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 ↓ 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 \times \text{Asset Turnover}
  \[ \text{ROA} = \frac{\text{Net Profit}}{\text{Net Sales}} \times \frac{\text{Net Sales}}{\text{Total Assets}} \]

- ROA = \text{Net Profits}/\text{Total Assets}

ROA (cont.)

- 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 is used to evaluate the performance of stores and used to evaluate managers
- 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

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

## RETURN ON NET WORTH

- \( \text{RONW} = \text{ROA} \times \text{Leverage Ratio} \)

## FINANCIAL LEVERAGE MANAGEMENT

- **Leverage Ratio** = \( \frac{\text{Total Assets}}{\text{Owner's Equity (Net Worth)}} \)
  - Net Worth = \( \text{Total Assets} - \text{Total Liabilities} \)
- Assuming debt allows a retailer to expand and grow
- Financial Leverage positively affects % return on stockholder’s equity

## 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?