

HOW TO BE PROFITABLE DURING BOTH GOOD AND BAD TIMES – OPEN-TO-BUY

by Linda Carter

© The Retail Management Advisors, Inc.

email: LC@the-retail-advisor.com

In last month's newsletter, I described the preparation of an annual Gross Margin Plan, the first step in planning to be profitable. As a re-cap, the five steps are:

1. Prepare an annual Gross Margin Plan
2. Use an Open-To-Buy
3. Prepare an annual pro-forma Income Statement (budget, done by month)
4. Prepare an annual Cash Flow Projection (done by month)
5. Track the productivity of their selling staff

This month, I will discuss in more detail the Open-To-Buy.

Open-To-Buy

The Open-To-Buy is very simply the buyer's buying plan and should be used to ensure you have the "right" amount of inventory to support your sales plans. The goal of the Open-To-Buy is not to keep you from buying! The goal is to ensure the correct inventory level so you do not have too much or too little inventory.

While preparing and following an Open-To-Buy is no guarantee of success and lack of a plan is no guarantee of failure, we feel Open-To-Buy planning is essential to ensure the optimum level of inventory to support monthly sales plans and to maximize the return on capital invested in merchandise inventory.

Below is a sample Open-To-Buy for a single classification for your review.

CLASS xxx - SAMPLE											Today's Date: 05/03/2008		
PLANNED:				IMU%	MD%	GP%	STR						
	Feb	Mar	Apr	May	Jun	Jul	Aug	Sep	Oct	Nov	Dec	Jan	Total
SALES													
3 YRS AGO	1126	1053	722	608	425	1642	1078	1439	1622	1614	4238	1411	16978
2 YRS AGO	1267	1184	813	684	478	1847	1212	1619	1824	1816	4767	1588	19100
LAST YR	1408	1316	903	760	531	2052	1347	1799	2027	2018	5297	1764	21222
THIS YR PLAN	1500	2000	1200	1000	750	2150	1350	1850	2100	2100	8500	1900	26400
ACTUAL	1625	2133	1287										5045
% VARIATION MO	8.33	6.65	7.25										
% VARIATION YTD	8.33	7.37	7.34										
MARKDOWNS													
LAST YR	259	157	385	10	157	385	185	838	325	124	98	125	3048
THIS YR PLAN	210	280	168	140	105	301	189	259	294	294	1190	266	3696
ACTUAL	85	202	118										405
BOM INVENTORY													Avg. Inv.
LAST YEAR	8124	7251	9251	10500	9253	8754	11124	12153	14854	19215	21054	14195	12144
THIS YR PLAN	7464	6314	4994	5193	6111	8053	7521	9038	9944	12661	17642	9464	8700
THIS YR ACTUAL	9467	7432	6285										
ON ORDER				775	1950	1289	500						4514
OPEN-TO-BUY				1283	847	630	2556	3015	5111	7375	1512	166	22495

Below is the Total Store Open-To-Buy result for this store. This is calculated by using simple addition to add up all the figures from the store's individual classifications. We will be using this information later when completing the budget.

TOTAL STORE (calculated by adding up all the individual classifications)					
	Planned	Planned	Planned		Open-To-
	Sales	MD \$	BOM	Inventory On Order	Buy
Feb	61,000	8,540	336,800		92,240
Mar	73,000	10,220	359,500		82,620
Apr	75,000	10,500	358,900		79,100
May	74,000	10,360	352,500	5,500	74,460
June	86,000	12,040	348,100	14,000	78,240
July	64,000	8,960	342,300		93,160
Aug	62,000	8,680	362,500		119,980
Sept	69,000	9,660	411,800		114,160
Oct	77,000	10,780	447,300		107,980
Nov	89,000	12,460	467,500		96,860
Dec	152,000	21,280	462,900		38,380
Jan	68,000	9,520	328,000		86,320
Total	950,000	133,000	Avg.Inv 381,508	STR 2.5	1,063,500
		14%			

A good Open-To-Buy format will give you management information in addition to buying information. Our example shows 3 years of sales history to help you spot any developing sales trends and variance percentages to plan for both the current month and year-to-date. The sales variance percentages help you see how sales are doing when compared to plan so you can change the plans upward or downward as needed during the year. The goal for Open-To-Buy is to keep the actual sales variance to plan no more than plus or minus 10%.

