



MK 322 Retail Management

Chapter 6: Financial Strategy

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Objectives and Goals

Black Friday weekend sales took a hit in 2014



Objectives and Goals

- Three types of objectives that a retailer might have are

1. Financial
2. Societal
3. Personal



Financial Objectives

- When assessing the financial performance of a firm, most people focus on profits
- What were the retailer's profits or profit as a percentage of sales last year, and what will they be this year and into the future?
- For retail, appropriate Financial measure is not profits but return on assets
- Return on assets(ROA) is the profit generated by the assets possessed by the firm

Societal Objectives

- Societal Objectives are related to broader issues that make a world a better place to live.
- Societal Objectives are more difficult to measure
- But explicit societal goals can be set such as specific reductions in energy usage, excess packaging, increased use in renewable energy and support for United Way, Habitat for Humanity which are non profit organizations
- For example providing employment opportunity for minority, disables, or environmentally friendly products

Societal Objectives



Achieving societal objectives is important to Blake Mycoskie, founder, CEO, and chief giving officer of TOMS shoes.

Personal Objectives

- Many retailers, particularly owners of small, independent business, have personal objectives including self gratification, status and respect
- By operating a popular store, a retailer might become recognized as a well-respected business leader in a community



Strategic Profit Model



Costco



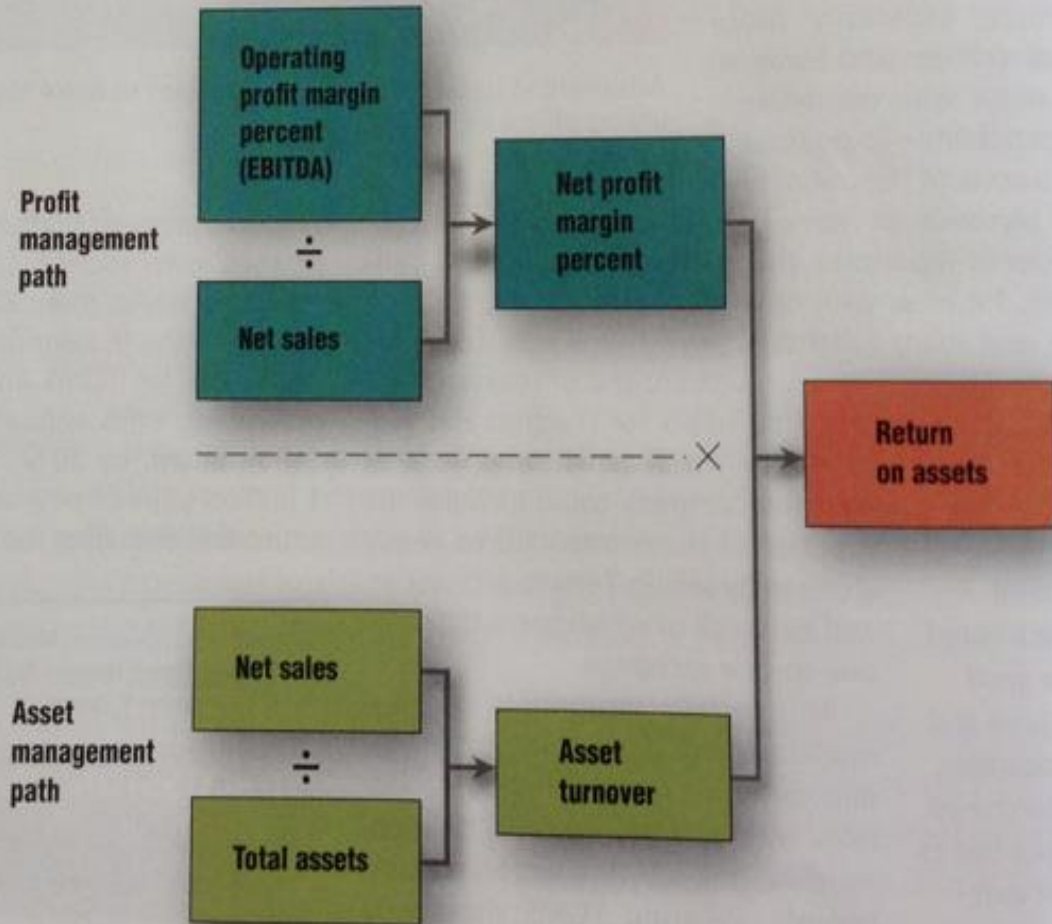


Strategic Profit Model

- The strategic profit model is a method for summarizing the factors that affect the firm's financial performance
- The operating profit margin also called earnings before interest, taxes, and depreciation (EBITDA) is a measure of the profitability from continuing operations if a retailer and is useful predictor if the retailer's profitability in the future
- Asset turnover is the retailer's net sales divided by the assets

