

# The One Key Skill Every Retailer MUST Master to Survive in the Cutthroat Economy

(Transcript of seminar given by Alim Thompson at INATS West 2008)

Good morning and heartfelt greetings to each of you.

I always like to start meetings with a conscious moment and a dedication, but first please be sure your cell phones are turned off. So let us please take just a moment to go into the deep silent stillness within ourselves. Now in this stillness, tune into the true presence that is beyond time and space. Now take a deep breath and as you exhale, open your eyes. Let us dedicate our efforts here to the highest good for all who are touched by our businesses.

So be it!

First I want to say that I do not take lightly that you have chosen to spend an hour and 15 minutes of your very precious time here, and I am honored that you have chosen to come. It is my deep desire, and I am confident that will you leave here feeling that it has been time very well spent!

Second, at the end of our time together, you will be given a guide book that will contain a transcript everything that I am going to say plus a lot more. So the only notes you will need to make are your own 'ah ha's' or ideas your colleagues may contribute. If I think of anything significant as we go that is not in the guide, I'll tell you in case you wish to write it down.

Third, I have a personal agenda. I am messianic about the need to master this skill, but I'm an introvert and standing up here is NOT my idea of a good time. I much prefer one on one conversations. So my agenda is to inspire one of you extroverts who would get off on being up here, to get so fired up about this that next year, you give this presentation!

As you know I am a wholesaler, not a retailer. **So what in the names of God gives me the audacity to stand up in front of you – many of you seasoned retailers – and tell you what you need to master?!**

Allow me to take a minute to tell you a little of my story. You've all heard tales of drug crazed hippies from the 60's and 70's – perhaps some of you may even have known of one or two – well, I was a sprout – crazed hippie. I had an entrepreneurial seizure from eating too many sprouts. And it gave me this delusion that I could start a wholesale book business with virtually no money. Yet somehow here I am today, and New Leaf is the world's largest wholesaler in this niche. How did this happen?

The odds were totally against me – virtually no money, razor thin margins and not one whit of business knowledge – I thought I was a communist! I did not even know what a margin was. But I learned early on that publishers would give me 90 day terms to pay for the books, and that if I didn't order too much and sold the books and collected the money quickly enough, then I could order again and order more than the first time before I had to pay for the first order. So not only would I not run out of cash, I would in fact, have some left over to add more inventory. So I always held this image in my head of books moving so fast, that they smoked!

So -any ideas about what this key skill I'm going to talk about is?

Not smoking books!

**(Slide 2) Inventory control.**

For the first 8 years New Leaf was in business, we lost money, but we were able to grow rapidly with very little infusion of capital because we kept a positive cash flow by ordering small amounts and moving our inventory really fast.

I tell people all the time that business has become very unforgiving and like it or not, you have to get really good at managing your inventory in order to survive. And for most of us, this is not at all what we enjoy and for many, it's downright scary because it involves MATH!

Alvin Domnitz, CEO of the American Booksellers Association, who was a successful bookseller for many years before becoming the head of the ABA tells of how for many old booksellers back in the day, managing a bookstore meant having lots of great books. He describes himself as the macho buyer who bought for the life of the book. If he thought he would sell 10 copies of a book, he would order 10 copies up front and carry them until they sold. Business meetings were chats about philosophy and books and maybe along the way, some business matters. They were statistically in total darkness.

Then in early 1986 the big boxes started moving in near his stores, and he suddenly realized that if his stores were to survive, those days were over. He describes spending the balance of 1986 giving himself a crash course on how to manage inventory and that is really what we all need to do to survive. He now teaches what I'm going to be showing you today at the ABA bookseller schools. Obviously in the little time we have, you cannot master everything you need to know. But you can take away a new perspective, the information to get started, and I hope a determination to get really smart about this.

Yes, I will be showing you a lot of number stuff, but I'm going to stay mostly with the concepts. The guide book I'll give you at the end of our session will have the actual formulas and explanations for how to use them. All you will have to do is plug in the numbers.

Also all formulas will be in a spreadsheet that you can download from the New Leaf website . I'll get it up as soon as I get back next week.

