

Operations Practice

# Turn slow-moving inventory into fast profits

For industrial-services organizations, slow-moving inventory can be a drag on financial performance. Why not transform it into a profit booster?

*by Paolo Baldesi, Florent Kervazo, and Hugues Lavandier*



**For many industrial companies,** aftermarket services are where the money is made. To perform well, they require access to the right spare parts at the right time to meet customers' service expectations. The result? Service organizations inevitably invest a lot of capital in inventory. But if they aren't careful, ballooning inventory can put significant strain on cash resources and drive down return on invested capital (ROIC).

In our experience of working with the aftermarket arms of industrial OEMs, a large part of the challenge comes from the 10 to 40 percent of inventory made up of slow-moving items. These are parts that are rarely sold, but which the organization must hold in stock to meet contractual obligations or capture commercial opportunities when they arise.

Slow-moving inventory is a particularly pernicious challenge for industrial players. Complex, highly-customized products with long operating lives mean that SKUs tend to proliferate over time, as companies attempt to stock components for every version of every item of equipment they produce. And because customers operate equipment in different ways, demand for slow moving parts can be highly volatile, encouraging companies to take a "better safe than sorry" approach when it comes to setting inventory targets.

### **Difficult to shift**

Many organizations' approaches to tackle high levels of inventory don't work very well, either because they address only part of the problem, or because they fail to recognize that the dynamics of slow-moving inventory are fundamentally different from fast-moving items.

For example, some companies attempt to impose an across-the-board reduction in inventory levels, but that can result in lost sales of fast-moving parts. Others hand over lists of excess inventory items to their sales teams and ask them to sell the items any way they can—without tailoring the lists to the installed base covered by each sales team. Puzzled sales teams typically respond in one of two ways, either ignoring the list in favor of bigger-ticket opportunities, or looking for the quickest, easiest

ways to dispose of the inventory, so little of its value is recovered.

### **Time to get smarter**

Facing cash shortages, one large industrial-equipment manufacturer took a more nuanced approach to its spare-parts inventory. Over a period of only six months, the company adopted a suite of measures to address the causes of inventory accumulation and stimulate sales of slow-moving parts. As a result, slow-moving inventory fell by one-third in three months, and spare-parts revenue increased by about 3 percent overall at gross margins of more than 60 percent.

Before the company began the program, its aftermarket inventory had grown unchecked for years. Moreover, the usual challenges of the sector were compounded by internal process and management issues.

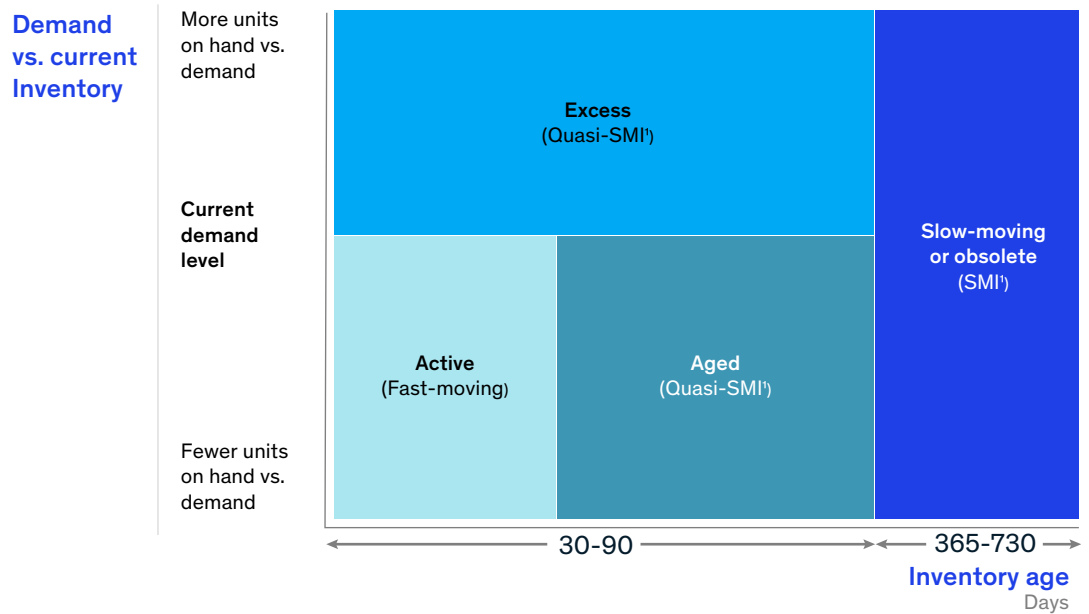
Previous management incentives emphasized revenue and margins over cash, with commercial teams sometimes ordering two lots of parts for the same equipment at the same customer: one set for a basic scheduled overhaul, and an additional set of more advanced parts, just in case the customer was willing to pay more for better performance. Adding to high levels of inventory, operations teams kept large buffer stocks to make up for problems such as low forecast accuracy, lack of communication with sales teams, poor delivery performance by suppliers, and a limited view of the inventory held at different sites. Then there was a growing pile of obsolete spare parts, including customized parts from cancelled orders and items inherited through acquisitions.

