



An Inside Look at Open to Buy for Direct Marketers

ONE OF A CATALOGER'S LARGEST ASSETS is its inventory — but if not controlled, inventory can quickly become one of its largest liabilities in terms of cash flow and overstock. Although catalogers try to control inventory by planning and buying to the marketing plan, very few actually create, implement, and monitor the controls on inventory purchases to the same degree as on other catalog expenses. Catalogers control with almost daily diligence their marketing, operations, payroll, and creative costs, working with an “open to buy,” or checkbook-spending, budget. Inventory tends to be another matter, as catalogers often scramble to buy more goods to account for a surprise best-seller while their funds are tied up with a product that is not selling. Essentially, you should create a line of credit for purchasing goods that accounts for changes in the forecast.

So why don't catalogers implement open-to-buy inventory-level and purchasing budgets? There are plenty of excuses: “As a catalog, our demand fluctuates by campaign.” “We have to buy based on projected demand.” “We don't have the tools to do it.” Nonetheless, a disciplined method of inventory budgeting can improve fill rates, reduce overstock, and enable a company to better meet cash flow requirements. Creating and enforcing a monthly open-to-buy budget will provide:

- an inventory spending line consistent with marketing and financial plans
- tools to adjust and react to changes within the season
- an acceptable overstock budget that can be tracked
- measurable accountability for management
- tools to prevent overspending/overbuying as well as to ensure that dollars are not being spent twice.

A common approach to inventory buying is to place “initial buys” as a percentage of the total demand needed rather than based on lead times and inventory turns. This has the potential of spending inventory dollars twice. Let's say we have three items that we expect to sell \$20,000 worth of each for the season, and our initial buy covers 70% of the total, or \$14,000, for each. After the mailing, item “A” forecasts at \$30,000 (requiring additional spending of \$16,000); Item B at \$20,000 (requiring additional spending of \$6,000) and Item C at \$10,000. The total buy would end up being \$64,000 to support needs of \$60,000. Should the forecast variances be even greater, so would the resulting overstock and drain on cash.

As in all budgeting, we need to develop the budget well before the expenditures begin, which for most catalogers means anywhere from six to more than 12 months in advance of the season. For the budget to be effective, we need to recognize that estimates or targets being used a year in advance will change as the process unfolds. The ultimate success of this process depends on the ability to track and identify potential problems, thus giving management the ability to adjust to those changes.



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Creating the Budget

We need only a few key pieces of information to establish a sound merchandise budget, provided we use logical reasonability checks along the way. Most of the information will already have been established at the time the corporate budgets were developed. The information needed:

- estimated dollar demand for the horizon/season. If you are planning a year in advance, a good starting point might be to establish a demand estimate “flat” to the current year, which allows changes as the season progresses. Demand should be included from both catalog and e-commerce channels.
- estimated initial product margin percentage at the overall catalog level.
- targeted final fill rates — item fill rather than order fill, based on historical achievements and realistic improvement targets.
- estimated returned to general stock (RGS) percentages, based on history and realistic improvement targets. In the “Spring Marketing Demand” chart at right, the percentage used assumes that 85% of returns will be usable and returned to stock. (The total return rate in our example is 13.5%, netted to RGS of 11.5%).
- estimate of overstock “at cost,” represented as a percentage of gross needs. This is based on historical amounts of overstock created and how profitably the overstock can be liquidated. For example, if your business has outlet stores, you can afford to generate a higher amount of overstock knowing that your cost recovery will be higher than a company that must resort to less-profitable liquidation strategies such as jobbers.
- an estimate of the overstock created in one season, which will be declared as “carry forward” to a subsequent season. Initially this is a subset of the overstock percentage in the previous step, as it will achieve a 100% cost recovery by being sold at full cost/retail in subsequent seasons. As this amount reduces the budget available to spend, it is important to carry forward into the budget only that amount you expect to use in the season being planned. For example, if you have \$250,000 of potential carry-forward but your estimate for sell-through is only \$190,000, you should use the smaller amount. The remaining balance should be reviewed for possible liquidation. This factor will definitely be adjusted as the detail planning begins to take shape later on in the planning cycle.

These factors drive the purchase plan template. The only data that need to be entered are the demand estimate and the carry-forward dollars. All other calculations are driven by the percentages entered and converted to cost for the actual budget.

Let's look at the logic behind the calculations. The table at right reflects two lines for demand, as some catalogers record Internet demand or demand from other sources separately. The result is total gross demand. From the gross demand we subtract anticipated canceled demand (the complement of the fill rate entered).



