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FOR PROGRESSIVE MUSIC RETAILERS

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Brad, Brett & Danny Palen of Palen Music Center

RETAIL BY NUMBERS

BY CHARLES FULLER

with reporting by Zach Phillips, photo by Jeremy Lawson

Each night at 1 a.m., software at Palen Music Center wakes up, compiles 15–25 reports, packages them into eight distinct e-mails and ships them off to the chain's employees — nearly every employee, from owners to front-line sales people.

Every morning, managers at each of the company's six Missouri locations gather with their sales staff to go over the numbers. Meanwhile, in their offices, upper management and other support staff open theirs.

Financially, everyone in the company is, more or less, on the exact same page.

Given that, it may come as no surprise that Brett Palen, CEO, and his brother Danny, vice president (two of the three second-generation co-owners), both trust the numbers over their gut instinct.

It wasn't always that way. Four years ago, when cash flow seemed inconsistent with income statement profits, the Palens refused to simply chalk it up to China or any other external variable. But without the ability to track and examine the company's dollars, they couldn't be sure either way.

At the NAMM Show that year, in the company of most of their staff, the book *Up Against The Wal-Marts* inspired a paradigm shift. An age of reporting was born.

Financial self-awareness revealed that the issue with cash flow came from within — it wasn't China, it was Springfield, Mo., and the way the company purchased product.

Since then, the full-line retailing chain has steadily learned more about the numbers behind all its operations and made adjustments accordingly.


From left: Brad, Danny and Brett Palen

TAKING STEROIDS

THE MUSCLE BEHIND RETURN ON INVESTMENT

Return on investment (ROI) on inventory, a.k.a. gross margin return on investment (GMROI). This number measures the profits you've earned against the investment you've made in inventory. It reflects the relationship between margins and inventory turns.

For MI retailers, it heavily influences cash flow — a high ROI goes a long way toward a healthy checking-account balance.

Calculating inventory ROI
Take profit made over the past 12 months and divide that by the average inventory figure. To find this figure, add up the worth of your inventory at cost for each of the past 12 months and divide by 12. This can also be done for specific brands or segments.

$$\frac{\text{PROFIT ON INVENTORY FOR THE YEAR}}{\text{AVERAGE WORTH OF INVENTORY EACH MONTH (FOR THE PAST 12)}} = \text{ROI on inventory}$$

An ROI < $1 doesn't mean you lost money on your investment, it means your profit couldn't justify your level of inventory. A low store-wide ROI means the profits you did make probably ended up paying for the cost of gear that's just sitting on the sales floor.

Each business model is different, but Palen Music estimates that **ROI > $1.30** *will contribute to cash flow.*

Alan Friedman, industry CPA, suggests **ROI ≥ $1.50** *shows healthy inventory management*

Improving ROI usually starts with smart purchasing. Palen Music uses an elaborate spreadsheet hinged on a target ROI to guide purchasing. Many may not have that capability, but the concept remains: work backwards.

For instance, if you can accurately estimate your profit from guitars for the year, divide that by an ROI you'd like to achieve. For example, $15,000 (predicted profit) / $1.5 (a solid ROI) = $10,000. How much inventory do you have right now? $20,000 worth? It may be time to buy less. Improving ROI takes time, and no equation tells you how to exactly. But this will give you a good idea of where you would be in an ideal world.

Today, according to Brett, the company is more successful than it's ever been, and cash flow is no longer something to worry about.

THE INFRASTRUCTURE

A big part of the switch came through humility — realizing they didn't know finance and taking the initiative to learn the difficult and often-times counter-intuitive concepts. This meant seeking out those who already did.

It's worth mentioning — and the Palens would have it no other way — that industry CPA Alan Friedman and brethren retailers shared what they knew about finances in order to help.

After some research, the team discovered Business Objects' Crystal Reports software, which would integrate with Palen Music's Windows-based POS/accounting software, Tri-Technical System's AIMsi.

Brett and Danny also found people to manage the data on a regular basis.

This took the form of two key employees, Daniel Jobe and Casey Tillman. Jobe, without a degree in accounting, learned the financial concepts — what the company would need to look at.

Tillman, now operations manager, learned the software. "I don't think the software itself cost all that much, but I bet [Casey] was in his office for three months with a book about it," Jobe said. "But now you can go in there and say, 'Hey, we need to look at this,' and he'll be out in two hours with a report that we can generate every day."

Tying it all together was Crystal's auto generator, which clicks on in the early morning to compile a variety of detailed reports.

CASH FLOW AND ROI

Of the figures Palen's management used to look at, sales and profits were pretty straight-forward. But the company's checking account balance seemed consistently out of whack — at least compared to the other numbers. Profits were fine — even strong — but on-hand cash remained low.

