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BUSINESS GUIDE

Boost Cash Flow With Better Inventory Management

5 strategies to expedite returns on your product investments

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The way business leaders and watchers talk about cash flow today, it's as if cash on-hand didn't matter before. While that's not quite true, when capital is cheap and easy to access, the impact of business decisions on available cash can be a secondary consideration.

As the Federal Reserve raises interest rates at the fastest pace in several decades to tamp down inflation and banks tighten their lending standards, that mindset has changed. Just like that, capital has become more expensive, the fire hose of equity financing dried up, and cash preservation is again a top priority.

Manufacturers, distributors, and retailers understand that their inventory represents a lot of money and that managing it better can directly boost available cash. There are many ways to reduce inventory spend, like lowering carrying costs, refining forecasting methods, and increasing the accuracy of inventory data. All of these strategies have a positive effect on one key metric: the cash conversion cycle.

Any business that wants to improve its cash flow should watch this metric closely.

The cash conversion cycle looks at the length of the entire inventory lifecycle — from purchase order through customer payment — to determine where problems arise. Are too many supplier orders arriving later than the promised date? Is a certain category of product sitting in the warehouse too long due to waning demand? Are customers regularly paying after the due date?

In this guide, we'll explain what the cash conversion cycle is and why it is of particular importance right now. We'll also lay out inventory management strategies that will shorten your cash conversion cycle.

Understanding the Cash Conversion Cycle

The cash conversion cycle, or cash-to-cash cycle time, measures the number of days it takes to recover the money a company spends to buy inventory. The cycle starts when you pay for the supplies or finished goods and ends when you receive payment for it from the customer, which is often a lengthy stretch. It's an important measure of operational efficiency and has a big impact on liquidity. The shorter the cycle, the better, because that's less time your money is tied up in inventory and you recoup the initial investment and hopefully earn a profit faster.

Calculating your cash conversion cycle combines three metrics: days inventory outstanding (DIO), days sales outstanding (DSO), and days payable outstanding (DPO). Let's break down each of those:

- DIO looks at how long a company holds inventory, on average.

DIO = (Average inventory value / Cost of goods sold) x Number of days in period

- DSO measures the average amount of time it takes to collect payment from the customer.

DSO = (Total accounts receivable value / Total credit sales value) x Number of days in period

- DPO is how long your business takes to pay suppliers for the materials, parts, or finished goods you purchase.

DPO = (Average accounts payable balance / COGS) x Number of days in period

Once you've calculated those three numbers, you can figure out your cash conversion cycle.

CCC = Days inventory outstanding + Days sales outstanding – Days payable outstanding

What qualifies as an average or speedy cash conversion cycle will vary by industry and what you're selling. Inexpensive consumables may have a fast CCC but low margins, while a piece of industrial machinery with a complex manufacturing process will have a slower CCC but much higher margins. Data from APQC says the median CCC is 53 days, with the top quartile taking 34 days and the bottom quartile 74 days, so those parameters make a good starting reference point.

How Does Inventory Management Impact the CCC?

The primary and most obvious way inventory management affects your CCC is through the amount of stock you buy and how long you hold it, which are often correlated. If a certain SKU is selling slowly and you order too much of it, your DIO will increase, and inventory often has diminishing returns the longer it sits. Bills for this slow-moving stock may come due well before a buyer pays you for it, also lengthening the CCC.

This is why an accurate and up-to-date view of what you have on hand at any moment is so crucial. It helps you monitor and lower carrying costs and make informed decisions about what to include in your replenishment orders and when to place them. Reliable inventory records can keep you from running out of the fastest movers or having an oversupply of less popular items. Both situations reduce available cash through lost sales and poor returns on your inventory investments, especially since excess stock is usually offloaded at a discounted price.

5 Ideas to Shorten Your Cash Conversion Cycle

A big piece of a faster CCC is turning inventory more quickly, because selling items faster not only lowers DIO but also means you get paid that much sooner, so many strategies center on that. Here are five ways to speed up your cash conversion cycle:

1. Improve Demand Forecasting

Poor demand forecasting is one of the biggest culprits of a slow inventory turnover ratio and a higher DIO because inaccurate projections leave you with the wrong items on hand. Forecasts premised in "feel," broad insights on the market, or past trends — like expecting a top-selling style from last winter to continue to fly off the shelves this winter — all lead to problems.

