

Financial Strategy

CHAPTER 06

Learning Objectives

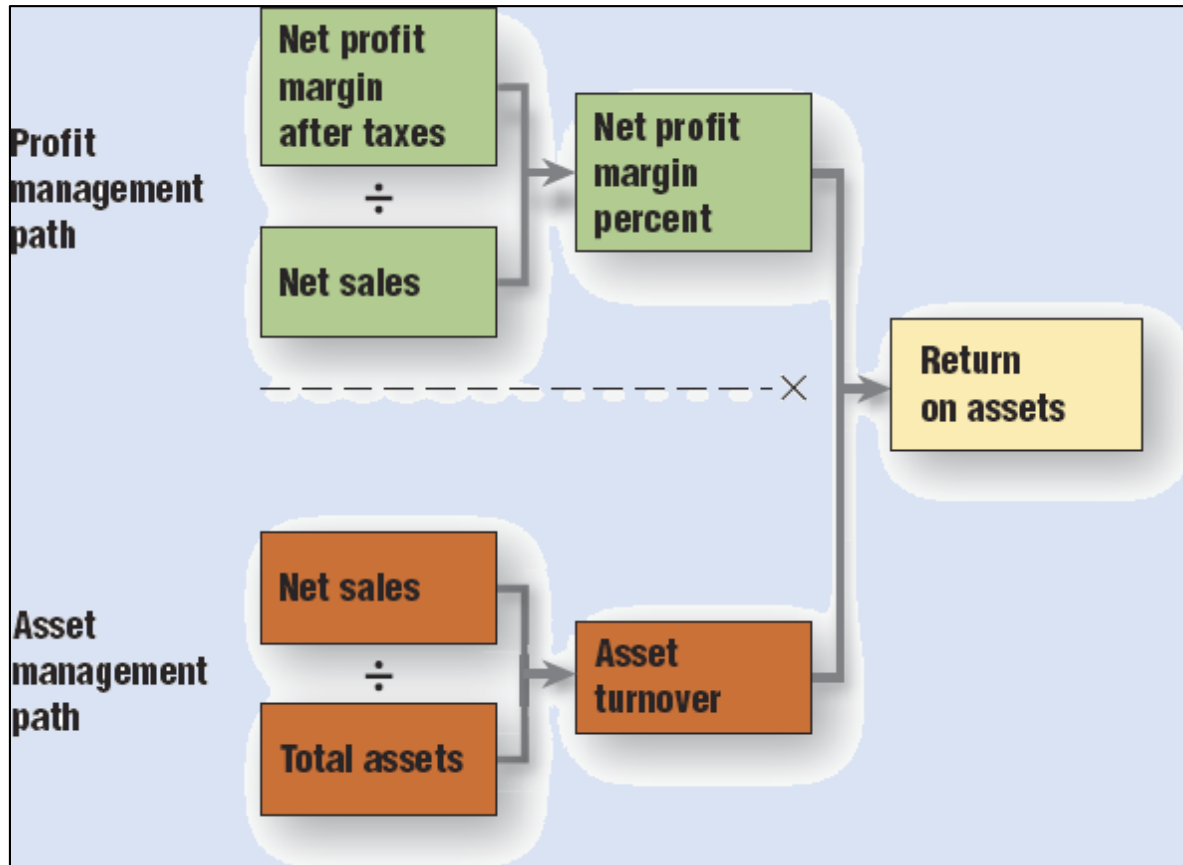
- Review the strategic objectives of a retail firm.
- Contrast the two paths to financial performance using the strategic profit model.
- Illustrate the use of the strategic profit model for analyzing growth opportunities.
- Review the measures retailers use to assess their performance.

Objectives and Goals

- Financial – not necessarily profits, but return on investment (ROI) – primary focus
- Societal – helping to improve the world around us
- Personal – self-gratification, status, respect

STRATEGIC PROFIT MODEL

Components of the Strategic Profit Model



STRATEGIC PROFIT MODEL

The Strategic Profit Model: An Overview

$$\begin{array}{rcl} \text{Profit Margin} \times & \text{Asset turnover} & = \text{Return on assets} \\ \frac{\text{Net profit}}{\text{Net sales (crossed out)}} \times & \frac{\text{Net sales (crossed out)}}{\text{Total assets}} & = \frac{\text{Net profit}}{\text{Total assets}} \end{array}$$