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Purchase Plan Template

Spring Marketing Demand as of February 2004

	\$MM	@ cost
Initial season demand	\$14,458	\$6,072
Additional demand (e.g. Web)	2,000	840
= Gross demand	16,458	6,912
Less out-of-stock cancels (incl. order rejects)	(1,646)	(691)
= Gross needs for the season	14,812	6,221
Returns to general stock (RGS)	(1,703)	(715)
Carry-forward/repeat items	(1,012)	(425)
Estimate of overstock generated	2,829	1,188
Estimate of defective receipts (2%)	333	140
TOTAL PURCHASE PLAN	\$15,259	\$6,409

Assumptions:

Cost	42.0%
RGS	11.5%
Fill rate	90.0%
out-of-stock cancels (incl. order rejects)	10.0%
Est. overstock (at cost)	19.1%
Markup	58.0%

At initial review, your first question should be “If we reduce the demand to be purchased by expected cancels, isn't this a self-fulfilling prophecy?” In my experience, if the process is managed with realistic and historical fill rate percentages, the answer is no. Look at the subsequent calculations in the template. The return percentage is calculated on net demand (demand less cancels), as merchandise cannot be returned — and therefore reshipped — on demand that was never initially shipped. In the calculations, if the usable returns were calculated on gross demand before cancels, the gross needs would actually result in a lower number.

Now that we have determined gross needs for the season, certain factors will further adjust the budget. A part of the existing inventory that has already been purchased will be carried forward into the season being planned. As we have already purchased the inventory, we don't want to spend the cash again, so we reduce the current season budget by the corresponding “usable” amount. If we overstate this amount, we will potentially under-buy in the current season; if we understate the



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amount of usable carry-forward, we run the risk of overbuying. The carry-forward part of the equation is the one most often changed early on the process as the item planning is refined.

The next largest factor is the estimate of overstock created during the season. It is a fact of the catalog business that overstocks will be created by forecasting issues, vendor minimums, vendor pre-packed assortments, and the like. The purpose of this estimate is to set a budget that becomes another target to monitor and to ensure that management has a liquidation plan for the overstocks ultimately created. By reviewing historical overstock and liquidation patterns, management can be assured that the resulting overstock can be carried forward or liquidated through the company's established channels — sale books, Internet, jobbers — without further cash drains and profit implications to the overall company budget. Since the point of this exercise is to manage the merchandise-purchasing budget for greater control, the overstock budget becomes a key factor to monitor and is just as important as the spending budget we ultimately create.

The final part of the template is an estimate of defective receipts (damaged goods, quality rejects, etc.) For most businesses this should be a small factor, if a concern at all, but by including it in the budget, we recognize that this merchandise will need to be replaced to achieve the fill rates targeted in the budget. Our example uses 2% of gross demand, an acceptable industry average.

Companies that would like to take this control to an even higher level or that anticipate a large variance in their first several undertakings could prepare two budget templates. Base the first on the realistic company financial budgets, which will be critical for achieving corporate goals; make the second slightly more conservative, by tweaking some of the percentages in the model — using higher RGS rates, for example, lower overstock estimates, or higher margin percent targets. This more conservative budget becomes the corporately issued guideline. Should it be necessary to allow additional spending or adjustments, the company will remain within its financial covenants. On the other hand, if the more conservative budget is achieved, the difference flows directly to the bottom line.

Since you'll have drawn up the budget months ahead of the season, by simply adjusting the demand you can drive the merchandise spending budget up or down as the season progresses. These changes will highlight potential problems before they happen.

Tracking to the Budget

Having created the budget, we can benefit only by tracking purchases and projected overstock estimates back to it on a regular basis, such as weekly. This may require you to change or create reporting systems. Simple tracking requires only a few pieces of high-level information, such as the total merchandise received and the total on order from the vendor. But if you institute the discipline



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within your organization, these tools can provide management with a historical record of why fill rates might not have been achieved or why overstock levels were higher than planned.