Relying on rudimentary tools for forecasts, like customized spreadsheets, or using incomplete, inaccurate, or outdated data — a problem with spreadsheets — are also common causes of inaccurate projections.

To determine what items to order and in what quantities, you first need up-to-date and thorough historical sales data down to the item level. Ideally this includes not only internal data, but forward-looking information from other sources, like U.S. Department of Commerce monthly retail sales for your sector.

Finally, you should review forecasts frequently so you can make any necessary adjustments to planned orders. This is especially important now, when overall demand and demand for specific items can shift quickly. Better estimates of future demand will generate faster sales that lower your CCC.

2. Refine Reorder Points for Replenishment

Forecasts shape your initial orders, but you also need to know the right time to replenish SKUs to maintain a strong turnover ratio. Reorder points, which factor in product popularity and lead time, help you figure out the ideal timing.

Reorder point = (Number of units used daily x Number of days lead time) + Number of units safety stock

Like inventory forecasting, the right reorder points strike a delicate balance between keeping enough stock to meet demand while limiting excess.

This is why you need to continuously evaluate and update your reorder points as lead times and demand fluctuate. This is especially important in a time when supplier turnaround times, while improving, are still not as short or consistent as they were before the pandemic.

Also note the importance of inventory accuracy to reordering at the right time. Frequent cycle counts help ensure accurate inventory records so you're using the latest data when deciding to replenish. Timing it right will free up cash.

3. Refine Product Portfolio and Pricing Strategy (80/20 rule)

Another way to accelerate the return on your inventory investments is by evaluating your product portfolio to make sure you're selling the right products. This requires constantly monitoring the sales and profitability 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 features like colors and sizes, geographies, and sales channels.

In the context of inventory, the Pareto Principle posits that for most businesses, 80% of profits come from 20% of products. Using the Pareto Principle to categorize your inventory is a great way to create an initial pool of goods that may warrant less investment or should be phased out entirely. However, it's not as simple as identifying the bottom 20% or 30% of SKUs and cutting them. Some items may be highly seasonal, accounting for the bulk of sales in the summer but contributing little in the winter. Others may be complementary, not earning a place in the top 20% themselves but contributing to sales of related, highly profitable items.

With mid-performers, there may be opportunities to increase sales via fresh marketing or promotional campaigns, a product revamp, or packaging them with related goods.

There are factors aside from profitability to consider before cutting a product. Where is it in the marketing lifecycle? Does it share common components or materials with other high-performing items? Do any key customers depend on you to supply it?

Most businesses have at least a handful of low-margin products that it no longer makes sense to offer, but be judicious.

Pricing is another area to zoom in on. You may want to increase the price for top sellers with low margins, experimenting to see how it affects demand. If you cannot keep up with current demand, a slight drop in sales may not be a bad thing. At the same time, you can cut prices for products with great margins that aren't moving well to see if that boosts sales. Note that price optimization should be applied selectively where the data suggests it would make a difference.

4. Minimize Obsolete Inventory

Obsolete inventory is a major problem for the cash conversion cycle because it increases DIO and may eliminate the receivables aspect altogether since this inventory is often donated or destroyed. And the cost of obsolete inventory only climbs when you consider it's adding to carrying costs and occupying increasingly expensive warehouse space that could be used for top sellers that put more money back in the business's pocket.

Companies that attempt to track inventory manually are almost certainly operating from incomplete or outdated inventory data. This can increase the amount of obsolete inventory for multiple reasons. First, you'll lose track of more goods, and by the time you find them, they will likely have lost some or all their value. Second, forecasts and reorders are based on unreliable information, increasing the chances of excess or difficult-to-move inventory that becomes obsolete.

Reliable and detailed inventory tracking makes it far easier to monitor all products and relevant information, like how long you've held items, so you can find a way to move the stock before it's too late. In addition, better forecasts based on accurate and real-time information help limit the amount of unneeded inventory that sits and ages in your facilities.

While writing off small amounts of inventory is unavoidable, most companies have unnecessarily large amounts of obsolete inventory. And fewer obsolete items equal a shorter CCC.

5. Explore Ways to Improve Sales

It's an obvious solution, sure, but an important one nonetheless. The real question is: How can you increase sales? You might start by reviewing customer feedback on products to figure out if there's a reason a certain item isn't selling as well as expected. Does it not solve the problem customers expect it to? Does it break easily, or are the wrong people buying it? You may even consider reaching out to select customers for in-depth surveys or interviews to learn more.

