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Newport Home: Multichannel Merchandising and Inventory Management

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INTRODUCTION

Newport Home, Inc. is a specialty retailer selling home furnishings, including dining, kitchen, bed and bath soft goods, glassware, china, and cutlery, and assorted décor items. The company's founder, Terrence Ransom, opened the first store in 1960. The company has grown to 154 retail stores throughout North America. In 1968 the company launched its direct-to-customer sales channel through a seasonal mail-order catalogue, and in 2000 direct-to-customer sales were brought online when the company introduced its e-commerce website, newporthome.com. Currently the retail and direct-to-customer sales channels are supported by distribution centers in Portland, Oregon, and Charlotte, North Carolina, providing 1.8 million square feet, and call and data processing centers in Syracuse, New York, and Moorhead, Minnesota. The company's corporate offices and design studio are located in Providence, Rhode Island.

Mr. Ransom founded the company with the goal of providing customers quality, creativity, and style. Product buyers and designers at Newport Home keep a close eye on fashion trends worldwide, so the company can respond to changes in customer preferences quickly. Over the years management has tried to position the company as a fashion leader rather than a follower, helping insure the success of its design concepts. Company management believes the key to success is to carry a mix of signature products and a fresh array of seasonal products throughout the year. Signature products, consisting mainly of big-ticket hard goods such as furniture, are based on classic designs that change somewhat over time. Seasonal products, mainly soft goods, upholstery, and small hard goods, change frequently.

The introduction of seasonal products has become a year-round job for the company designers and buyers. Designers continually work with new color schemes, fabrics, and materials. Buyers arrange one-time purchases of seasonal and holiday merchandise throughout the year. The company sources its inventory from domestic and international manufacturers, and must commit to designs and purchase contracts up to a year in advance. This places the company at risk of overestimating or underestimating demand when predicting the success of a concept. Ideally, an item of seasonal inventory would sell out completely by the end of the season. But in practice, merchandise buyers plan to sell through only a portion of the inventory, replacing unsold inventory with new seasonal items before floor stock becomes sparse. Buyers keep a close eye on seasonal items, and will remove an item from the store schematic and replace it with something else as soon its sales volume starts to decline. Each time a new schematic is issued, stores can be left with varying amounts of overstock items no longer on the schematic.

Overstock merchandise on closeout is sold in each store's "Marketplace." Mr. Ransom introduced the Marketplace in his first store to merchandise inventory reaching the end of the season, along with limited special-purchase items. With markdowns of 10%-50%, the Marketplace has become a customer favorite. The company usually disposes of unsold

Marketplace closeouts after four weeks on the floor through a third-party liquidator. Inventory left to liquidation is almost always sold below original cost, resulting in a reduction in gross profit in the period of the sale.

Recently, in meetings of senior management individuals are questioning the role of the Marketplace concept in sustaining the company's goals. Jason Klein directs the retail channel. He favors moving the Marketplace to the catalogue/Internet channel. "Our stores should be the showcase for what is new," he says, "not an attraction for bargain hunters. Also, I think closeouts would be more profitable online. We could maintain the closeout for a longer period, and probably sell through more inventory than we do now. Currently, Marketplace closeout sales only yield a 50% inventory reduction. The rest goes to liquidation. But most important, our floor space is too valuable now to use for closeouts. With the freed space we could significantly increase selection and sales."

Jason's counterpart in the direct-to-customer channel is Rosella Hernandez. Rosella is concerned about taking on the Marketplace. "If Marketplace is not consistent with our image, maybe we should do away with it altogether, not move the problem to our other channel. We're all aware that we need to increase volume in the direct-to-customer channel given our fulfillment costs are largely fixed. But transferring low or negative margin inventory is not the answer. What about simply bypassing markdowns and going directly to outside liquidation? The sooner we liquidate excess inventory the better terms we are likely to get anyway."