Strategic Profit Model

EXHIBIT 6-1
Strategic Profit Model



Strategic Profit Model

The retailer's ROA is determined by multiplying the two components together:

$$\begin{aligned} \text{Operating profit margin percent} \times \text{Asset turnover} &= \text{Return on assets (ROA)} \\ \frac{\text{Operating profit margin percent}}{\text{Net sales}} \times \frac{\text{Net sales}}{\text{Total assets}} &= \frac{\text{Operating profit margin}}{\text{Total assets}} \end{aligned}$$

	Net Profit Margin	×	Asset Turnover	=	Return on Assets
La Chatelaine Bakery	1%		10 times		10%
Lehring Jewelry	10%		1 time		10%

EXHIBIT 6-2

Different Approaches
for Achieving an
Acceptable ROA

Profit Margin Management Path

- The information used to examine comes from the retailer's income statement or called statement of operations
- The income statement summarizes a firm's financial performance over a period of time, typically a quarter (three months) or a year
- To capture all the sales, gift card purchases, and returns from the holiday season, Macy's like many retailers, sets its fiscal year as beginning on February first and ending January 31

Profit Margin Management Path

	Costco Income Statement 2012	Macy's Income Statement 2012
Net sales	97,062	26,405
Membership fees	2,075	
Total revenue	99,137	26,405
Cost of goods sold (COGS)	(86,823)	(15,738)
Gross margin	12,314	10,667
Selling, general, and administrative (SG&A)	9,518	8,281
Operating profit	2,796	2,386
Other income (expenses)	(95)	25
Interest income	103	(447)
Provision for income tax		(712)
Net profit	2,720	1,252
g = + Gross margin percent	10.5%	40.4%
SG&A percent of sales	9.8%	31.4%
Operating profit percent	2.9%	9.0%
Net profit percent	2.8%	4.7%

EXHIBIT 6-3

Income Statements for
Macy's and Costco

Sources: 10-K filings with the SEC.

Profit Margin Management Path

- Some retailers have additional revenue sources related to merchandise sales, such as payments to vendors
- For example retailers often charge vendors for space in their stores known as slotting fee or slotting allowance
- Retailers may also require that vendors pay a fee, known as chargeback fee when the merchandise bought from vendor does not meet all terms of the purchase agreement, such as those regarding delivery