Net Profit Margin: reflects the profits generated from each dollar of sales

Asset Turnover: assesses the productivity of a firm's investment in its assets

STRATEGIC PROFIT MODEL

Profit Margin Management Path

	Nordstrom Income Statement (FY 1/30/2016)	Walmart Income Statement (FY 1/31/2016)
	Values in Millions	Values in Millions
Net sales	\$14,437	\$482,130
Less cost of goods sold (COGS)	9,168	360,984
Gross margin	5,269	121,146
Less operating expenses (SG&A)	4,168	97,041
Operating profit margin	1,101	24,105
Less other income (expense), interest, taxes	501	9,411
Net profit margin	600	14,694
Ratios		
Gross margin as a percentage of sales	36.50%	25.13%
Operating expenses as a percentage of sales	28.87%	20.13%
Operating profit margin as a percentage of sales	7.63%	5.00%
Net profit margin as a percentage of sales	4.16%	3.05%

EXHIBIT 6-3 Income Statements for Nordstrom and Walmart

Sources: Walmart 10K, filed March 30, 2016; Nordstrom, Inc. 10K, filed March 14, 2016.

STRATEGIC PROFIT MODEL

Profit Management Path



EXHIBIT 6-4 Profit Margin Management Path of Strategic Profit Model

STRATEGIC PROFIT MODEL

Components in the Profit Margin Management Path

- Net Sales = Gross Sales + Promotional Allowances - Return
- Cost of Good Sold (COGs)
- Gross Margin (GM) = Net Sales - COGs

STRATEGIC PROFIT MODEL

Components in the Profit Margin Management Path

- Operating Expense
 - Variable (e.g.. sales commissions)
 - Fixed (rent, depreciation, staff salaries)
 - Selling, general, and administrative (SG&A) expenses

STRATEGIC PROFIT MODEL

Components in the Profit Margin Management Path

- Operating profit margin
 - Operating profit margin = Gross margin - Operating expenses - Extraordinary (recurring) operating expenses
 - Net profit margin = Operating profit margin - Taxes - Interest - Extraordinary nonrecurring expenses

STRATEGIC PROFIT MODEL

Analyzing Performance in the Profit Margin Management Path

- Gross margin percentage is gross margin divided by net sales.
- Retailers use to compare
 - the performance of various types of merchandise
 - their own performance with that of other retailers with higher or lower levels of sales.

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

STRATEGIC PROFIT MODEL

Analyzing Performance in the Profit Margin Management Path

- SG & A or operating expenses can be expressed as a percentage of net sales to facilitate comparisons across items, stores, and merchandise categories within and between firms.

$$\frac{\text{Operating expenses}}{\text{Net sales}} = \text{Operating expenses \%}$$

STRATEGIC PROFIT MODEL

Analyzing Performance in the Profit Margin Management Path

- Net operating profit percentage is gross margin minus operating expenses divided by net sales

$$\frac{\text{Gross margin} - \text{Operating expenses}}{\text{Net sales}} = \text{Net operating profit \%}$$

STRATEGIC PROFIT MODEL

Asset Turnover Management Path

- Assets:
 - Economic Resources (e.g., inventory, buildings, computers, store fixtures) owned or controlled by a firm
- Current Asset and Fixed Asset
 - Current Assets = Cash + Account Receivable + Inventory + Other current assets

STRATEGIC PROFIT MODEL

Asset Turnover Management Path

- Accounts receivable are primarily the monies owed to the retailer by customers that have bought merchandise on credit.
- Fixed Assets = Fixture, Stores (owned)
- Asset Turnover = Sales/Total Assets

- Inventory Turnover = COGS/Avg. Inventory (cost)

$$\frac{\text{Net sales}}{\text{Total assets}} = \text{Asset turnover}$$

$$\frac{\text{Cost of goods sold}}{\text{Average inventory at cost}} = \text{Inventory turnover}$$