Every retailer needs to use an Open-To-Buy. The small retailer cannot afford any mistakes because his sales volume and cash flow are critical. The large retailer needs it due to his very size, which makes planning and control all the more critical.

Retailers tend to overstock when sales increases are good and to decrease inventory too much when prospects are bad. Thus, a relatively small increase in sales often leads to excessive buying - then when sales slow down high markdowns are taken to clear out this excess supply of merchandise. This, in turn, leads to lower gross profit and lower overall store profit or losses. The goal of good merchandising is to maintain the level of inventory that provides adequate assortments when sales are low and not excessively high assortments when sales pick up. This is where the Open-To-Buy comes into play. It tells you how much inventory should be on hand at the beginning of any given month and how much new merchandise should be received during the month.

BENEFITS OF USING OPEN-O-BUY

1. Able to estimate in advance the amount of cash that will be required to be invested in inventory from month to month for the coming season.
2. Helps to ensure an adequate amount of inventory on hand to support the level of planned sales.
3. Places restraints on merchandise commitments so the store does not receive too much new merchandise too early in the season -- or not enough.
4. Keeps a fresh flow of new merchandise coming into the store throughout the season. This keeps the customer interested in coming back again and again, keeps the sales staff excited and also helps your cash flow.
5. Establishes goals so actual performance can be compared to the plan, thereby pointing out those areas where corrective action needs to be taken.

PLANNING LEVELS

An Open-To-Buy can be prepared at many levels. It may be planned at the company level by a multi-store operation or at the store, department, classification or buyer level, or a combination of some of these. However, to be most effective, a buying plan must be prepared at the classification level. If there are multiple stores that are geographically close so transfers can be made on an as needed basis, the Open-To-Buy is effective at the corporate/classification level. In other words, even though a classification may be carried in 3 stores there is only 1 Open-To-Buy plan for that classification.

RETAIL, COST OR UNIT OPEN-TO-BUY?

There are techniques for preparing an Open-To-Buy based on each of three elements: units, cost or retail; or on a combination of two of these three elements, such as units and cost or units and retail or cost and retail.

We believe an Open-To-Buy should be prepared at retail. In a sales organization sales are made at retail and inventory is needed to meet sales plans; therefore, it makes sense that inventory should be managed at retail and buying plans to meet sales goals should be made at retail.

OPEN-TO-BUY TIMEFRAME

The Open-To-Buy can be prepared for almost any timeframe: week, month, season or year. We recommend it be prepared on a monthly basis, for at least 12 months out into the future. Once you have the Open-To-Buy prepared by month you can easily combine the months into seasonal Open-To-Buys. For example, if the season for a classification is 4 months long, just add together the monthly Open-To-Buy amounts for the month preceding the season plus the first three months of the season. This will give you your Open-To-Buy for the season. We “back up” a month since normally, what you receive this month is to support next month’s sales.

THE OPEN-TO-BUY FORMULA

The Open-To-Buy amount for each month is really the open-to-receive. It is the amount of new merchandise that should be received each month in each classification. The formula for computing Open-To-buy is:

$$\text{OTB} = \text{Planned Sales} + \text{Planned Markdowns} + \text{Planned EOM Inventory} - \text{Planned BOM Inventory} - \text{On Order}$$

The formula to calculate Open-To-Buy is simple. The planning of the various elements that are included in the formula are not so simple. Following we will take a look at the components of Open-To-Buy.

SALES PLANNING

Determining the sales plan is the most critical decision the merchant must make, not only for OTB planning but for every other aspect of the business. Expense budgets, the number of employees, etc. are always planned in relation to sales. If sales are planned too low they become a self-fulfilling prophecy. The store will be merchandised for the lower sales level, and will not have sufficient goods on hand to meet a higher demand. Conversely, if sales are planned too high, too much merchandise will be bought and the retailer may find himself unable to pay the bills when the planned sales level is not achieved.