### **Identifying the culprits**

The company began its improvement effort with a rigorous segmentation exercise. It classified every SKU by age (the average time an item was held in inventory) and by demand (the current inventory position compared to historical and forecast demand for the part). That work helped to identify active fast-moving inventory, excess inventory of fast-moving parts, and a long tail of aged, slow-moving or obsolete parts (Exhibit 1).

Exhibit 1

## Age and demand determine whether inventory is 'slow-moving.'



<sup>1</sup>Slow-moving inventory

### Turning off the tap

Once the slow-moving culprits were identified, the company implemented a series of initiatives to cut off the source and prevent further unwanted accumulation of inventory. A service-level review identified the most appropriate balance between the need to support installed equipment and the cost of inventory. Cash metrics were included in the incentive schemes of its commercial and operations teams, and new measures limited SKU proliferation, discouraging minor equipment changes or new-product introductions with limited sales potential. The company also improved its sales and operations planning processes to ensure the organization could react quickly in the case of order changes or cancellations. And a purchase-order control tower stopped unnecessary orders for slow-moving items when sufficient inventory was already available.

### Reduction strategies

In parallel, the company launched a second set of initiatives designed to release its excess inventory of

slow-moving parts in a way that maximized residual value. Some of the techniques were straightforward, such as moving parts to regions that actually needed them, or finding ways to incorporate parts into new equipment. It modified some obsolete parts to make them fit equipment that was still in service with customers. And, only as a last resort, it sold excess inventory as scrap to reclaim the value of the materials used—typically 2 to 5 percent of the part cost for industrial products (Exhibit 2).