So fear not – even if math is really not your thing, all you have to do is plug numbers into the spreadsheet and it will do all that scary stuff for you. Of course many of you have computer systems that I assume can give you most of the measures we'll talk about or at least give you the data you need to plug into the formulas. But even if your computer system gives you the measures, I hope to help you understand better how to apply them in running your business more effectively.

Effective inventory control is having just enough but not too much of the right inventory.

**(Slide 3)**

There are 5 factors that go into having just enough of the right inventory

1. Knowing what your customers are likely to buy
2. Finding where to buy the most saleable of those books and products
3. Prioritizing what to buy
4. Appearance – you need to have enough inventory to create the illusion if not the reality - of bountiful stock
5. Astutely ordering for the best possible return on the money you invest

The first THREE have to do with having the right stuff. Numbers 4 & 5 have to do with having just the right amount. And I submit that number 5 is far and away the most difficult and too often, the least fully understood.

So we'll talk about each of these factors in turn.

#### **(Slide 4)**

##### **5 factors for knowing what your customers are likely to buy**

1. Knowing your customers
2. Keeping up with what's happening - trends
3. Intuition
4. Sales history
5. Seasonal fluctuation

I can't help you with the first three – they're as much right brain as left. But I do want to say about # 1 that one of the great advantages of small businesses over the big boxes is that you are close to your customers. At least you should be. The big boxes spend millions on knowing their customers. If whoever is making purchasing decisions for your store is not spending at least some time on the floor, then you are in danger of losing some of this advantage.

So what we're going to dig into this morning is how you analyze sales history to help you manage your inventory. Of course to the extent that history does not repeat, you have to weigh the first three factors. Finally, you can use sales history to help predict seasonal fluctuations.

##### **(Slide5) Finding where to buy the most saleable of those books and products**

I'm sure you all do this quite well – you talk among yourselves, look at the magazines, come to INATS. I will put in a plug here for the COVR online retailers group. Is anyone here NOT on this? OK everyone on the group, please raise your hands. Those of you not on the group, I recommend that after we finish, you speak to one of these people with their hands up and learn what this is.

##### **(Slide 6) Prioritizing what to buy**

Here I want to give you a nugget that if you do not take away anything else, I want you to remember this:

When you place an order, you are doing much, much more than just buying. Everybody, myself included uses the term buyer which gives us a totally counterproductive mindset.

When someone goes out and buys something, they're buying it to use it or to keep it. If you are buying something to turn around and sell it at a profit, what are you doing?

**(Slide 7) YOU'RE INVESTING!**

Whatever you buy for your inventory is an investment. You are investing your limited resources in certain items and you need to always be mindful of what you are going to make from that investment. If you don't sell it and sell it as quickly as possible, you're not maximizing your investment which in this unforgiving cutthroat economy, you simply cannot get away with. So when you are out here on the floor making purchases or anytime you are buying, you need to always remember that you are an investor.

And you need to act like an investor.

**(Slide 8) Basic Rules of Investing**

- Have a budget
- Have a Plan
- Balance Risk vs. Reward
- Maintain Discipline

Is this not exactly what you need to consider when buying? You need to know how much you can spend. You need to know what areas of your store you want to grow and where you need to cut back. When considering a new line, the risk is that it might not sell, or perhaps you need to invest in building a display – is the potential return worth the risk? Is it unusually high margins? You need to stick to your plan and your budget. When you come to INATS, and see all this cool stuff, most of you cannot afford just to buy with no limits. You need to be disciplined and only buy within your budget.

Does anyone have a budgeting method that you would like to share?

**(Slide 9) Simple Budgeting Formula**

Purchasing Budget = Cost of Inventory Sold in Previous Month + % of net profit in previous month

Example:

Sales in May = \$50,000.00

Average Margin on those sales = 45%; you paid \$22,500.00 for inventory sold

Profit in May = \$2500

You choose to re-invest 50% of your profit back into inventory = \$1250

Purchasing budget for the month = \$22,500 + \$1250 = \$23,750

You may also add any money saved for future purchasing from previous months. So for example you might for a few months prior to coming to the show, not put any of your profit back into inventory so you have it to spend at the show.