STRATEGIC PROFIT MODEL

Asset Turnover Management Path

Balance Sheets for Nordstrom and Walmart

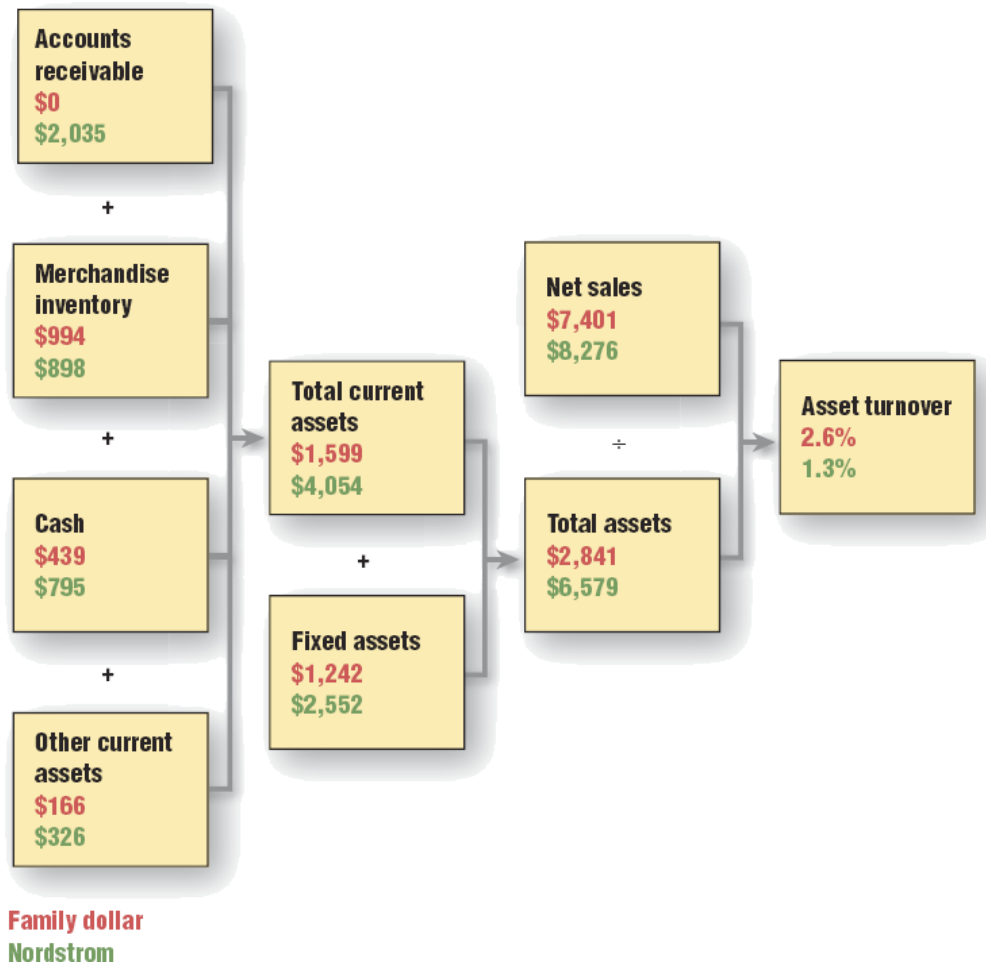
	Nordstrom Income Statement (FY 1/30/2016)	Walmart Income Statement (FY 1/31/2016)
	Values in Millions	Values in Millions
Cash and cash equivalents	595	8,705
Merchandise inventory	1,945	44,469
Other current assets	474	7,065
Total current assets	3,014	60,239
Property & equipment (net)	3,735	110,171
Intangible assets	435	23,040
Other noncurrent assets	514	66,370
Total noncurrent assets	4,684	139,342
Total assets	7,698	199,581
Inventory turnover (cost of goods sold ÷ inventory at cost)	4.71	8.12
Asset turnover (sales ÷ total assets)	1.88	2.42
ROA (net profit margin ÷ total assets) or net profit margin percentage × asset turnover	7.79%	7.36%

EXHIBIT 6-5 Balance Sheets for Nordstrom and Walmart

Sources: Walmart 10K, filed March 30, 2016; Nordstrom, Inc. 10K, filed March 14, 2016.

STRATEGIC PROFIT MODEL

Asset Turnover Management Path in Strategic Model
(Walmart and Nordstrom)



STRATEGIC PROFIT MODEL

Components in the Asset Turnover Management Path

Inventory Turnover

- A Measure of the Productivity of Inventory:
 - It is used to evaluate how effectively retailers utilize their investment in inventory
- Shows how many times, on average, inventory cycles through the store during a specific period of time (usually a year)

$\text{Inventory Turnover} = \text{COGS} / \text{avg inventory (cost)}$

$\text{Inventory Turnover} = \text{Sales} / \text{avg inventory (retail)}$

EVALUATING GROWTH OPPORTUNITIES

Profit Margin Management Path

Operating Expenses

Income Statements	Gifts To Go Stores	Gifts-To-Go.com (projected)	Businesses Combined
Net sales	\$700,000	\$440,000	\$1,140,000
Less cost of goods sold	350,000	220,000	570,000
Gross margin	350,000	220,000	570,000
Less operating expenses	250,000	150,000	400,000
Operating profit	100,000	70,000	170,000
Less interest expenses and taxes	40,000	24,000	64,000
Net profit margin	\$60,000	\$46,000	\$106,000
Ratios			
Gross margin as a % of net sales	50.0%	50.0%	50.0%
Operating expense as a % of net sales	35.7%	34.1%	35.1%
Operating profit as a % of net sales	14.3%	15.9%	14.9%
Net profit margin as a % of net sales	8.6%	10.5%	9.3%

