Business Skills Training

Financial Planning and Decision Making

Presented by
Patricia M. Johnson, CMC & Richard F. Outcalt, CMC
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PART 1

BUILDING A PLATFORM FOR FINANCIAL PLANNING

Dedicated to the Financial Professionalism of Independent Retailers
The Three Levels of Issues in Strategic Retailing

OWNER ISSUES – WHY?

Why should the business survive?
- Increase personal wealth?
- Provide a way of life? Something to do?
- Have a business to pass on to the children?
- To grow the business?
- To sell the business?
- To support/contribute to a larger cause?
- Other?

PRESIDENT/CEO ISSUES – WHAT?

What do we do to achieve the Owners’ goals?
- Translate into a Business Vision

“Pickle in the Middle”
- Board & Owners
- Management Team

MANAGEMENT ISSUES – HOW?

How do we achieve the vision?
- People Management
- Sales Management
- Margin Management
- Expense Management

Is there a CAPACITY to be in retail?
Is there an APPETITE to be in retail?
Is there the STOMACH to be in retail?

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The STRATA:G® Business Wheel.
Remember, it’s cause-effect, cause-effect, cause-effect, cause-effect. The customers (a) drive sales (b) and margin (c) which drive profit (d) which drives retained earnings (e) which pays down debt (f) and/or drives all three kinds of assets (g) which should drive the target markets (a) for your stores.

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The STRATA:G® Business Wheel
For those who want to know why...and why not!
### Key Financial Ratios

<table>
<thead>
<tr>
<th>How To Calculate Your Key Financial Ratios</th>
<th>Where To Find The Information</th>
<th>What The Ratios Tell</th>
<th>Why These Ratios Are Important</th>
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<tbody>
<tr>
<td><strong>Current Ratio</strong></td>
<td>Current Assets ÷ Current Liabilities</td>
<td>Tests for solvency or ability to meet current debt obligations. Measures how well you can pay liabilities due in the short term.</td>
<td>(Higher is better.)</td>
</tr>
<tr>
<td><strong>Debt-To-Worth Ratio</strong></td>
<td>Total Liabilities ÷ Total Owners’ Equity</td>
<td>Compares the amount in your company owed to creditors to that invested by owners. Measures the financial strength of the business.</td>
<td>(Lower is better.)</td>
</tr>
<tr>
<td><strong>Return On Assets (R.O.A.)</strong></td>
<td>Profit Before Taxes ÷ Total Assets</td>
<td>Indicates pretax return on assets; measures productivity of assets.</td>
<td>(Higher is better.)</td>
</tr>
<tr>
<td><strong>Gross Margin %</strong></td>
<td>Gross Profit $ ÷ Sales</td>
<td>Indicates percentage of sales dollars remaining after costs related to purchasing merchandise are recognized.</td>
<td>(Higher is better.)</td>
</tr>
<tr>
<td><strong>Inventory Turnover</strong></td>
<td>COGS (cost of goods sold) ÷ Average Inventory@Cost</td>
<td>Measures how often, at present rate of sales, your entire inventory is completely sold and replaced during a given year.</td>
<td>(Higher is better.)</td>
</tr>
<tr>
<td><strong>G.M.R.O.I.</strong> (Gross Margin Return On Inventory)</td>
<td>Gross Margin $ ÷ Average Inventory@Cost</td>
<td>Measures the gross margin returned for each dollar invested in inventory. Measures inventory productivity.</td>
<td>(Higher is better.)</td>
</tr>
</tbody>
</table>
The owner’s business must fund his/her household.

Lender’s require both balance sheets before financing – whether for business or personal loans.
The Strata:G® Business Wheel: 
The wheel that gets retailers rolling

by Patricia M. Johnson, CMC and Richard F. Outcalt, CMC
Principals, Outcalt & Johnson: Retail Strategists, LLC

Interest rates are down and opportunities are up, but how do you know what to do and what to avoid? Introducing the Strata:G® Business Wheel. It will give you a framework for deciding which of the bright ideas coming your way are actually good for your business and which are not worth considering.