Marina Dodd is the company vice president of sales. She is ultimately responsible for all buying, pricing, and merchandising decisions for the company as a whole. She is also an important voice in all strategic marketing, development, and capital investment decisions made at the corporate level.

Marina has been thinking about the possibility of moving the Marketplace, and has listened to the arguments of both directors carefully. In addition to their concerns, she wonders what impact the move will have on the traffic in the stores, and how important the Marketplace is to the customer's shopping experience and purchases.

RETAIL AND DIRECT-TO-CUSTOMER CHANNELS

The company makes approximately 58% of its sales through its retail stores. Direct-to-customer sales make up the remainder of sales. Direct-to-customer sales are customer purchases from the company's direct mail catalogues or the company's e-commerce website. Catalogue orders come through the company's call centers, by telephone, fax, and mail order. While it is possible to trace direct-to-customer sales to e-commerce versus the call centers, it is impossible to ascertain whether the customer decided to make the purchase after browsing through a catalogue or the website. Therefore, company management defines direct-to-customer as a single distribution channel for management purposes. Exhibit 1 shows sales, gross profit, and operating profit for the two channels over the last three years, excluding non-traceable corporate costs.

While the company sells mostly the same merchandise in both channels, the similarity ends there. The sales mix, operations, and costs structures of the two channels differ significantly. As is common in the industry, sales revenue for both channels is adjusted for markdowns and returns. Cost of goods sold includes merchandise cost (including the cost of damage, shrink, and replacement), freight cost, and finally, distribution channel occupancy costs. Exhibit 2 provides a breakdown of cost of goods sold for the two segments.

Exhibit 1
Newport Home Segment Revenue and Expense Information
(dollar amounts in thousands)

	Retail Channel			Direct-to-Customer Channel		
	2006	2005	2004	2006	2005	2004
Sales Revenue (net)	1,194,917	1,205,620	1,139,877	896,188	892,159	832,110
Cost of Goods Sold	(765,703)	(756,527)	(712,993)	(489,767)	(490,420)	(460,074)
Gross Profit	429,214	449,093	426,884	406,421	401,739	372,036
Selling, General, and Administrative Costs	(282,478)	(284,044)	(267,529)	(264,644)	(264,436)	(239,897)
Segment Profit before Common Costs	$146,736	$165,049	$159,355	$141,777	$137,303	$132,139
Sales Space in Square Feet	1,878,800	1,863,400	1,832,600			

Exhibit 2
Newport Home Cost of Goods Sold by Segment
(dollar amounts in thousands)

	Retail Channel			Direct-to-Customer Channel		
	2006	2005	2004	2006	2005	2004
Merchandise Cost	488,960	483,307	454,633	399,308	397,884	370,084
Occupancy Cost	115,613	116,119	109,346	26,192	27,422	26,647
Freight Cost	153,078	149,830	141,783	64,007	64,029	62,126
Return Freight Cost	7,551	7,219	6,948	-	-	-
Other	501	52	283	260	1,085	1,217
Total	**$765,703**	**$756,527**	**$712,993**	**$489,767**	**$490,420**	**$460,074**

Occupancy costs include rent, depreciation, and maintenance for the distribution network. The most significant occupancy costs in the retail channel are store-level rent and common area maintenance costs. The most significant occupancy costs for the direct-to-customer channel are warehouse and call center depreciation and maintenance. While store-level and call center costs are directly traceable to each channel, warehouse costs are allocated between the two distribution channels based on their relative inventory storage needs, which are significantly greater for the direct-to-customer channel. The retail channel incurs freight cost for all merchandise received by the warehouse and shipped to stores, as well as all direct store deliveries from vendors. It also incurs return freight cost, which is the cost of shipping unsold store merchandise back to the warehouse. The direct-to-customer channel incurs freight costs mainly for merchandise received by the warehouse.[1]

Selling, general, and administrative costs for the company include all non-occupancy costs associated with the distribution network, including buying, receiving, and inspection costs. The most significant SG&A cost is the cost of sales and fulfillment labor. This includes the cost of warehouse labor, store-level labor cost for the retail channel, and IT, warehouse, and call center labor costs for the direct-to-customer channel. Corporate administrative, promotional, and advertising costs are also a significant SG&A category.