With the numbers in front of them, management realized that strong profits put money in the bank, but didn't necessarily keep it there.

"Generally, I think not just in our industry, but in most industries, small businesses don't understand cash flow," Brett said. "Cash flow is primarily a function of return on investment on your inventory."

Return on investment (ROI) on inventory, also known as Gross Margin ROI, tells you what was made for each dollar spent on inventory. It's calculated as the ratio of profit made by selling inventory to the average inventory worth at cost. (See sidebar for more on ROI.)

In early 2004, Palen Music had a store-wide ROI of $1.25. (For every dollar they invested in inventory, they got back their dollar and then an extra 25 cents.) That's a margin similar to many U.S. retailers who are considered successful. But it wasn't enough for the Palens.

Based on the company's model, management estimated that Palen's break-even point was actually an ROI of $1.30.

The team began to look at ways to improve their return. They concluded that, with their profits as they were, stronger ROI — and better cash flow — could best be achieved through better inventory control.

Sitting in a board room in the company's Springfield South location, Brett showed the *Music Inc.* editors his ROI spreadsheet. He had it broken down by store, and then further by segment and by brand.

During March, some guitar brands sat strong at more than $2 for every dollar invested. Another was at 63 cents.

A SKU from that vendor could easily have brought in more profit per sale, but it also cost Palen Music more sitting on the sales floor.

"The key is not to confuse profit with ROI," Palen said. "If you spend an average of $10,000 on inventory for a sub category for a year, and your profit on that category is $6,000, you actually lost cash flow. It's not an easy thing to understand until you can really track it. Even though you made $6,000 — you made money in addition to getting back your $10,000 — you didn't make enough to justify the level of inventory you were stocking."

Improving ROI for any or all brands meant reducing total inventory and turning more of it, if possible at higher margins.

Margins can be tough to adjust and some guitars attract business whether they bring in big money or not. That said, with ROI as a guide, the Palens bought less of the product that didn't move fast enough and more of what did; they reduced average inventory and simultaneously improved profit. ROI started to climb.

"What we actually found is that we were selling 30 percent of our inventory over and over, and 70 percent was sitting," Brett said. That 70 percent was weakening ROI and draining cash.

Since February 2004, the team has been able to reduce its overall inventory by 40 percent. But instead of turning only 30 percent, they've been able to regularly move 70 percent.

The outcome: even though they've reduced inventory by nearly half, the company's orders to vendors have increased every year, and storewide ROI is up to $1.80. In short, they went from negative to positive cash flow.

SMART BUYING

Understanding ROI and its relation to inventory wouldn't fix cash flow until the company could purchase more effectively. Danny Palen, who had been in charge of purchasing for the company, realized that even he could only do so much.

He and Brett decided to get a little closer to the front line; they put purchasing in the hands of store managers. Who knows what a store can sell better than the people that see the action up-front every day?

"We know that Dave [in Springfield] is going to move different gear than Ray does in Joplin or that Dick does in Liberty, in particular because of personalities," said Tom Hosick, district manager, of the different store managers. "We believe that the boss culture is a thing of the past. Our front-line managers have the power to do what they believe is best for their stores. They do a better job of it than I could."

All orders still go through a central purchasing office, still run by Danny, for discount purposes. But the fact remains that Dave Coble, manager at Springfield South, decides what lines the walls and sits on the show floor.

In the 14 months since the managers began purchasing, ROI has increased 46 percent.

This doesn't mean that the managers work on gut instinct. They are guided by a massive, linked spreadsheet that the CFO, Jobe, developed and that, according to Coble, "Does everything but make your coffee in the morning."

The sheet, separated by product segment, hinges on a target ROI number. It starts with a beginning inventory value, budgeted sales figure and — the mother of numbers — projected sales.

"[This line] is looking at the last three months performance actual versus budget, and it takes that pace and blows it forward," Jobe said. "So it will catch a trend going up or down to make sure you have the right amount of inventory. It's making sure we're not tightening the noose."

So if January and February were up big, but March was down, April could still be projected above budget. One down month won't scare management into choking potential growth.

Again, it protects against gut. "There's many reasons why people buy and don't buy," Hosick said. "We choose not to dwell on the things we can't control. You have to let the numbers dictate."

Using the predicted sales figure and an average margin number, the sheet estimates profit for each segment — one half of ROI. Then, using the target ROI, inventory worth at the beginning of the month, purchases month-to-date and a little magic, the spreadsheet tells the manager how much he has left to spend on inventory while staying within that target.

Said another way, based on what's in house at cost and what's likely to be made based on previous performance, the spreadsheet will give the manager a dollar figure that he has left to spend that will still move that instrument category toward an ROI that management believes it can achieve.