That would be:

**(Slide 10) Simple Budgeting Formula Including Savings**

Purchasing Budget = Cost of Inventory Sold in Previous Month + % of profit in previous month + savings

Example:

Sales in May = \$50,000.00

Average Margin on = 45%; you paid \$22,500.00 for inventory sold

Profit in May = \$2500

You choose to re-invest 50% of your profit back into inventory = \$1250

You have \$2000 saved from previous profits

Purchasing budget = \$22,500 + \$1250 + \$2000 = \$25,750

### **(Slide11) Have a Plan**

How do you plan *what* to buy?

Here's where we loop back to sales history and begin to get into some more serious analysis. An investor needs to measure the return she gets on her investments in order to see which investments are doing well. This shows her where she may need to sell off some and put that money into something that is performing better. This measurement is called what? Anybody?

**Return on Investment or ROI.** It basically tells you what you are getting back for what you have invested in your inventory – your profit.

For example, it's easy to know what your return on investment will be for each order you place.

### **(Slide 12) Return on Investment (ROI) for an Order**

It's the difference between how much you get from selling what you ordered and how much you pay for it.

So if you come to the New Leaf booth and place an order that has a retail value of \$1000 and you get the show special of 46% off, then your gross margin is \$460 – that's how much gross profit you will make when you sell all of what you buy.

But for this ROI measure to be really useful, you need to factor in time. There is a huge difference on your bottom line between whether you sell everything in this order in one month or six months.

Another way of looking at it is that it's interesting but not particularly useful if you look back and say "Over the last nine years, the store has made a total profit of \$856,000." It's much more useful to be able to look back by year: in 2007 we made \$45,000; in 2006 we made \$92,000, etc.

To plan your purchasing, you need to know how much different sections in your store and different product lines are contributing to your profit. For each section or product line in your store, you need to know how much you're getting back from your investment.

This is called **Gross margin Return on Investment or GMROI**

**GMROI is the ratio of what you make – your gross profit to what you have invested in inventory for a period of time.**

### **(Slide 13) Gross Margin Return on Investment for a Store Section**

GMROI is the gross margin (or profit) you make on sales in the section against your inventory value in that section for unit of time – usually one month.

**Example:** You have sales of \$1,000 at retail in your clothing section for the month of May. You mark up your clothing x's 3 or 300% so your **gross margin** on clothing on \$1,000 sales is \$667 or 66.7%. For the month of May you had an **average** of \$3000 invested in that inventory. Your GMROI on clothing for May =  $\$667/\$3000 = .22$

So let's look at the components here:  
How do you get average inventory?

**(Slide 14) Average Inventory**

Average inventory is simply your beginning inventory plus your ending inventory divided by 2.

**Example:** Beginning inventory for clothing in May was \$3500. Ending inventory was \$2500. Average inventory for May was \$3000.  $Avg\ Inv = (\$3500 + \$2500) / 2 = \$3,000$ .

**(Slide 15) Gross Margin or Gross Profit**

**GM \$ = Sales – Cost**

Cost in accounting terms is called what – anybody?

**Cost of Goods Sold or COGS.**

Now I know that this is very elementary for many of you, but my philosophy is that we're all in this together, so I want to do everything I can to not lose anyone. So here is just a little more accounting 101.

**(Slide 16) Cost of Goods Sold (COGS)**

$COGS = Sales - (Sales \times Gross\ Margin\ \%)$

Gross Margin %, Gross Profit % and Discount % are equivalent. If you buy some soapstone boxes at 45% discount, your COGS is 55% of your sales.

**(Slide 17) Gross Margin % When Using Markup**

From previous example: In May you sold \$1,000 in clothing and you had marked them up 200% or 3 x's (1 + 200%). This means that your COGS was **(what is COGS again?)**

COGS \$333.00 and your Gross Margin was \$667.00.  $GM\% = 67\%$

$GM\% = MU/(1+MU) = 200\%/300\%$  or 67%

So getting back on track, how do you use GMROI in your investment plan?

