Financial Strategy

The Strategic Profit Model

STRATEGIC PROFIT MODEL

- Margin Management - ↑ profit margins
- Asset Management - ↑ rate of asset turnover
- Financial Leverage Management

MARGIN MANAGEMENT

- ***Net Profit Margin = Net Profit/Net Sales***
  - How much profit each dollar of sales generates
- Net Profit Margin = Gross Margin- Total Expenses
  - Gross Margin = Sales - COGS
- Info found in Income Statement

Margin Management (cont.)

- You can ↑ the net profit margin by : ↑ sales and reducing ↓ expenses *(wages, rent, selling expenses, interest, depreciation)*
- You can also ↓ the COGS *(invoice cost, freight costs, discounts from vendor, etc.)*

ASSET MANAGEMENT

- Improve how productively the firm uses its resources
- Asset Turnover (sales generated per dollar of assets) is of concern here
- ***Asset Turnover = Net Sales/Total Assets***
- Asset Turnover of 1.5: Each dollar invested generates $1.50 in sales

Asset management (cont.)

- Info is taken from the Balance Sheet (with the exception of sales)
- Asset turnover can be improved by ↑ sales or ↓ assets (like inventory, accounts receivable, or fixed assets)
- Objective: Turn inventory into accounts receivable or cash and back into inventory

Asset Management (cont.)

- Accounts receivable choices:
  - *Bank cards, Proprietary Cards (like Sears), or Private Label Credit Cards with 3rd party "factor"*
- Asset turnover is *similar to* inventory turnover but more encompassing
  - *includes fixed and variable assets, not just level of average inventory*

- Inventory Turnover = Net Sales / Avg. Inventory

RETURN ON ASSETS

- ROA reflects both Margin Management and Asset Management
- ROA = Net Profit Margin X Asset Turnover

  ROA = (Net Profit/Net Sales) X (Net Sales/Total Assets)
- ROA = Net Profits/Total Assets

ROA (cont.)

- ROA is used to evaluate the performance of stores and used to evaluate managers
- Firms can get their return on assets in different ways
  - *Discounters have low profit margins but high turnover*
  - *Specialty stores have high profit margins but low turnover*

ROA (cont.)

- ROA can be compared across different types of firms
  - measures of how well a retailer is performing
- Asset turnover and profit margins can't be compared across different types of retailers given retailers' varying strategies

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Improving ROA

- Increase sales
  - *lower prices, better advertising, minimize stockouts, control inventories*
- Control COGS
  - *monitor supplier's prices and payment terms*
  - *take advantage of special discounts and trade deals, better credit terms*
  - *opportunistic buying*
- Control expenses
- Control assets

Improving ROA

- Control Expenses
  - *cut costs carefully*
  - *be careful of inadequate service or unqualified sales help*
- Control Assets
  - *Quick response - stock should reflects demand*
  - *Eliminate slow moving merchandise, prune brands and sizes*

FINANCIAL LEVERAGE MANAGEMENT

- ***Leverage Ratio = Total Assets/Owner's Equity (Net Worth)***

  Net Worth = Total Assets - Total Liabilities
- Assuming debt allows a retailer to expand and grow
- Financial Leverage positively affects % return on stockholder's equity

RETURN ON NET WORTH

- RONW = ROA X Leverage Ratio

Financial Constraints of Electronic Retailers

- Cost of distribution centers and warehouses
- Discounts and price wars abound
- Marketing consumes revenue (it costs money to advertise and draw people to your web site)
- Costly to develop web sites, continuously improve them, and service them

Financial hurdles (cont.)

- Customer service costs more than expected
- Fees/rents are high on portals like Yahoo
- Rent and other marketing costs can run 65% of sales according to the Boston Consulting Group
- Is the web just a catalog business with lower barriers to entry? Will margins get better?