Understanding Gross Margin Impacts on Profitability

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Presented by:
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GJM Associates
Gross Margin Audit: Agenda

- Identify Gross Margin Components
- Review Mathematics Components for Gross Margin Determination
- Explore the GMROI concept as a productivity measure for category evaluation
Gross Margin Audit: Audit Steps

- Identify Components of Gross Margin
- Report and Track
- Evaluate by individual category and then in total
- Use GMROI to enhance business decisions
Gross Margin Audit: GOALS

- Increase Margin Dollars vs. Percentages
- Reduce Cost of Goods Sold
Gross Margin Audit: Margin Components (front end)

- Initial Product Costs
- Initial Mark-on
- Inbound freight costs
- Samples
- Receiving and Marking
Gross Margin Audit: Discounts, Allowances and Chargebacks

- Discounts
  - Invoice Terms, Specials, Incentives
  - Anticipation
  - Quantity discounts (Initial orders, reorders)
  - Bulk Warehouse discount
Gross Margin Audit: **Discounts, Allowances and Chargebacks**

- Allowances
  - Advertising
  - Photography
  - Inside Catalog placement
  - Defective Merchandise
  - Year End Allowance
Gross Margin Audit: Discounts, Allowances and Chargebacks

- Chargebacks
  - Contract Violations - Late shipments, early shipments, packaging errors
  - Excessive Markdowns
  - Excessive Returns
  - Defective Merchandise
Gross Margin Audit: **Margin Erosion**
(back end)

- Markdowns
- Defective merchandise, write offs
- Shrinkage
- Operational costs of Backorders, Return processing
<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Net Product Sales</td>
<td>100.0%</td>
</tr>
<tr>
<td>Initial Mark-on</td>
<td>50.0%</td>
</tr>
<tr>
<td>Discounts</td>
<td>4.0%</td>
</tr>
<tr>
<td>Allowances</td>
<td>5.0%</td>
</tr>
<tr>
<td>Anticipation</td>
<td>0.1%</td>
</tr>
<tr>
<td>Vendor Chargebacks</td>
<td>0.3%</td>
</tr>
<tr>
<td>Year End Allowance</td>
<td>2.0%</td>
</tr>
<tr>
<td><strong>Product Gross Margin</strong></td>
<td><strong>61.4%</strong></td>
</tr>
</tbody>
</table>
### Gross Margin Audit: Margin Mathematics

( - ) Gross Margin

<table>
<thead>
<tr>
<th>Category</th>
<th>Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product Gross Margin</td>
<td>61.4%</td>
</tr>
<tr>
<td>Damages</td>
<td>0.2%</td>
</tr>
<tr>
<td>Samples</td>
<td>0.3%</td>
</tr>
<tr>
<td>Freight In</td>
<td>2.0%</td>
</tr>
<tr>
<td>Markdowns</td>
<td>6.8%</td>
</tr>
<tr>
<td>Shrinkage</td>
<td>0.5%</td>
</tr>
<tr>
<td>Backorder Processing</td>
<td>1.5%</td>
</tr>
<tr>
<td><strong>Net Maintained Margin</strong></td>
<td><strong>50.1%</strong></td>
</tr>
</tbody>
</table>
Gross Margin Audit: **Goals**

- Generate Capital for Growth
- Growth (Items, Categories, Catalog, Company)
- Optimize Capital Usage
- Increase Economic Value of Business
Gross Margin Audit: **Return On Investment**

Commonly defined as:

- Dividend Yield (+ Market fluctuations) on stock
- Interest Rate on Savings accounts
- Interest Yield (+ Market fluctuations) on bonds
Return on Investment is a function of:

- Profit Margin
- Rate of Turnover of Invested Capital
“....No other financial principal with which I am acquainted serves better than rate of return as an objective aid to business judgment.”

Alfred P. Sloan, Jr.

“My Years With General Motors”

President of General Motors 1923-1937;
Founded the Sloan-Kettering Institute for Cancer Research, 1945.
Gross Margin Audit: Return On Investment

\[
\frac{\$5.00\ \text{profit}}{\$100.00\ \text{sales}} \times \frac{\$100.00\ \text{sales}}{\$50.00\ \text{investment}} = 10\%
\]

\[
\frac{\text{(percentage)}}{\times} \frac{\text{(ratio)}}{= \text{ROI}}
\]

\[
5\% \times 2.0 = 10\%
\]

OR

\[
\frac{\text{(profit)}}{\$5.00} \times \frac{\text{(investment)}}{\$50.00} = 10\%
\]

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Gross Margin Audit: GMROI

- Gross Margin Return on Investment
  GM “per inventory dollar Invested”
- Combines into one number ....
  Maintained Margin
  Inventory Turnover
  Total Dollars on hand in Inventory
- Provides ROI on this major asset
- Indicates profitability variations due to product category differences only
Gross Margin Audit: **Gross Margin per Inventory Dollar Invested**

\[
\text{Gross Profit} \times \frac{\text{Gross Profit \%}}{\text{Ratio of Sales to Inventory}} = \text{Gross Return}
\]
Gross Margin Audit: **GMROI**
(examples)