SEASONAL INVENTORY IN THE RETAIL CHANNEL

The decision of what and how much seasonal inventory to purchase for the retail channel is a careful calculation of future customer preferences, the expected sell-through percentage, purchase cost, retail price, and expected markdowns. These parameters vary from product to product, but in general, management expects seasonal purchases to achieve 80% sell-through[2] at the regular retail price. In contrast, the seasonal inventory forecast for the direct-to-customer channel is based on 100% sell-through because there is no merchandising need for a planned amount of overstock. Also, the number of items carried on the Internet is not constrained as with retail floor space, though it is effectively constrained by warehouse space. Overall inventory levels needed to support the same dollar sales are, therefore, higher in the retail channel than in the direct-to-customer channel.

While overstocks are a fact of life for the retail channel, the actual amount and value of overstock merchandise varies from season to season, and from store to store. The average cost and retail value of overstocks are determined when corporate headquarters issues a new store schematic. The schematic indicates what inventory will be stocked in each display area of the store, and applies to all stores. The biggest change from one schematic to the next occurs when headquarters rolls out the new season. At that point, floor stock not on the new schematic is considered overstock, which must be moved in time to receive and display the new inventory. Since the new schematic coincides with the timing of the company's catalogue and advertising, all stores make the transition at the same time, irrespective of the amount of overstock this leaves a given store. Corporate headquarters issues closeout orders on all overstock with the new schematic, including markdown percentages and disposal instructions for exceptionally large inventory amounts. Closeout inventory is first offered through the Marketplace. Marketplace inventory is carefully monitored and supplemented with special purchase merchandise to insure that the display is always attractive. Depending on the type of merchandise, closeout inventory remains in

Exhibit 3
Newport Home Disposition of Overstock Merchandise in the Retail Channel
(dollar amounts in thousands)

	2006	2005	2004
Marketplace Sales Stated at Average Historical Cost	$25,352	$17,500	$ 16,501
Marketplace Sales Stated at Original Retail Price	50,737	35,255	33,167
Marketplace Sales at Realized Price	30,824	22,564	20,897
Liquidation Sales Stated at Average Historical Cost	24,836	16,073	16,582
Liquidation Sales Stated at Original Retail Price	49,563	32,346	33,268
Liquidation Sales at Realized Price	8,083	7,115	5,891

Marketplace for as little as two weeks or as long as four weeks before being pulled off the floor. Unsold Marketplace inventory is sold to an external liquidator. Exhibit 3 shows the historical cost, original retail price, and recovered amounts for overstock inventory in the retail channel over the past three years.

THE JANUARY 2007 MEETING

Marina decided that the decision regarding the future of Marketplace should be made early in the 2007 fiscal year. In January she met with her two directors and key managers within the distribution network to identify the issues that needed exploration to support the decision. They identified the following issues:

1. **Logistics of selling store-based inventory in the direct-to-customer channel:** Currently, the company ships seasonal inventory to the stores from its main receiving center or directly from the manufacturer. Any merchandise that cannot be sold through the stores, either because of damage or obsolescence, is shipped to the "return center," which is part of each distribution center. There it is slotted to be returned to the manufacturer, destroyed, donated, or sold to a liquidator. Moving closeouts to the direct-to-customer channel would involve the creation of a fifth slot at the return center, where inventory would be channeled back into the distribution centers. The company would have to arrange and pay to ship this inventory back to the return center. Warehouse space and personnel would have to be made available for receiving and slotting the merchandise. Inventory slotted for direct-to-customer closeout would require additional labor and other resources to be restocked at the distribution center. The subsequent sale and shipment to customers would require picking and packaging individual items as they are ordered, the same as with all direct-to-customer merchandise. Estimates of current capacity utilization in the company facilities indicate there is adequate labor and warehouse capacity to accommodate the reintegration and sale of the closeout inventory. Inventory remaining after the closeout period would go to liquidation, as is the current practice.
2. **Terms of liquidation:** Third-party liquidation of saleable inventory usually takes place when other alternatives for selling it have been exhausted. For Newport Home, liquidation of store inventory takes place after the inventory has been removed from the sales floor and shipped to the return center. Liquidation of any leftover seasonal inventory still in the warehouse occurs as soon as the sales season ends.[3] The company has an established relationship with liquidators where general terms of pricing and shipping are negotiated periodically. But it also might offer specific product lots for bid, so it is difficult to predict specific liquidation prices. Terms of liquidation can range as high as 50% of historical cost. The general rule, however, is that the older the lot, the lower the amount it will bring. Also, odd lots are discounted more than full lots because the liquidator wants enough volume to make an individual item worth merchandising through its own channels.
3. **The value of the retail floor space that Marketplace occupies:** Currently Marketplace occupies 3% of the sales space in the standard store schematic. If Marketplace were removed from the stores, there would be room for new product lines. Company management is continually evaluating possible new product lines, including household wall and window décor, specialized furniture

lines for media rooms, home offices, and hobby rooms, and fine art. Management evaluates the potential contribution of new products on several dimensions, principally brand building, sales and gross profit per square foot, and space and merchandising requirements.

4. **Marketplace closeout terms:** Currently, in-store closeout items in Marketplace are marked down 10%-50% off the full retail price, with an average markdown of 35% and an average success rate of 50%. If this inventory were offered in a direct-to-customer channel closeout, management would consider lowering the average markdown and extending the closeout period to try to increase the total revenue from the closeout. However, Rosella Hernandez cautions that Marketplace should not be expected to perform as well on the Internet because of high competition from other low-cost merchandise and the fact that Internet customers must pay shipping cost.

5. **The costs of holding inventory:** Lowering the markdown and extending the closeout period means that cash recovery is pushed back, perhaps several weeks. The company would have to make working capital available for this delay in liquidation. To manage seasonal fluctuations in working capital requirements, the company uses a revolving credit facility and currently pays 8% annual interest.

After discussing these factors at the meeting, Marina decided to pursue more concrete cost-benefit analysis. She decided that the relevant comparison was among three alternatives: the status quo, moving Marketplace to the direct-to-customer channel, and bypassing closeouts altogether, sending all overstocks immediately to liquidation. She instructed a team of analysts to construct a comparison.

"This is a really complex problem. There are immediate logistical issues to resolve and potentially significant long-term ramifications that are hard to see at this stage. Also, we would not consider taking Marketplace out of the stores without investing substantially to plan, execute, and promote a fresh new layout. But I think you should start by setting aside the changeover cost issues. Simply list all the differential costs and benefits across the alternatives, assuming whatever we do is already up and running. It will be hard enough to put numbers to many of these factors, so decide what you can readily quantify and make some assumptions about the other things.

"Put together a first-pass analysis using our historical overstocks information as a benchmark. We are really uncertain about how Marketplace will perform in the DC channel. I would like to see how we perform there under a range of sell-through assumptions without changing the markdown percentage. I would also like to see the liquidation alternative under varying recovery assumptions because we don't really know what liquidation terms will be.

"We can use your results as the basis to decide what additional information we will have to get to make a better comparison."

ENDNOTES

1 The direct-to-customer channel also incurs freight costs for promotions and for replacement of defective products. These costs are included with "other" in cost of goods sold. Under GAAP, regular shipping and handling cost charged to customers is included in revenue and offsets shipping costs recognized in cost of goods sold. These amounts are excluded from revenue and cost of goods sold in Exhibits 1 and 2.

2 Sell-through percentage is calculated using the ratio of sales volume to purchases volume for a given item over a season or a promotional period. The company measures and updates sell-through percentage for a given item weekly and on specific benchmark dates against its forecast amounts.