**(Slide 18) How to use GMROI in your Investment Plan**

1. Compute GMROI for each section in your store.  
If your computer system can give you the information to be able to do this quarterly or even monthly, that is ideal because then you can see trends.
2. Rank your sections in descending order of GMROI
3. Using your budget, allocate your purchasing dollars weighting toward those sections where you have the higher return

4. Remember the 'soft' factors:
  - a. Knowing your customers
  - b. Keeping up with what's happening - trends
  - c. Intuition

It would be a mistake to get so into the analysis that you lose the 'art'.

You can fine tune by calculating GMROI for any specific product line which works the same as calculating for a specific section

#### **(Slide 19) Gross Margin Return on Investment (GMROI) for a Product Line**

**GMROI** is the ratio of the gross margin (or profit) you make on sales for a specific product line against your inventory value in that product line for a unit of time.

**Example:** *You have sales of \$1,000 at retail in a jewelry line for the month of May. You mark up this line x's 4 or 400% so your **gross margin \$** on this line on \$1,000 sales is \$750 or 75%. For the month of May you had **average** of \$3000 invested in that inventory. Your GMROI on jewelry for May =  $\$750/\$3000 = .25$*

$$\text{GMROI} = \text{GM \%} \times \text{Sales} / \text{Avg. Inventory} = .75 \times \$1000 / \$3000 = .25$$

**If you're not following the math, don't worry about it. The important thing to remember is that you can plug numbers into a formula and get your GMROI for a product line or a section and compare this to other lines or sections to see how much money they're making you. The higher the GMROI, the more they are contributing to your profit.**

**(Slide 20)** So now we're back to balancing risks vs. rewards.

#### **(Slide 21) Balance Risks vs. Rewards**

- For new lines project GMROI based on estimated sales projections and how much inventory investment is required
- Risks
  - Are the books/products returnable?
  - Will they require any special handling which will increase labor costs?
  - Will they require construction of a special display?
  - What might go wrong? **(In business we always have to look around corners so to speak for the unforeseen)**
- Rewards
  - High GMROI
    - Strong sales
    - Large margins
  - Perhaps adds to your store's variety
  - Perhaps draws new customers

**(Slide 22) last and not least is maintain discipline.** This is always an inside job but here are some things I do.

**(Slide 23) Maintain Discipline**

- **Make a commitment to yourself**
- **Tell others what you are doing and ask them to remind you of your commitment**
- **Use the COVR newsgroup to compare GMROIs with others on the group.** (If we weren't all into transcending our egos, you could impress your colleagues how on top of things you are!)

**(Slide 24) (Appearance)**

Y'all know much better than I about how to make your displays look attractive, but I mention this so you don't order so thin on something that it looks skimpy.

**(Slide 25) Astutely ordering for the best possible return on the money you spend**

Now we come to ordering.

As a small, independent retailer, you have little leverage to negotiate 'deals' with your suppliers. Thus your options for improving your margins are quite limited. Most of your suppliers probably have a price schedule or discount schedule such that the more you buy, the better your deal. It stands to reason that better margin means more profit, but does it really?

Is it ever more profitable to buy 'thin' at a lower margin and thus turn the inventory quicker than to buy at higher margin but larger quantities? Over the years, I have been asked countless times which is better and my answer never changes and is usually surprising: in almost all cases, ordering small quantities and thus moving the inventory quicker even though the profit margin may be much less almost without exception is more profitable than buying at greater margins but holding the inventory longer.

Now it's time for true confession: What I am about to demonstrate without a shadow of doubt is blatantly self-serving for New Leaf because I will show you why it is almost always better to buy from wholesalers than it is to order directly from the publisher or producer.

The key factor here: **GMROI**. GMROI is? Gross return on investment.

The best way for you to see this is for us to step through some examples. Let's say that you fortuitously get a \$2000 tax refund and you can budget \$1000 of that to invest in inventory. You have found a line of beautiful hand painted gidgets which you feel will do well. You have not seen these gidgets anywhere around you, and you think you can sell them for \$30. They're only going to cost you \$10 each so you're marking them up 3 x's.

**(Slide 26) Gidgets**

The minimum order for gidgets is 50 units @ \$10 each or \$500 so you decide to spend half of your budget on gidgets. There are 5 different designs so you get 10 of each.

So let's project our GMROI.

**(Slide 27) Gidgets GMROI**

Remember, GMROI is the ratio of the profit you'll make against what you invest in inventory for a period of time.