Perhaps your sales team knows little about a new product line and consequently struggles to answer customers' questions about the new items or avoids selling them altogether. An educational session led by those who developed or manufacture the product could go a long way.

Closely monitor the performance of your items at an individual level, too. That requires a system that can crunch numbers like sell-through rate, gross margin return on investment (GMROI), or another metric of your choice at a detailed level and continuously update them. Then you can see what SKUs require a closer look and assess strategies to lift sales.

The other steps outlined here, like more accurate forecasts that keep the right products in stock, selectively cutting down your product catalog, and adjusting prices for certain goods will all help boost sales, as well.

Expediting Your CCC With NetSuite ERP

Tracking the cash conversion cycle for the various items you sell, much less improving it, will prove very challenging without inventory management software. You need a system that can monitor DIO for each SKU in your warehouse. This inventory system should be connected to your accounting system so you can get the information on payables and receivables required to calculate CCC. This is where an ERP shines by bringing together inventory, financials, and sales.

And NetSuite Inventory Management brings other benefits beyond crunching the numbers to help speed up your cash conversion cycle. It tracks the movement of inventory in real time, providing the accurate data that forms the foundation for better forecasts. NetSuite's Demand Planning module considers historical sales and future-dated transactions for various SKUs to determine inventory needs based on the sales forecast. As the numbers change, forecasts will reflect that. You can even break these projections down by channel to further optimize inventory levels.

NetSuite makes it easy to see reports on top sellers, item profitability, inventory turn, and other critical metrics. The system comes with dashboards to track common KPIs, and you can add your own metrics with just a few clicks. Having all that information at your fingertips makes it much more realistic to strike an ideal inventory balance that will generate a faster return on your investment.

These insights can help you devise strategies to increase sales and guide strategic changes to your product portfolio.

NetSuite ERP has everything necessary to act as the product lifecycle management system, as each inventory record holds all relevant data regarding COGS, MSRP, bill of materials, release date, and historical performance.

Operations managers can also automatically determine reorder points for items and alert purchasing managers when it's time to replenish. If lead time or daily use changes, NetSuite automatically updates the reorder point so you maintain optimal inventory levels. These steps all help minimize excess inventory that may become obsolete, giving a substantial lift to your bottom line.

Customer Story: HydroJug

Two brothers looking for an alternative to disposable plastic water bottles started HydroJug in a Utah garage in 2017. The brand's reusable glass, stainless steel, and plastic containers have since developed a loyal following with an expanded catalog of bottles and accessories, including many limited-release products.

As HydroJug released new products, it had to manually create and record item details, barcodes, and other information for each item long before it started selling them. Managing this data in spreadsheets was one challenge that signaled the need for an ERP system. Another was the increasing difficulty of developing demand and supply forecasts for a growing list of items with tools that didn't scale.

HydroJug made the jump to NetSuite ERP because similar businesses had success with the system and it had a proven integration with Shopify, which the company uses for ecommerce. While HydroJug still uses a custom forecast engine, a script automatically pulls the data from NetSuite. What previously required four or five days of transferring, sifting through, and manipulating data to submit the right purchase orders now takes just one day. The operations team simply reviews the numbers in the demand and supply forecasts, makes any necessary adjustments, and submits POs to its vendors.

The projections are also much more accurate with NetSuite, helping the retailer turn inventory faster. That gives HydroJug more cash to invest in other products customers want — informed by automated NetSuite dashboards that help the company quickly respond to fast-moving trends.

"We've just been really, really dialing in on making sure we're turning our products fast enough so that we can get the money out of those and then invest those into new products to help support the customer," said Director of Supply Chain Ryan Holmes. "The customer always has to be at the forefront in your mind, but there's so many things that lead you to being able to support whatever that customer needs."

Co-founder Hayden Wadsworth sees careful management of inventory and cash as key in the face of today's economic uncertainty, and NetSuite provides the insights to help with that. For example, access to real-time on-hand and in-transit inventory numbers and performance metrics helps HydroJug decide what items to discount or through which channels to sell specific goods. As the surge of pandemic-fueled ecommerce sales slowed, HydroJug also built up its wholesale channel from 5% to 20-30% of total revenue.

Wadsworth and Holmes credit NetSuite with helping HydroJug quickly resolve the complexities of B2B — for example, transacting with large retailers via EDI — and giving it the reporting tools to back these big decisions.

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