EXHIBIT 6-7 Income Statement Information of Analysis of Gifts To Go Growth Opportunities

EVALUATING GROWTH OPPORTUNITIES

Profit Margin Management Path

Operating Expenses

	$\frac{\text{Operating expenses}}{\text{Net sales}}$	$\times 100 = \text{Operating expenses (in \%)}$
Stores:	$\frac{\$250,000}{\$700,000}$	$\times 100 = 35.7\%$
Gifts-To-Go.com:	$\frac{\$100,000}{\$440,000}$	$\times 100 = 34.1\%$

EVALUATING GROWTH OPPORTUNITIES

Profit Margin Management Path

Net Operating Profit Margin

$$\frac{\text{Net profit}}{\text{Net sales}} \times 100 = \text{Net profit (in \%)}$$

Stores:	$\frac{\$100,000}{\$700,000} \times 100 = 14.3\%$
Gifts-To-Go.com:	$\frac{70,000}{\$440,000} \times 100 = 15.9\%$

Net profit margin percentage, expressed as a percentage of net sales, is calculated as net profit margin (or net profits) divided by net sales. Gifts-To-Go.com generates a much better net profit margin as a percentage of sales.

$$\frac{\text{Net profit margin}}{\text{Net sales}} \times 100 = \text{Net profit margin (in \%)}$$

Stores:	$\frac{\$60,000}{\$700,000} \times 100 = 8.6\%$
Gifts-To-Go.com:	$\frac{\$46,000}{\$440,000} \times 100 = 10.5\%$

EVALUATING GROWTH OPPORTUNITIES

Asset Turnover Management Path

Balance Sheets	Gifts To Go Stores	Gifts-To-Go.com (projected)	Businesses Combined
Cash	175,000	131,000	306,000
Merchandise inventory	175,000	70,000	245,000
Total current assets	350,000	201,000	551,000
Fixed assets	30,000	10,000	40,000
Total assets	380,000	211,000	591,000
Ratios			
Inventory turnover	2.00	3.14	2.33
Asset turnover	1.84	2.09	1.93
ROA	15.8%	21.8%	17.9%

EXHIBIT 6-8 Balance Sheet Information of Analysis of Gifts To Go Growth Opportunities

	$\frac{\text{Cost of goods}}{\text{Average inventory}} = \text{Inventory turnover}$	
Stores:	$\frac{350,000}{\$175,000} = 2.0$	
Gifts-To-Go.com:	$\frac{220,000}{\$70,000} = 3.1$	

EVALUATING GROWTH OPPORTUNITIES

Asset Turnover Management Path

$$\begin{array}{l} \text{Net sales} \\ \hline \text{Total assets} = \text{Asset turnover} \\ \text{Stores:} \quad \frac{700,000}{\$380,000} = 1.84 \\ \text{Gifts-To-Go.com:} \quad \frac{440,000}{\$211,000} = 2.09 \end{array}$$

Because Kelly's estimates for the net profit margin and asset turnover for Gifts-To-Go.com are higher than those for her stores, Gifts-To-Go.com achieves a higher ROA. Thus, this strategic profit model analysis indicates that Gifts-To-Go.com is a financially viable growth opportunity for Kelly.

$$\begin{array}{l} \text{Asset turnover} \times \text{Net profit margin (in \%)} = \text{Return on assets (in \%)} \\ \text{Stores:} \quad 1.84 \quad \times \quad 8.6\% \quad = \quad 15.8\% \\ \text{Gifts-To-Go.com:} \quad 2.09 \quad \times \quad 10.5\% \quad = \quad 21.8\% \end{array}$$

SETTING AND MEASURING PERFORMANCE OBJECTIVES

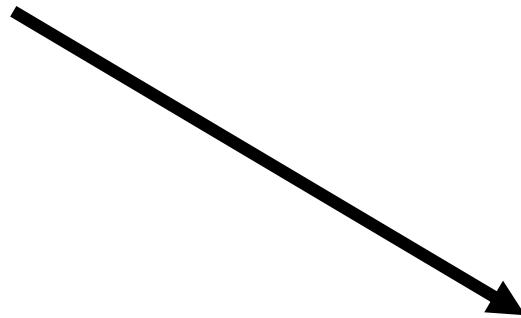
- Retailers will be better able to gauge performance if it has specific objectives in mind to compare performance.
- Should include:
 - numerical index of performance desired
 - time frame for performance
 - necessary resources to achieve objectives