Look at what’s happening in our economy—we’ve had the lowest interest rates in years; single family housing start-ups are on the rise; and auto sales are up and expected to continue up. Things are happening! So why is it that, for many retailers, sales are not rebounding?

To answer that, we must first answer the question, “What drives retail sales?” Is it the economy? Location? Advertising? Low prices? No, what drives retail sales is customers. Many retailers wonder, “Where are the customers? Where are my customers?”

We believe there are many reasons why customers are on the endangered species list. First, today’s customers no longer are one mass market, but rather a lot of “particle” markets. One recent study showed more than 25 different particle markets of consumers! The economy will affect each market “splinter” somewhat differently. Add to this that many are changing demographically, which will also influence your business.

Clearly, the time is ripe for the Strata:G® Business Wheel (see Figure 1 at the end of this article). By using it in your business, you can refocus your store—not on merchandise nor price, but on customers. The Strata:G® Business Wheel merges strategic marketing with strategic financial planning.
marketing with strategic financial planning.

By focusing on the customer who is most profitable for your business, you can more effectively make decisions about what financial changes can and should be made to maximize results and minimize risk.

The following is an example of how one retail business owner applied the Strata:G® Business Wheel to his store’s financial situation. We will refer to this retailer as Ralph. (This case is designed to teach the principles, not the specifics, of the Wheel.)

For the last twelve months, Ralph’s store had $3 million in sales with 40 percent gross margin ($1.2 million). After operating expenses, taxes and owner’s draw, Ralph cleared a net profit of $30,000. That $30,000 was added to retained earnings, while changes in assets and liabilities were also entered on the balance sheet. (Take a look at these numbers in Figure 2.)

At this point, Ralph’s total assets were $1 million, of which inventory represented $600,000. The other side of the balance sheet showed $750,000 in liabilities and $250,000 in net worth.

From our viewpoint, Ralph’s customer base and sales trend were the areas of greatest concern. Ralph’s $3 million in sales not only wasn’t growing, it was netting him only one percent, $30,000! Like most retailers, Ralph

**Figure 2- BEFORE**

<table>
<thead>
<tr>
<th>Income Statement</th>
<th>Balance Sheet</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales $3,000,000</td>
<td>Cash $10,000</td>
</tr>
<tr>
<td>(-) COGS 1,800,000</td>
<td>+ $250,000</td>
</tr>
<tr>
<td>(=) Gross Margin 1,200,000</td>
<td>Trade payables +</td>
</tr>
<tr>
<td>Gross Margin % 40%</td>
<td>Accounts Payable 40,000 +</td>
</tr>
<tr>
<td>(-) Total Expenses, Taxes &amp; Draws 1,170,000</td>
<td>Receivable 450,000 +</td>
</tr>
<tr>
<td>(=) Net Profit $30,000</td>
<td>Inventory 600,000 +</td>
</tr>
<tr>
<td></td>
<td>Furniture, Fixtures, Equipment, Improvements 325,000 +</td>
</tr>
<tr>
<td></td>
<td>Vehicles 25,000 +</td>
</tr>
<tr>
<td></td>
<td>= TOTAL ASSETS $1,000,000</td>
</tr>
<tr>
<td></td>
<td>= TOTAL LIABILITIES plus NET WORTH</td>
</tr>
</tbody>
</table>

           | Notes payable + |
|                       | Other Liabilities + |
|                       | = TOTAL LIABILITIES + NET WORTH |

           | = TOTAL ASSETS |
|                       | $1,000,000 | $1,000,000 |
knew a great deal about what he was selling but next to nothing about who was buying. The market Ralph traditionally depended on was shifting away from him, and Ralph didn’t even realize it.

Another major concern was Ralph’s 3:1 debt-to-worth ratio ($750,000 divided by $250,000). Currently, a debt-to-worth ratio of 1:1 is “bankable” and 2:1 is about as leveraged as a retailer should be. At 3:1, with total liabilities of $750,000, Ralph was making less from his business than what he was paying in interest. Worse yet, with such a high debt-to-worth ratio, if Ralph needed more working capital, he probably couldn’t get a banker to loan him a dime.

