.

With business growth comes the need for applications dedicated to functions like demand planning, vendor management, warehouse management and reverse logistics. NetSuite offers these complementary applications within its ERP suite to help you further optimize these aspects of your organization. With NetSuite, all of the inventory data in the system can be pulled into demand planning models, and as the numbers get updated, so will the forecasts.

The software can also keep a list of all vendors and contact information in one place, then monitor their performance over time to predict whether your next order with a certain supplier will arrive early or late. The NetSuite Warehouse Management System (WMS) can maximize productivity in the warehouse by guiding employees through picking and fulfillment and allowing operations managers to leverage different picking methods and lay out the warehouse in a way that maximizes efficiency.

Finally, multi-location inventory capabilities in NetSuite Inventory Management allow a store employee to quickly add returned items back to available stock and put them back on shelves or use them for drop-ship orders.

Conclusion

In light of supply chain problems and steeply rising costs, many products businesses are continuing to look for ways to maximize working capital, and they should take a close look at carrying costs as part of that effort. As a business starts to work on lowering holding costs, it's important to establish a method for measuring these expenses so it can monitor changes and improvements over time. Then it can spot increases or decreases in carrying costs and identify potential causes.

Technology—especially an inventory management system—can support many of the recommendations covered here. Even in the most challenging times, these tools can give you options beyond buying as much product as possible and hoping for the best.

Among expenses that are often overlooked, carrying costs are some of the most substantial, especially for companies that have started carrying more inventory. Finding ways to reduce the money spent on storing and handling goods could unlock a competitive advantage for your business.

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