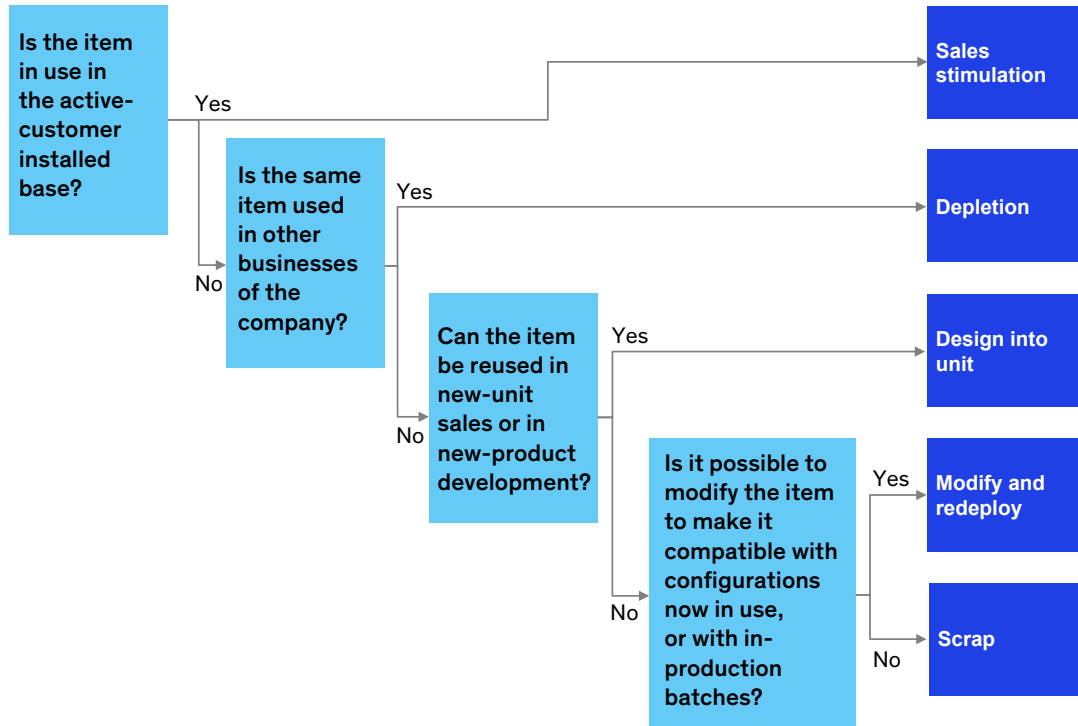
### From cash sink to profit uplift

The company's most effective change, however, was the adoption of a set of initiatives designed to sell excess slow-moving inventory to customers, suppliers, and third parties.

Leaders recognized that tailoring is essential in aftermarket-services sales: two identical units that are run under different operating regimes or that

Exhibit 2

**A basic decision tree provides options for slow-moving spare parts.**



are installed in different environments will have totally different overhaul schedules and parts-replacement needs. Accordingly, the first step was to map the installed base and customize the commercial offering to the target unit (e.g., equipment version, age, installation condition, operating regime).

In addition, to ensure sales teams were appropriately supported and incentivized to pursue higher-value opportunities, the company established an internal “deal desk.” The deal desk helped account managers create individual proposals for customers, based on their purchase history and installed base. Leadership also introduced additional sales bonuses for slow-moving inventory items, and established tracking metrics to monitor sales progress, for discussion at weekly meetings between executives and regional sales teams.

This preparation culminated in the launch of five commercial campaigns, ranked in order of the highest value created:

1. **Ready-to-sell parts.** To find customers who might be ready to buy, the company developed a forward-looking model capable of generating highly likely leads. The model was based on historical orders, equipment installed at customer sites, and future scheduled maintenance events. The output was a set of leads for parts that were ready to sell for specific installed units and customers. Items in these pools were cross-checked against existing sales orders to prevent any cannibalization of demand, or pricing inconsistencies.
2. **Kitting/de-kitting.** To make the product offer more appealing, the company looked at how

different items were combined in kits and sets of parts. That allowed it to pursue two different strategies: “kitting,” in which slow-moving items were bundled with more popular, faster-moving parts to make an appealing package for specific customers, and “de-kitting,” in which items with higher demand potential were removed from existing kits and sold individually. To help sales teams ensure that offer prices for the inventory were both competitive and profitable, the company analyzed the market and set minimum, target, and maximum price guidelines for each ready-to-sell SKU.

Where the company could not identify suitable target customers for items lingering in its inventory, it explored the final three alternative sales routes.

3. **“Last-time-buy.”** For parts suitable for equipment that was still in service but approaching obsolescence, it made last-time-buy offers to customers or distributors.
4. **Sell back to suppliers.** Certain highly specialized or customized parts, typically in inventory after cancellations of major-overhaul projects, were sold back to their original suppliers.

5. **Online auctions.** Where the organization didn't know the market potential for an SKU, it offered the SKU for sale via an industry auction platform to all customers with a compatible installed base.

Finally, to coordinate its entire inventory-reduction effort and ensure excess parts were allocated to the initiative that offered the highest potential value, the company established a slow-moving-inventory control tower, which tracked the overall progress of the effort and moved SKUs into and between initiatives as required.

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Slow-moving inventory is a fact of life for industrial-services organizations. These businesses depend on their ability to supply parts that are difficult for customers to get elsewhere. That doesn't mean inventory should be allowed to get out of control, however. As this company's experience shows, the combination of disciplined inventory management and a smart, creative sales approach can transform an inventory burden into a powerful source of additional revenue at a healthy profit margin.

**Paolo Baldesi** is an associate partner in McKinsey's New Jersey office and **Florent Kervazo** is a partner in the New York office, where **Hugues Lavandier** is a senior partner.

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