Profit Margin Management Path

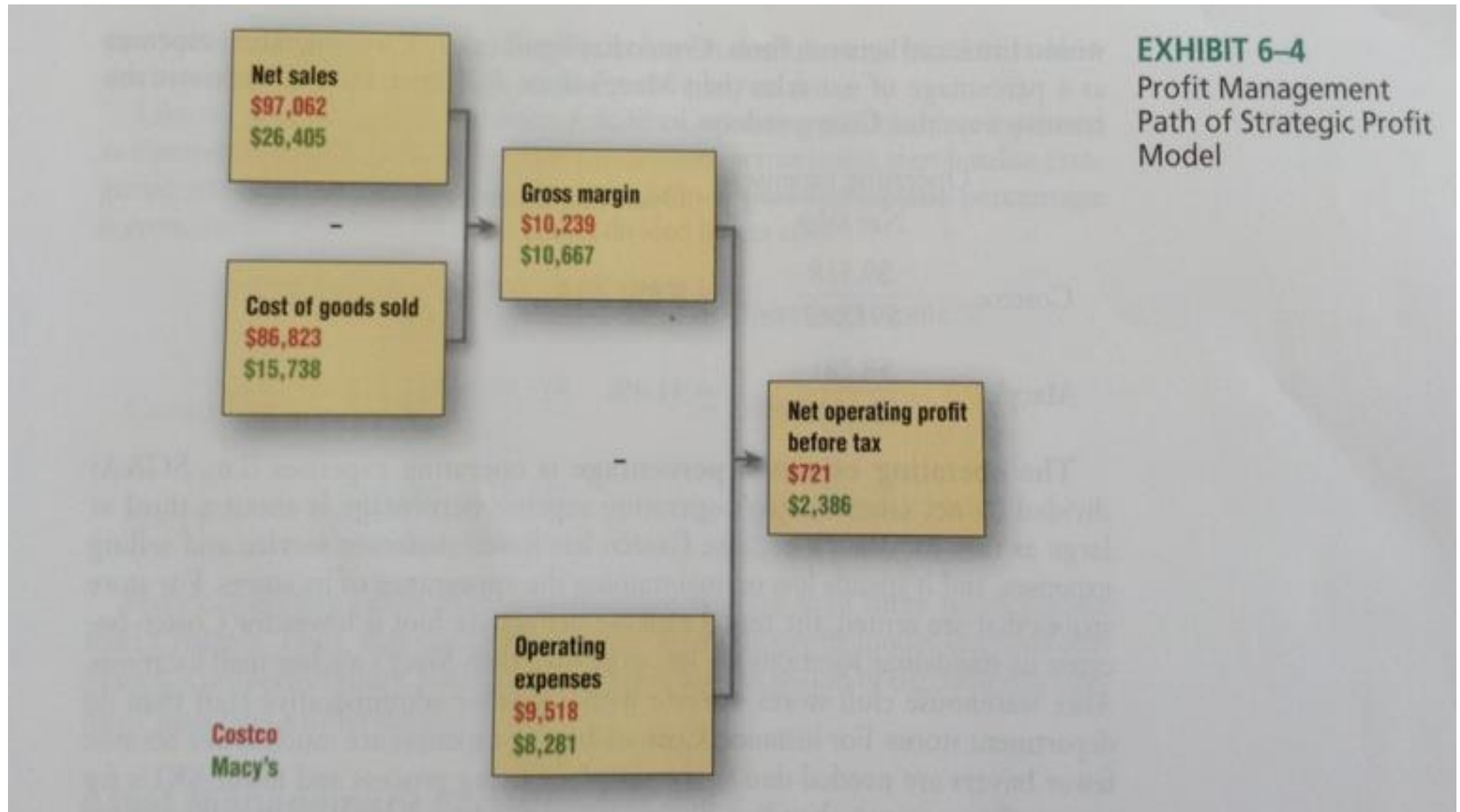


Slotting Fees for placing products on shelves

Profit Margin Management Path

- Gross margin percentage is gross margin divided by net sales
- Retailers use this ratio to compare
 1. The performance of various types of merchandise and
 2. Their with that of other retailers with higher or lower levels of sales

Profit Margin Management Path



Profit Margin Management Path

$$\frac{\text{Gross margin}}{\text{Net sales}} = \text{Gross margin percent}$$

Costco:	$\frac{\$12,314}{\$97,062}$	= 12.7%
Macy's:	$\frac{\$10,667}{\$26,405}$	= 40.4%

Department stores like Macy's often have higher gross margins than warehouse clubs because they target less-price sensitive customers who are interested in branded fashion merchandise and personal service and are willing to pay for it.

Asset Management Path

- This information used to analyze a retailer's asset management path primarily comes from a retailer's balance sheet



Asset Management Path

- Assets are economic resources (eg.inventory,buildings, computer, store fixtures) owned or controlled by the firm
- Current assets are assets that can normally be converted to cash within one year. For retailers, current assets are primarily cash, accounts receivable, and merchandise inventory
- Fixed Assets are assets that require more than one year to convert to cash. The fixed assets are building (if store property is owned by retailer than leased).Distribution centers, fixtures (e.g. Display racks) and equipment (e,g. Computers, delivery trucks)

Asset Management Path

- Merchandising Inventory is a critical retailer asset that provides benefits to customers.
- It enables customers to get the right merchandise at the right time and right place
- Stocking more merchandise increases sales because it increases the chances that customers will find something they want
- But by increasing inventory= increase amount of investment

Asset Management Path

- Inventory turnover is COGS during that time period, typically a year, divided by the average level of inventory (expressed at cost) during the time period



Asset Management Path

	Costco	Macy's
Cash and cash equivalents	4,009	2,827
Short-term investments	1,604	
Accounts receivable	965	368
Merchandise inventory	6,638	5,117
Other current assets	490	465
Total current assets	13,706	8,777
Property and equipment (net)	12,432	8,400
Other assets	623	4,918
Total assets	26,761	22,095
Current liabilities	12,050	6,263
Long-term debt	1,253	6,655
Other liabilities	885	2,344
Total liabilities	14,188	15,262
Stockholder equity	12,573	6,833