Historical sales records are usually the starting place for setting sales plans. However, the sales plan must also take into consideration a host of variables which the retailer is in the best position to be aware of and to judge. Things such as local and national economic conditions, changes in competition, fashion changes, plans to expand customer credit, changes in selling personnel, etc. all impact the sales plan.

MARKDOWN PLANNING

Markdowns need to be planned and included in the OTB calculation. WHY? Markdowns reduce the retail amount of inventory on hand, just as sales do. Therefore, if they are not included in Open-To-Buy planning the store would not bring in enough new merchandise for any particular month.

Although markdowns do not occur evenly throughout the year, we recommend that they be planned as a static percent of planned sales for each month. This then acts as a markdown reserve and ensures adequate levels of inventory each month. As an example, for Open-To-Buy purposes, if 60% of the season's markdowns are planned for the last month of the season there will be a large Open-To-Buy for that month. However, when it is the end of the season, the retailer does not want to bring in more merchandise just so they can mark it down. In other words, the merchandise that you will be marking down at the end of the season is the merchandise that was received 3, 4 or 5 months ago. Unless you have reserved a significant amount of your Open-To-Buy dollars for the purchase of off-price goods in season, the merchandise on sale is not normally the merchandise that you just received.

PLANNING INVENTORY LEVELS

Inventory amounts make up two parts of the Open-To-Buy formula. One is beginning inventory. The other is ending inventory, which is really the beginning inventory for the next period. Too much inventory on hand spells a poor return on investment and high markdowns. Too little means missed sales.

How much inventory is enough? Oversimplified, you could divide the annual sales plan by the desired stock turn rate to get the monthly amount. For example, for an annual sales plan of \$54,000 and a stock turn rate of 3.0 the average beginning-of-month inventory should be \$18,000 (\$54,000 divided by 3.0). This would be fine if sales for each month were \$4,500 (\$54,000 divided by 12), but it never happens that way.

Ideally, beginning-of-month inventory should be higher in the months sales will exceed the average and less in the months you plan less than average sales. However, it doesn't take twice as much inventory on hand at the beginning-of-the month to do twice as much volume.

Management must complement this mathematical process or formula with that mysterious sixth sense called "feel". There is no substitute for knowledge gained from past mistakes, talk with other merchants and good, common horse sense and judgment.

The users of certain computer software systems enjoy the benefits of more sophisticated techniques that we have developed for their users. This makes it easier for the retailer since the software program handles the complicated task of planning the optimum monthly inventory levels, based on the retailers plans. For others, we offer an Open-To-Buy service that allows us to "look over your shoulder" to make sure you are following your plans and revising plans as necessary.

ON ORDER

The Open-To-Buy for each month must be reduced by the amount of merchandise on order scheduled for delivery during that month. Open-To-Buy can not be used effectively to control inventory unless a purchase order is generated for every order placed. If all orders are not recorded as soon as they are placed, the Open-To-Buy amount will be overstated and overbuying will occur, leading to future high markdowns and lower profits.

A very important part of using the Open-To-Buy is determining how much of your Open-To-Buy to commit to advance-of-season purchases. This amount cannot be determined statistically by computer. To decide, get the latest input from the market place. You must consider textile availability, delivery schedules and how much merchandise will be ordered in-season (re-orders, special orders, new mid-season items, vendor close-outs).

Retailers can be more successful with a well-formulated Open-To-Buy plan, skillfully combining statistical techniques with the human element of sensitivity and insight. If you are not using a monthly classification-level Open-To-Buy you are missing a valuable extra-profit opportunity.

Next, we will discuss, developing an annual pro-forma Income Statement (budget, done by month).

© The Retail Management Advisors, Inc., All Rights Reserved
510 Red Oak, Allen, TX 75002
Phone: 877-206-1299