SETTING AND MEASURING PERFORMANCE OBJECTIVES

Top-Down versus Bottom-Up Process

Top-Down Planning

Corporate Developmental Strategy



Category, Departments
and sales associates
implement strategy

SETTING AND MEASURING PERFORMANCE OBJECTIVES

Setting Objectives
in Large Retail
Organizations

Corporate

Bottom-Up Planning

Buyers and Store
managers estimate
what they can
achieve

Operation managers
must be involved in
objective setting
process



SETTING AND MEASURING PERFORMANCE OBJECTIVES

Performance Objectives and Measures

Types of Measures

Input Measures – assess the amount of resources or money used by the retailer to achieve outputs such as sales

Output measures – assess the results of a retailer's investment decisions

Productivity measure – determines how effectively retailers use their resource – what return (e.g., profits) they get on their investments (e.g., expenses)

SETTING AND MEASURING PERFORMANCE OBJECTIVES

Corporate Performance – three critical resources (Inputs)
- manage to generate sales (output)
- comparable store sales growth

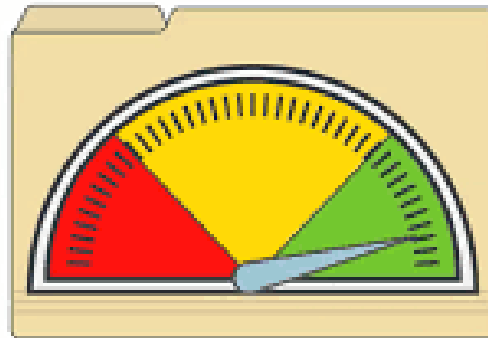
Merchandise Management Measures

Store Operations Measures

SETTING AND MEASURING PERFORMANCE OBJECTIVES

Assessing Performance: The Role of Benchmarks

BENCHMARK



Keywords

- **assets** Economic resources, such as inventory or store fixtures, owned or controlled by an enterprise as a result of past transactions or events
- **asset turnover** Net sales divided by total assets.
- **bottom-up planning** When goals are set at the bottom of the organization and filter up through the operating levels
- **cash and cash equivalents** Currency, checks, short-term bank accounts, and investments that mature within three months or less.
- **chargeback fee** The fee that retailers require vendors to pay when the provided merchandise does not meet the terms of the purchase agreement
- **comparable-store sales growth** The sales growth in stores that have been open for over one year. Also called same-store sales growth
- **cost of goods sold (COGS)** The fee the retailer pays a vendor for merchandise that the retailer sells.
- **crowdfunding** Method of raising money to support a particular project by convincing a large group of people to donate money, often in relatively small amounts.

Keywords

- **current assets** Cash or any assets that can normally be converted into cash within one year.
- **fixed assets** Assets that require more than a year to convert to cash.
- **gross margin** The difference between the price the customer pays for merchandise and the cost of the merchandise (the price the retailer paid the supplier of the merchandise). More specifically, gross margin is net sales minus cost of goods sold. Also called gross profit.
- **gross margin (in %)** Gross margin divided by net sales expressed as a percentage.
- **gross profit** The difference between the price the customer pays for merchandise and the cost of the merchandise (the price the retailer paid the supplier of the merchandise). More specifically, gross profit is net sales minus cost of goods sold. Also called gross margin.
- **income statement** A summary of the financial performance of a firm for a certain period of time. Also called a statement of operations or profit and loss (P&L) statement.

Keywords

- **input measure** A performance measure used to assess the amount of resources or money used by the retailer to achieve outputs.
- **intangible assets** Nonphysical assets such as patents and goodwill
- **inventory turnover** Net sales divided by average retail inventory; used to evaluate how effectively managers utilize their investment in inventory.
- **merchandise inventory** The goods the retailer invests in and holds in stock, to enable customers to find what they want in the right place at the right time.
- **net income** Calculated as: Operating profit margin – Other income or expenses – Interest – Taxes. Also called net profit margin.
- **net profit margin** Calculated as: Operating profit margin – Other income or expenses – Interest – Taxes. Also called net income.
- **net profit margin (in %)** Refers to profit after taxes, interest income, and extraordinary gains and losses a firm makes divided by its net sales expressed in percentage terms.
- **net sales** The total number of dollars received by a retailer after all refunds have been paid to customers for returned merchandise.
- **noncurrent assets** Assets that are not likely to be converted to cash within one year.

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