<table>
<thead>
<tr>
<th>Basics Mix</th>
<th>Import Private Label</th>
<th>Branded Merchandise</th>
<th>Licensed Goods</th>
</tr>
</thead>
<tbody>
<tr>
<td>Product Cost</td>
<td>43.5%</td>
<td>40.0%</td>
<td>50.0%</td>
</tr>
<tr>
<td>Initial Mark on</td>
<td>56.5%</td>
<td>60.0%</td>
<td>50.0%</td>
</tr>
<tr>
<td>Discounts/Allow</td>
<td>4.5%</td>
<td>1.5%</td>
<td>4.0%</td>
</tr>
<tr>
<td>Freight (IN)</td>
<td>-1.5%</td>
<td>-3.0%</td>
<td>-1.5%</td>
</tr>
<tr>
<td>Markdowns</td>
<td>-8.0%</td>
<td>-10.0%</td>
<td>-8.0%</td>
</tr>
<tr>
<td>Total Cost of Goods</td>
<td>48.5%</td>
<td>51.5%</td>
<td>55.5%</td>
</tr>
<tr>
<td>Maintained Margin</td>
<td>51.5%</td>
<td>48.5%</td>
<td>44.5%</td>
</tr>
<tr>
<td>Inventory Turn</td>
<td>3</td>
<td>2.5</td>
<td>5</td>
</tr>
<tr>
<td>GMROI</td>
<td>319%</td>
<td>235%</td>
<td>401%</td>
</tr>
</tbody>
</table>

Turns X Maintained Margin / COGS = GMROI
Gross Margin Audit: **GMROI**
(examples)

Turns X Maintained Margin / COGS = GMROI

Example: 3.0 x 51.5% / 48.5% = 318.6%
Gross Margin Audit: **Inventory Turns**

(formula)

*Inventory Turns = Annual Cost of Goods Sold / Average Inventory (at cost)**

**Average includes 13 periods......

Example: $10.0mil COGS / $ 3.1mil Avg. Inv = 3.23 annual turns*
Gross Margin Audit

Negative Impacts to Profitability
Gross Margin Audit: Margin Erosion

- Markdowns (Overstock)
- Damages, Write-Offs
- Operational Costs of Backorders & Returns
- Shrinkage
Gross Margin Audit: **Backorder Costs**

- Split packages
- Postage Expedited delivery expense (in & out)
- Packing Supplies expense
- Manpower - multiple handling
- Additional Phone Costs
- Additional Cancels
- Customer Retention Rates
Gross Margin Audit: **Backorder Improvements**

- Better forecasting
- Improved inventory flow
- Communication to DC on priorities
- Profitable backorder chasing
- Recover costs thru vendor chargebacks
- **Buy** overstock on low price items
### Backorder Improvements

**Example:**

<p>| | | | |</p>
<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Cost</td>
<td>$4.50</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Retail</td>
<td>$10.00</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Margin</td>
<td>55.0%</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

- **Backorder Cost**: $5.00
- **Liquidation Costs @80%**: $3.60
Gross Margin Audit: **Canceled Demand**
(including credit rejects)

- Costs associated with processing the order
  - Phone time & costs
  - Keying

- Potential Overstocks
Gross Margin Audit: **Cancellation Improvements**

- Better forecasting (Planning!)
- Improved inventory flow, etc.
- Credit rejects analysis
Gross Margin Audit: **Returns**

- Reduction of sales
- Warehouse handling
- Potentially missed sales
- Returns postage - customer requests
- CSR time
- Postage (customer confirmation)
- Damaged returns
Gross Margin Audit: **Returns Improvements**

- Analysis of top reasons for returns
  - Attack top reasons - returns will probably drop by more than 25%
- Establish “up-front” QC efforts
Gross Margin Audit: **Overstocks**

- Cost of liquidation - recovery costs are generally low
- Warehouse space
- Handling Inefficiencies
- Carrying cost of inventory
- Extra manpower to coordinate liquidation
Gross Margin Audit: **Overstock Improvements**

- Implement Assortment Planning
- Implement Open-To-Buy controls
- Project overstocks and liquidate “in season”
- Cancel Open PO’s
- NEGOTIATE with vendors
- In season bouncebacks, “add-on programs”, sale books
Gross Margin Audit: **Cost of Goods Sold (COGS)**

- Have all merchandise costs been considered?
- Additional prep charges?
- All inbound freight costs included?
Gross Margin Audit: **Cost of Goods Sold (COGS)**

- **Imports -- Complete landed cost**
  - FOB cost
  - duty
  - ocean/air freight
  - broker’s fees, agent’s fees
  - insurance
  - bank L.C. costs (amendments)?
  - local freight from POE to dock, etc.
Gross Margin Audit: **COGS Improvements**

- Margin check
- All factors included?
- What is the assortment plan by department?
- Set thresholds
Gross Margin Audit: **COGS Improvements**

- Negotiate costs
- Adjust retails
- Negotiate lowest base price (contrary to earlier statements)
- Review costs of “Inbound Freight” & small package shipments
- Vendor “Drop” Shipments – Review how shipping charges are applied
Gross Margin Audit: **Production/Marketing Costs**

- Are we developing merchandise to fill the allocated pages? **Or** are we building pages based on merchandise availability?
- Item level space cost analysis -- Sell Ratio
- Proper list analysis
Gross Margin Audit: Distribution Costs

- Information flow for:
  - Receipts flow
  - BO priorities
  - Item estimates for proper pick set-up

- Is merchandising arriving in a ship ready condition?
Gross Margin Audit: **Distribution Costs**

- Are inbound/outbound freight shipments efficiently consolidated?
- Are automated procedures up to date? Are they relevant to today’s business?