To the rescue, the Strata: G® Business Wheel. The circular pattern of the Wheel made a powerful impression on Ralph: Customers (a) drive sales (b) and margin (c) which drive profit (d) which drives retained earnings (e) which pays down debt (f) and/or drives all three kinds of assets (g) which drive the target market (a) for any store. Not only did the Wheel show Ralph what to do and why to do it, it helped him explain his decisions to his staff and banker.

The first step Ralph took was to ask his customers why they shopped at his store. For one week, Ralph and his staff asked each customer who entered the store to answer the question “Why do you shop with us?” The customers were given this list of answers to choose from:

- A) You always have the merchandise I need/want.
- B) The brands you carry.
- C) I can use a charge account.
- D) Helpful, knowledgeable staff.
- E) I’ve just always shopped here.
- F) Location.
- G) Low prices.
- H) Other.

Each response was noted along with the amount of the transaction, the frequency of shopping visits, and the customer’s ZIP code. When the results were tallied, some very meaningful findings emerged.

What Ralph discovered was that the customers with the highest average purchases—the most “profitable” customers—came to his store not because it had a wide assortment of merchandise, but because the staff
would patiently answer any question. The results also confirmed that those shoppers with the smallest average purchases were the ones who cared most about price and least about brands. (These are the people who want a “cheap steak” rather than a “steak, cheap.”)

Ralph started advertising with much more focus, both in ad message and media buys, with less cost (See Figures 2 and 3). He instituted a frequent buyer program in certain merchandise categories to build customer loyalty. And he began to eliminate duplicate items from his inventory. Within six months he cut inventory from $600,000 to $450,000 (turnover went from 3 to 4.2). That reduction reduced total assets from $1 million to $850,000.

Ralph’s balance sheet continues to balance—total liabilities plus net worth equaled $850,000. So what decreased? Debt. $150,000 of it, plus, the net profit of $104,000, in addition to being added to retained earnings, retired more debt! Ralph’s debt-to-worth ratio had fallen to 2.4 to 1 ($600,000 divided by $250,000), and dropped $104,000 further from the profit to $496,000 divided by $354,000 or 1.4 to 1.0! !

Ralph’s banker was a happy man. His vendors started shipping to him “on account” again and, mercifully, he wasn’t paying more in interest than he was making for himself. On an

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**Figure 3- AFTER**

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| Income Statement | | Balance Sheet |
|------------------|---------------------------------|
| Sales $3,160,000 | Cash $10,000 | $150,000 |
| (-) COGS 1,896,000 | Accounts 40,000 | 400,000 |
| (=) Gross Margin 1,264,000 | Receivable | <104,000> |
| Gross Margin % 40% | Inventory 450,000 | 50,000 |
| (-) Total Expenses, Taxes & Draws 1,160,000 | Furniture, Fixtures, Equipment, Improvements 325,000 | $496,000 |
| (=) Net Profit $104,000 | Vehicles 25,000 | 104,000 |

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**TOTAL LIABILITIES**

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**NET WORTH**

---

**TOTAL LIABILITIES plus NET WORTH**

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annualized basis, with his interest rate at 10 percent, he would save $25,000 ($254,000 less debt times 10 percent). Ralph planned to take $15,000 of that savings and spend it on more training (and bonuses!) for his staff.

Who responded the most to these changes? The customers who wanted knowledgeable sales help. These customers now had reason to drive past the discounters and other competitors. Ralph was able to focus his entire operation—staffing, merchandising, in-store signage, advertising, pricing—to more effectively serve his priority customers.

Ralph’s business is one example that, these days, bigger isn’t always better—better is better. A very modest increase in sales translated to a significant increase in profit. More important, it created substantial improvements in his balance sheet, which measures financial strength.

Is a picture worth a thousand words? Maybe. But the picture of the Strata:G® Business Wheel was worth more than words to this retailer. It was the key to prospering in these times and beyond.