- **Gidgets GMROI = GM % x Sales / Avg. Inventory**

**(Slide 28) Gidgets Gross Margin %**

$$\text{GM\%} = 1 - (1 / \text{MU})$$

$$\text{Gidget GM \%} = 1 - (1/3) = 67\%$$

**(Slide 29) Gidgets Avg. Inventory**

$$\text{Average Inventory} = (\text{Beginning Inventory} + \text{Ending Inventory}) / 2$$

Let's assume that you expect to sell 20 gidgets per month.

$$\text{Beginning inventory} = \$500$$

$$\text{Ending inventory} = \$500 - (20 \times \$10) = \$200$$

$$\text{Average inventory} = (\$500 + \$200) / 2 = \$350$$

**WRONG!**

I just wanted to see if anyone was awake! So what should the average inventory be?

**(Slide 30) Gidgets Avg. Inventory (Corrected)**

- Average Inventory = (Beginning Inventory + Ending Inventory) / 2
- Assume sales of 20 gidgets per month.
- Beginning inventory = \$500
- Ending inventory = \$500 - (20 x \$10) = \$300
- Average inventory = (\$500 + \$300) / 2 = \$400

**(Slide 31) Gidgets GMROI**

- **GMROI is the ratio of the gross margin (or profit) you make on sales for a specific product line against your inventory value in that product line for a period of time.**
- **Gidgets GMROI = GM % x Sales in Period / Avg. Inventory**
- **Gidgets GMROI = .67 x \$600 / \$400 = 1.005**

**Again, please remember that you will have the transcript with all of these formulas so the important thing is to get the concepts so you can understand how to plug in the numbers and what they mean.**

OK now lets look at a second scenario where we order from a wholesaler.

**(Slide 32) Gidgets from a Wholesaler**

The wholesaler has no minimums for these items but you pay \$14 per unit instead of \$10 (40% more). Your profit on each unit is now \$16 instead of \$20. In placing your order, you use the old "one to show and one to go maxim" meaning you order two each with the idea that when you sell one, you will re-order immediately. This means that you only spend \$120 and you would have \$380 to invest in other inventory. We'll look at the full impact of that in a minute.

### (Slide 33) Gidgets GMROI from a Wholesaler

- **GMROI = GM % x Sales in Period / Avg. Inventory**
  - **GM% = GM / R = \$16 / \$ 30 = 53%**
  - **Avg. Inv = (Beginning Inv + Ending Inv) / 2**
    - **Order 10 each week so beginning and ending inventory = 10**
    - **Beginning Inv = 10 x \$16 = \$160**
    - **Ending Inv = 10 x \$16 = \$160**
    - **Avg. Inv = \$160**
- **GMROI from wholesaler = .53 x \$600 / \$160 = 1.99**

**That's a two times higher return on your investment even though you are paying 40% more for the product!**

So now let's look at the impact on your bottom line.

### (Slide 34) Gidgets Profit Buying Direct

The gidgets arrive 2 weeks after you place your order, and you sell out after 10 weeks which is 12 weeks after you placed the order. This means that after 12 weeks, you have made a gross profit of \$1,000 on your order. Not bad – most investors would be pretty happy with that kind of return.

But now let's look at the other scenario of ordering from a wholesaler. Remember that \$380 that we did not spend on gidgets? Let's say that you use this \$380 to buy different items, and for simplicity they happen to have the same pricing structure and sell at the same rate as the gidgets.

### (Slide 35) Invest \$380

- Invest in other items for \$14 / unit that will sell for \$30
- For \$380, you buy 2 each of 13 items or 26 units (That comes to \$364 so you have a little left over – \$16 – **maybe you can buy a gallon of gas.**)
- Now instead of 5 new items, you have 18 for the same investment of \$500
- Sell at same rate as gidgets = 1 each per week of each item
- Sell for 11 weeks instead of 10 so you sell 198 units over 12 week instead of 50
- Over the same 12 week period for the same \$500 investment:

### (Slide 36) Gross Profits of \$3168 $198 \times \$16 = \$3168$

Is that dramatic or is that dramatic? That's over 3 x's as much profit on the same investment! It's like compound interest on steroids!