3 Historically, this amount has not been significant.

NEWPORT HOME: CASE ANALYSIS

1. **Compare and contrast the operations and cost structure of the retail and DC channels. Describe the items included in cost of goods sold and SG&A costs and how they compare across channels. Do the differences described in the case make sense to you? Which of the categories of cost of goods sold and SG&A should vary with volume? Which should remain fixed?**

2. **Explain why the retail channel has planned overstock. Could the company avoid planned overstock inventory in the retail channel? Why or why not?**

3. **What should be the company's financial criterion in determining a disposal strategy for overstock inventory?**

4. **Identify the revenue sources and incremental disposal costs and capacity costs and benefits of each alternative distribution strategy, assuming it is up and running.**

5. **Determine the assumption you will use to analyze and compare the above alternatives. For each assumption, consider potential objections to your assumption and provide justification for your assumption based on the case.**
   a. **Demand of Retail channel and of DC channel** *(positive, no effect, or negative)*
   b. **Revenue potential of Marketplace floor space in the retail channel** *(positive, no effect, or negative)*
   c. **Potential Marketplace sell-through percentage in the DC channel at current 35% average markdown** *(0%, 25-50%, or 100%)*
   d. **Potential liquidation revenue from remaining overstock as a percentage of investment** *(0%, 30-50%, or 100%)*
   e. **Occupancy costs [firm wide]** *(Possible cost drivers: sales volume, or plant capacity/store size, or mixed/other)*
   f. **SG&A costs** *(Possible cost drivers: sales volume, or plant capacity/store size, or mixed/other)*
   g. **Freight costs** *(freight capacity, or freight volume, or mixed/other)* *[note: volume is measured using sales at regular retail price. All reported revenue is assumed to be stated at regular retail price unless the case states otherwise].*
   h. **Merchandise costs** *(purchase volume or purchase mix)* *[note: volume is measured using sales at regular retail price. All reported revenue is assumed to be stated at regular retail price unless the case states otherwise].*
   i. **Volume** *(if you were to assume that volume is based on sales measured at regular retail prices, how would you defend this assumption?)*
   j. **Financing cost** *(if you were to assume that the cost of capital is zero, how would you defend this assumption?)*

6. **For each cost or benefit line item, provide an estimated dollar value, given the facts of the case and your assumptions. Explain each calculation. Explain whether you think a particular estimate is optimistic, pessimistic, or of unknown bias. If there is any amount you cannot quantify, decide what information you would need to do so, and how the missing information affects your comparison.**

7. **Based on your findings, formulate and present a recommendation for the management of Newport Home. As part of your presentation to management, provide:**
   (a) a spreadsheet that clearly presents your assumptions and analysis, and
   (b) a report that guides the decision makers through your analysis. In your view, what are the most important things you need to communicate in your recommendation?

8. **Discuss the points of view and claims of each manager in the case. Do you agree with their concerns? Did your analysis alter your opinion regarding their concerns?**

9. **Suppose Jason and Rosella are each evaluated on their channel's profits. If Marketplace is moved to Rosella's channel, how should the performance measure of each manager change? Which manager should be responsible for the sales, cost of goods sold, and SG&A costs associated with Marketplace? How could the management accounting system be changed to accommodate the new responsibilities?**

10. **Assume you have presented your analysis to the managers in this case. To come to a final decision, management must be able to weigh the up-front costs of implementing a change against the ongoing incremental benefits of making it. Provide a list of up-front costs the company can expect to incur if your analysis indicates a change could provide ongoing benefits. Provide a framework for determining how much up-front cost the company should be willing to incur to make the change.**

11. **Your analysis might have revealed significant unresolved uncertainty with respect to the ongoing benefits and costs of each alternative. Provide a list of practical steps that could possibly lead management to a confident final decision.**

12. **Evaluate the decision process: Why do you think the Marketplace issue is being brought up at this time? Do you agree with the way this decision is being approached in the case? Can you think of other alternatives that should have been included?**