Purchase Commitments

Changes to Buying Plan – Spring Media Season

Date	Demand	Buy to	Purchase
08/15	22.1mm	22.1mm	9.0mm
11/22	23.2mm	23.2mm	8.9mm
12/16	23.1mm	25.0mm	10.0mm
01/14	21.1mm	22.9mm	9.1mm
02/01	19.9mm	19.9mm	8.6mm
02/22	17.6mm	17.6mm	7.7mm

Purchase Tracking

To date	week ended	01/07	01/14	01/21	01/28	02/04	02/11	02/18	02/25
Receipts	\$3,868	4,181	4,294	4,613	4,713	4,936	5,256	5,479	
On order	\$2,550	2,162	2,287	3,054	3,032	2,790	2,546	2,419	
Purchase order cancellations	(\$93)	184	194	329	418	450	447	461	
Accepted overshipments	57	63	64	83	84	102	104	117	
TOTAL COMMITTED	\$6,382	6,222	6,450	7,421	7,411	7,378	7,460	7,553	
Percentage committed to date	64.0%	62.4%	70.8%	81.5%	81.4%	85.6%	97.2%	98.4%	

Note: Some dollar figures may be rounded.

Looking at the “Purchase Commitments” chart above, the first piece of information to track is shown in the box directly to its right, “Changes to Buying Plan.” Here we simply record any time the overall marketing plan changes to any significant degree. We record the demand and the calculated revision to the purchase budget. We also record a buy-to notation, which in most cases will be the same as the demand target. But there may be times when management authorizes buying to a higher or lower budget prior to the official company change. This record keeping can help to explain variances in achieving fill rate goals or overstock after the season is over.

The basic model in the “Purchase Commitments” chart requires data that should already be available in existing systems but may require some IT manipulation for weekly reporting. The key to success is creating a way to report the information by the season or horizon being tracked. (Note: Many



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companies don't segregate their purchase orders by season. This information can usually be captured by creating an identifier in the purchase order record when written by the buyer/inventory controller — something as simple as “F4” for fall 2004, “S5” for spring 2005, and so on.)

Reviewing the details on the tracking template, we note that all information is as of the week-ended date. Line one represents aggregate receipts; line two reflects total open purchase orders; line three shows any purchase orders that have been officially canceled (canceled purchase orders will increase the spending balance in the same manner a canceled check returns the money into a checking account); and line four reflects overshipments that have been accepted into inventory (these will in turn decrease the available spending balance, as we have in essence authorized the additional spending by accepting the overshipment). While line five shows the cumulative committed spending in dollars, line six reflects that total as a percent of the current budget.

The chart indicates that as of Feb. 18 we were committed to 97% of our total budget, which could raise issues of overspending potential as we consider the need to cover future backorders and new products being added in later books of the season. It also raises awareness should the overall season demand estimate be lowered; we could potentially be in an “overdrawn,” or overspent, condition.

Conversely, if the demand estimate is raised, it would illuminate a potential “chasing” situation. After several seasons of tracking this information, you will begin to gain historical perspectives of where you should be within the purchase-to-season cycle to balance ultimate fill rates and overstock.

Depending on your business and your desire for sophistication, you can enhance this template to track purchase commitments for piece goods or raw materials, import loads (difference between merchandise cost and landed cost when importing), and transfers between other divisions, as your business may require.

As in any profit objective, the ultimate success or failure with an open-to-buy plan results in communication of the issue, raising awareness, and coordinating a common goal throughout the entire organization. Catalog companies employing these controls have seen not only increases in overall fill rates — and therefore increased customer satisfaction — but also improvements in terms of reduced overstock, fewer split shipments, increased warehouse efficiencies, and overall profitability.



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Vocabulary List

Demand:

That which the customer has requested, regardless of whether we can immediately ship it. It is important to record all demand except for cases in which the customer calls to go through a shopping list before starting the order process (which is not true demand and could cause you to overstate needs). Companies not capturing all demand expose themselves to a number of issues, including increased list rental and acquisition costs, overstated fill rates, increased overstock, and incorrect merchandise performance assumptions — which could lead to dropping potentially strong-selling items.

Fill Rate:

For inventory budgeting purposes, we mean item fill rates, not order fill rates. For example, if an order had two of three items that could be shipped immediately, the initial item fill rate would be 66.6% vs. an initial order fill rate of 0%. Presuming the third item was ultimately shipped, our item final fill (and in this case our order final fill rate) would be 100%.

Overstock:

We refer to overstock created or generated “at cost” vs. the ultimate profit-and-loss statement “cost of” overstock. In our buying model, we also create a budget for overstock, which is a fact of life in the catalog business.

Returns:

In a merchandise-purchasing budget our return rates reflect “usable” returns that can be “returned to good stock” (RGS) and reshipped vs. the overall return rate.