These examples may be a bit exaggerated in that the minimum order when ordering directly could be much less, but the important thing is to understand the relationship.

And I'm not done yet. You also need to consider the impact on cash flow. In the example above, for simplicity I assumed that payment was made at the time the order was placed. In reality of course, you

are hopefully working on credit. If you have net 30 with all accounts, the first scenario of ordering direct also has negative cash flow. Let's take a look.

### **(Slide 37) Cash Flow**

Assume net 30 terms

Scenario 1 – Ordering Direct

After 30 days, sales = \$300

(2 weeks of sales x 5 units / week x \$30)

Negative cash flow = \$200

- Scenario 2 – Ordering from Wholesaler
- After 30 days, sales = \$1620
- (3 weeks of sales x 18 units / week x \$30)
- First bill is for only \$120

**Positive cash flow = \$1500**

**So I hope this gets you excited because if you get smart with this, it can be like a cash infusion into your business.**

Now I want to go back to ordering considerations one more time. The GMROI considerations would apply when deciding whether to buy more units from the same supplier to gain greater margin.

Let's review how we would calculate GMROI for an order

### **(Slide 38) GMROI for an Order**

- **For sales use projected unit sales per month x retail price**
- **For average inventory use your order cost for beginning inventory and for your ending inventory, use your beginning inventory – COGS for the month**

Now let's look at two scenarios:

### **(Slide 39) Deciding Whether to Buy More for Better Margin**

Scenario 1

Buy 50 units that retail for \$10 @ 45% discount

Assume sales of 25 units / month

Scenario 2

Buy 60 units that retail for \$10 @ 50% discount

Assume sales of 25 units / month

### **(Slide 40) Scenario 1**

Buy 50 units that retail for \$10 @ 45% discount

GMROI = GM% x Sales in Period / Avg. Inventory

- GM% = 45%
- Sales = 25 x \$10 = \$250
- Avg Inv = (Beginning Inv + Ending Inv) / 2
  - Beginning Inv = 50 x \$5.50 = \$275
  - Ending Inv = Beginning Inv – COGS = \$275 - \$137.50 = \$137.50
  - Avg Inv = (\$275 + \$137.5) / 2 = \$206.25

GMROI = .45 x \$250 / \$206.25 = .55

(Slide 41) Scenario 2

Buy 60 units that retail for \$10 @ 50% discount

GMROI = GM% x Sales in Period / Avg. Inventory

- GM% = 50%
- Sales = 25 x \$10 = \$250
- Avg Inv = (Beginning Inv + Ending Inv) / 2
  - Beginning Inv = 60 x \$5.50 = \$330
  - Ending Inv = Beginning Inv – COGS = \$330 - \$137.50 = \$192.50
  - Avg Inv = (\$330 + \$192.5) / 2 = \$261.25

GMROI = .45 x \$250 / \$261.25 = .43

What we have been looking at here is called 'just in time inventory' which is having the precise quantity of items on hand so that you don't run out but don't tie up any more of your money than absolutely necessary. It's what the big boys do, and I hope that you see that with a little attention, you can play the same game.

If you take nothing else away from our time together, I hope that you are impressed with the impact that thin ordering can have on your business.

So now I want to give you one last tool that will help you keep your overall score. It's called Inventory Turnover or Turn and it's the best measure to tell you how well you're controlling your inventory.

(Slide 42) Inventory Turnover

Inventory turn is the number of times your inventory sells in a period of time - usually one year.

- **Example:** Book sales for 2007 = \$300,000 purchased at an average discount of 40%. Your COGS was .6 x \$300,000 or \$180,000. **What are COGS?** If your average inventory for the year was \$100,000, then your inventory on books turned over 1.8 times in 2007.

- $\text{Turn} = \text{Cost of Goods Sold for Sales Period} / \text{Average Inventory}$

Both inventory turnover and GMROI are such a common numbers that you can find statistics for comparison.

### **Conclusion**

**Remember that you are an investor**

**GMROI and Turn are the key measures for controlling inventory**

- **GMROI improves with less inventory *even if* the margins are smaller**
- **Turn also improves with less inventory**