'If we didn't have the interpersonal skills that we have, these reports would have never come to pass.'
—Tom Hosick

From left: Daniel Jobe, Dave Coble and Tom Hosick

As a side note, managers at Palen Music locations will almost never buy a product unless it's in stock with the manufacturer. If they purchase something that won't come for three months, they've still reduced the amount they're able to buy the month they ordered it. This hurts ROI and takes away from potential sales.

"For me, it goes deeper than that," Coble said. "I won't order a product if I know I don't have a guy that's going to sell it. If the product fits my personnel and is in stock, and we have the purchasing dollars to buy it because we sold enough last month — all those things line up, and I can get it in and sell it before the end of the month. Then we can do it all over again."

MUTUAL EFFORT

Coble's interest in ROI isn't just something that Palen or Jobe or Hosick have encouraged or inspired. He certainly cares about the overall financial health of the company, and therefore a strong ROI, but he has another influence. His monetary rewards, his bonuses — and everyone else's — are based on strong numbers.

Actually, they're based on the three financial figures that Brett deems most important to running a successful business: ROI, net profit and inventory accuracy.

The profit-sharing equation works off a target net profit number for each store. If the store exceeds that target — something Brett said happens often — the excess, less any negatives from previous months and/or missing inventory, is available for sharing.

A percentage of that number is taken based on the store's ROI. The higher the ROI, the higher the percentage.

Palen pumps 70 percent of the shared money right back into the individual store that earned it: 30 percent goes to the manager, 16 percent to the sales people (based on a ranking that incorporates profit dollars, margin, average amount of items per sale and other factors), 16 percent to the road staff and 8 percent to repair.

Non-store-specific staff splits the remaining 30 percent, including 20 percent to central management and 3 percent to support staff.

A manager could walk with an extra $1,000 or more and a top salesperson could walk with several extra $100s, in addition to his or her salary, each month.

None of this has led to a rise in prices; staff focuses on other figures. Ultimately, the profit-sharing brings both money *and* financial awareness to front-line staff. It has the deliberate effect of aligning everyone's focus. Whether they work in accounting or sales, they're working toward the same goal.

"There's no way to cheat the system," Brett said. "There's no way around just doing a great job. Every day, you're looking at cash flow, margins, getting control of your inventory. It can't help but to improve them."

HUMAN CAPITAL

If you notice one non-calculated trend in Palen Music, it's the trust — the investment — that Palen has put in key employees to do the calculating and day-to-day management.

If Jobe or Tillman or Eric Matzat, company president, or any other employee hadn't empowered the changes in the company structure — helping to implement them and keep them going — the company wouldn't be where it's at. Brett and Danny know that, but it doesn't scare them.

"Danny and Brad (the third co-owner) and I, we've really tried to create a culture that's not at all dependent on us as owners for the business to thrive," Brett said. "I feel confident that these guys are running the business."

It's an interesting give and take. If it weren't for that attitude, Palen Music may never have made it through the humbling financial pilgrimage.

Egos had to be left at the door. "Do you know how difficult is was for us?" Hosick asked. "If we didn't have the interpersonal skills that we have with one another, these reports would have never come to pass."

At the same time, the system now in place has opened the door for more of what put it there; management has more time to understand and contribute socially and professionally to the personalities they work with because everything else is laid out every morning in black and white.

For management, it's about treating staff as more important than customers. They feel the customers end up getting the best possible treatment this way. It's nice to be in a place where people enjoy their jobs.

"Everybody says their people are important, but when we pour into the lives of our people, I'm talking about all kinds of things," Brett said.

The stores will regularly host seminars on investing in the stock market or real estate. Jobe has done sessions on personal finance.

"Several [people] in this company are partners with me and my brothers in other ventures," Brett said. "We are a small company compared to someone like Guitar Center or Daddy's Junky Music, but we still have several guys making substantial incomes — it's just that not all of it comes from the music business."

Annually, Palen will also sponsor a trip for eight to 10 people — and pay their salaries while they're gone — to go to Brazil to work with Christian Missions Unlimited.

It creates a culture whereby Palen Music can attract and cultivate new leaders. It also makes a long-term investment in staff. According to Hosick, while he's heard the industry average is 55 days, the average tenure for any Palen employee is three or four years.

Brett wonders if the hands-off approach can be construed as non-interest or fear of leading, but he always comes back to the difference between intelligence and wisdom.

"Since we run our company by wisdom and processes rather than policies and procedures, there's kind of a connotation that we're weak," he said. "We talk a lot about weakness vs. wisdom — there's a fine line between them. The funny thing about it is, when it comes to getting rid of people that are bad apples or not on board, we probably have a quicker fuse than most people.

"If somebody's not where they should be, it's the axe. 'We love you, but this is not the right thing for you.'"

And with 15–25 reports every morning, there's no doubt about where they should be. MI