EXHIBIT 6-5

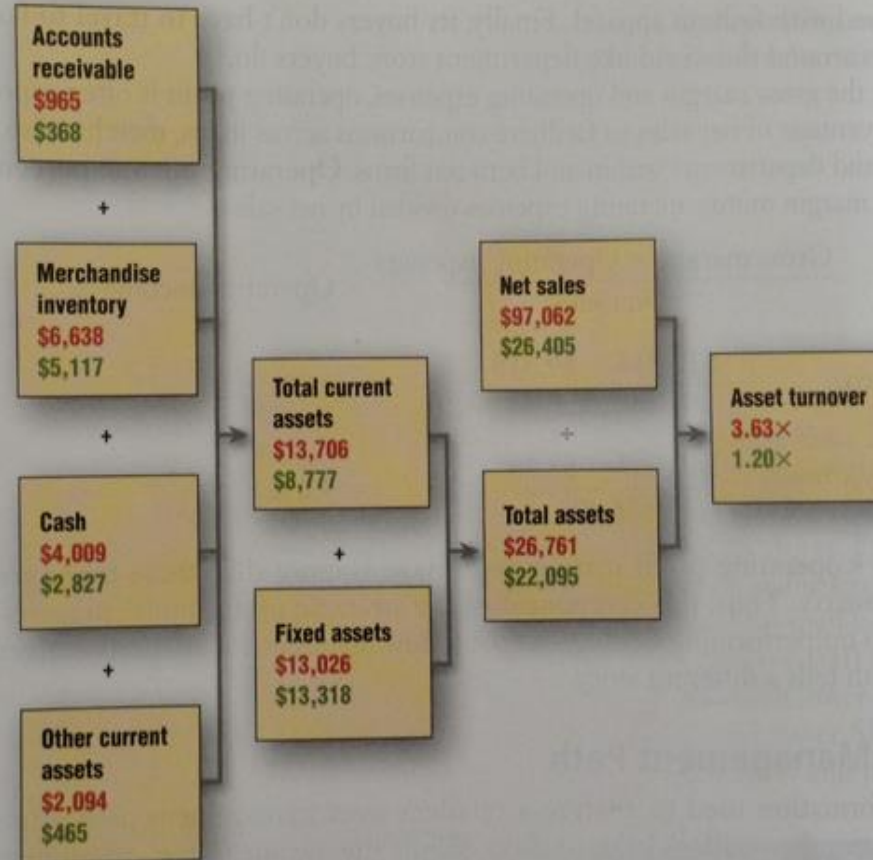
Balance Sheet for
Macy's and Costco

Sources: 10-K reports filed with the SEC.

Asset Management Path

EXHIBIT 6-6

Asset Management Path in Strategic Profit Model



Costco
Macy's

Asset Management Path

$$\frac{\text{COGS}}{\text{Average inventory at cost}} = \text{Inventory turnover}$$

Costco:	$\frac{\$86,823}{6,638}$	= 13.08
Macy's:	$\frac{\$15,738}{5,117}$	= 3.08

Costco's higher inventory turnover is due to the nature of its retail strategy and merchandise it sells. Most of Costco's are commodities and staples such as food, batteries, housewares, and basic apparel items. These staples can replenish rapidly as it has 4,000 SKUs incl, for example 2 sizes of Ketchup.

Combining Profit and Asset Management Path

- In terms of profit management path, Macy's has higher operating profit margin and thus performs better than Costco
- Costco performs better on higher asset management path
- Although this type of performance is expected, given their overall strategy and retail formats, both retailers strive to increase their performance on these key ratios

Combining Profit and Asset Management Path

- For example Macy's department store develop supply chains and buying systems that allow less merchandise to be delivered more often- more closely matching supply and demand
- This lowers average inventory and in turn, total assets, while at the same time may actually increase sales, resulting in higher inventory and asset turnovers

Combining Profit and Asset Management Path

Strategic Profit Model Ratio for Selected Retailers EXHIBIT 6-7

	Sales	Operating Profit	Total Assets	Operating Profit Percentage	Asset Turnover	ROA (Operating Profit)
Department Stores						
JCPenney	17,260	1,109	11,424	6.4%	1.51	9.7%
Kohl's	18,804	2,936	14,094	15.6%	1.33	20.8%
Macy's	26,405	2,386	22,095	9.0%	1.20	10.8%
Discount Stores						
Costco	87,048	2,494	27,261	2.9%	3.19	9.1%
Walmart	443,854	26,558	193,406	6.0%	2.29	13.7%
Target	65,786	6,592	43,705	10.0%	1.51	15.1%
Specialty—Apparel						
The Gap	14,549	1,438	7,422	9.9%	1.96	19.4%
Abercrombie & Fitch	4,158	194	1,489	4.7%	2.79	13.0%
American Eagle Outfitter	3,160	393	3,048	12.4%	1.04	12.9%
Specialty—Category						
Home Depot	70,395	8,234	40,518	11.7%	1.74	20.3%
Lowe's	50,208	4,757	33,559	9.5%	1.50	14.2%
Best Buy	50,705	2,331	16,005	4.6%	3.17	14.6%
Office Depot	11,489	34	4,250	0.3%	2.70	0.8%
Staples	25,022	1,693	13,430	6.8%	1.86	12.6%
Supermarket						
Kroger	90,347	410	23,478	0.5%	3.85	1.7%
Safeway	43,630	1,134	15,074	2.6%	2.89	7.5%

Sources: SEC 10-K filings.

Combining Profit and Asset Management Path

	Asset turnover	×	Profit operating margin percent	=	Return on assets
Costco:	3.63	×	2.9%	=	10.5%
Macy's:	1.20	×	9.0%	=	10.8%



That's All Folks