

Is Freight the Tail that Wags the Dog?

By Rick Pay

I talk to many operations and supply chain people who place a great deal of importance on reducing the cost of freight. As they develop purchase orders, the freight cost, which can seem substantial, often drives the size of the PO; in an effort to cut freight costs, they add to the size of the order until they “make freight.” Making freight might include taking a full truckload for a discounted rate or reaching an order size where the supplier pays for the freight. However, if you look at freight as a percent of total materials purchased, while the dollars add up, it is usually a small percentage of the total. Putting too much emphasis on freight cost can generate excess inventory, increase the cost of holding inventory, and elevate the risk of stock outs. Freight can become the proverbial tail that wags the dog.

Focusing on freight can cause excess inventory because companies often order in very large quantities in order to make the freight minimum levels. A prime example of a misguided effort to make freight is a company who ordered several

shipping containers of materials from China before the market for their product was even proven. The result was substantial overstock that can easily become obsolete inventory in the future. Whether it is container loads, pallet quantities or just extra stock, ordering more than you need in the short term decreases inventory turns and depletes cash resources.

Another consideration is the cost of holding inventory. Many companies only look at interest expense when calculating inventory holding cost, but warehouse costs, handling, obsolescence, taxes and insurance, scrap and damage, as well as management costs like cycle counts and physical inventory counts are all part of the total cost picture. If you have to rent an additional warehouse to store the extra inventory you bought to save on freight (yes, I have actually seen that), you probably won't come out ahead on total cost. Two recent articles suggest the cost of holding inventory for manufacturers and distributors is 30% per year on average. I've seen companies with holding costs of

over 50% annually, but the typical range is between 27% and 36%. You could look at that as 2.5% to 3% per month. With that figure in mind, if you order two months extra inventory to get a 5% cost reduction through freight, you break even at best and lose money

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at worst. Clearly, understanding the total cost of holding inventory is critical in assessing whether potential freight savings justify a spike in inventory levels.

Though it may seem counterintuitive, a narrow focus on freight costs can actually cause stock outs. I have observed purchasing departments postpone replenishment orders to make

freight, but the delays cause stock outs resulting in lost orders and/or decreased margins due to substitutions. The pertinent question is how much those lost sales cost the company, which is in the neighborhood of the contribution margin generated by the sale.

The following graph shows the impact of warehousing and

logistics on total costs. As you can see, once you get to a certain point, larger orders become counterproductive, driving up other costs to the point where they easily outweigh any savings on freight. Should you ignore freight costs when making purchasing decisions? Certainly not. But the ramifications of excess inventory can quickly erase the benefits of a freight discount.

