Early Warning Signs of Disaster

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These are challenging times for the retail and wholesale industries. Low growth and capital limitations have had severe effects on companies, whether struggling for survival or for success. As an owner, a CEO, or a member of the board you may have been involved with a company that has done well in the past, has many good people and good customers, but now the company is struggling. You want to do what is best for the long-term health of the company. Denial is powerful and the temptation to maintain the status quo is often fostered by hidden agendas or conflicts of interest such as stock options and bonus arrangements. A combination of the natural tendency of retailers to be optimistic and the ego involvement so necessary for success in retailing can sometimes produce a recipe for failure. Timely recognition of the early warning signs that a company is headed for disaster can often make the difference between a successful recovery or a bankruptcy filing. It is important to be realistic about addressing problems as early as possible. At the first sign of serious problems or major external changes, it is critically urgent to focus the organization's energies on resolving those difficulties.

Fortunately, there are some clear, easily employed indicators that can be used to determine whether your business is in need of help from professionals who bring an outsider's objectivity and a commitment to aid management quickly and effectively.

Comparable Store Sales. This is a simple and highly visible indicator. Namely, in stores that have been opened for more than a year (usually more than 13 months), what are the current sales compared with those of the same period last year? If inflation is 2% and a retailer's sales are exactly the same as last year, this is bad news because costs are likely to be higher, so profits are lower. If your comps are up 5%, you are really ahead by only 3%.

Market Share. Although not as easily measured, it is important, and smart retailers watch this closely. If a store is in a mall, it is easy to find out how the total mall is doing with respect to sales and how categories of retailers are doing in the mall. For instance, a mall may be growing at the rate of 6% this season but your store's sales are flat. This is not good news, because it is very likely that you are losing share of market by giving up sales to another competitor in the mall.

Inventory Aging Analysis. This is a big, important indicator and it is easy to measure. However, retail merchants often rationalize as to why the statistics are unfavorable. Think apples, oranges, and pears. If they just came off the truck today, and I sprinkle them with water and stack them in high pyramids, they look luscious and the customers will buy and buy. Three days later the same fruit is beginning to look a little tired and some have bruises. Customers have picked out the best-looking fruit and now some are a bit too ripe and won't last long at home. If you still have the same shipment at the end of the week, forget it. It's "toast."

The same applies to every classification of merchandise. It's only the length of time over which obsolescence occurs that varies. For a dress this may be six weeks, a sweater may be 18 weeks, a sofa may be 18 months. Every category has a life and an identified rate of average obsolescence. Stores carry thousands of SKUs (stock keeping units), but the age of the inventory can be tracked easily. If the aging analysis shows that the inventory is getting older, the goods are beginning to spoil. No matter how much the merchant believes that "this is a truly great sweater," if it is aging, getting older on the shelf, this is a negative indicator.

Retailers might focus on the gross margin rate or the markdown rate, and think things are going well. However, if the gross margin implied by the merchandise you have in stock is high, yet the goods are aging, then what might look like a valuable asset on paper is really not as valuable, and future profits will be lower.

Turnover. This refers to the ratio of sales in a specified period of time to the average inventory needed to support those sales for that period. If you have 150 sweaters at the beginning of the month, sell 75, received 25 new ones, and have 100 left at the end of the month, then the turnover ratio is 75 divided by 125 or 6/10 or 0.6 times in the month. This might be a good turn rate for high-priced sweaters, but it would be a poor rate for low-priced sweaters. If the turnover rate slows down, then we know the age of the inventory is going to go up.

Merchandise Mix. If you have great basic sweaters and no fashion sweaters, the sweater business will suffer. If you have only fashion sweaters, the business will suffer. The mix is important and getting it right requires skillful merchants who understand customer demand.

Customer Surveys. Retailers don't do a lot of good customer analysis by survey, but it is easy to do. Focus group analysis can be an excellent way to understand a retail business. Analysis by focus group is more expensive and time consuming than are surveys, but the payoff can be far greater.

Sales Dollars per Square Foot of Selling Space. This is a very simple tool for analyzing how effectively space is being used. It is useful in all stores, but it is particularly useful in specialty stores. Let's say you are running a mall-based ready-to-wear (RTW) shop that has 2,000 square feet of selling space. Sales for the year are $625,000, so annual sales per square foot equal $313. Looking around the mall you find that other RTW stores of varying sizes are running at $500 to $750 per square foot. You may have the wrong product, a bad fit, a wrong location, poor customer service, or a combination of many things. Productivity per square foot is an extremely useful indicator.

Average Check. This refers to the retail prices at which items are sold. For instance, if you are selling sweaters and most of your unit sales are at $100, then measuring the average prices of the goods available to sell indicates the "average check" size. If next year you bring in primarily lower-priced sweaters and the average check goes down to $50, then you will have to sell twice as many units just to be even, and that means more labor costs, more handling costs, more customer returns—more of many elements that create expense dollars. On the other hand, if you can trade up and successfully sell $125 units, the chances are your sales will be up and your profits will go up as long as you intelligently control costs.

Average Transaction Size. This refers to the size of the shopping bag when the customer leaves the store. If she or he is typically buying one sweater, one blouse, and one skirt, then your average transaction will be a function of the average check of those items. If the average price of the sweater is $100, the blouse is $75, and the skirt is $200, then you have a $375 average transaction.

In general, a higher average transaction will result in a more profitable and efficient sale transaction for two reasons: 1) for a given level of sales volume, the number of customers who must purchase is lower, and 2) the cost of the transaction will be less because the salesperson is handling one customer, so the selling cost per transaction is lower.

Response to Advertising. When Macy's spends $2 million to insert a color catalog in the newspaper for a weekend, Macy's can measure sales for the next several days to determine whether the advertising helped. It can track each item that was advertised, comparing "sell-through" or how many units were sold out of how many that were available to sell. If the response is strong, it is good news. Remember, you would only advertise those things that you think are the most likely to attract customers and sales. If the response is poor, you have big troubles—the customers just don't love your goods.

If these performance indicators reveal substantial problems, then investors, the board of directors, and the management team must be willing to be objective, stand back and examine them. You may debate whether the problems can be solved with the help from the board, the owner, or the management team, or whether there is a need for specialists with the skills and objectivity to fix the problem, while working with the management team in a positive way, without fixing blame. Often it is the outside specialists who have no conflicts of interest or hidden agendas that can provide the required help. The speed with which the problems are addressed can mean the difference between successfully turning the business around or facing bankruptcy.