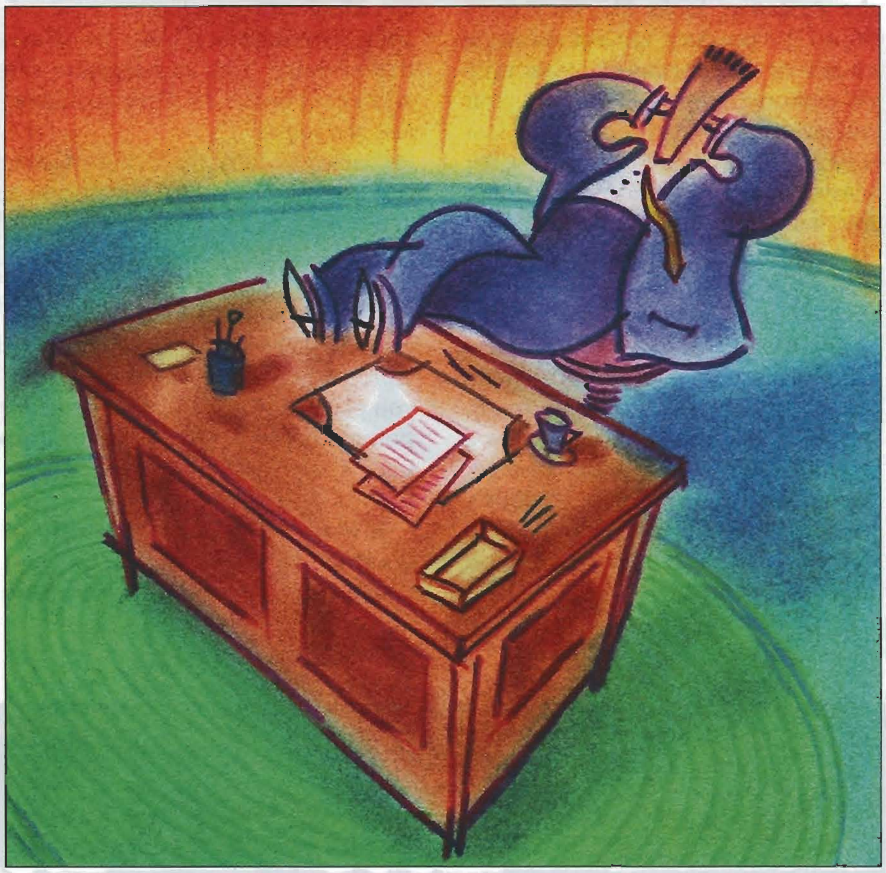
Ask Alan

by Alan Friedman

The 'Ins & Outs' of GMROI



Q: Alan, can you please explain GMROI (Gross Margin Return On Investment)? I want to better understand how to calculate this number and what it means to my business.

For example, what exactly does a 2.5 or a 5.0 GMROI mean, and which is better? What should I do with this information?

—Joe Kane, Bang Music

A: Joe, congratulations on being the first music retailer to write in to *Ask Alan*, inquiring about a critical calculation for effective inventory management.

Many years ago, when I was just a young and stupid guitarist, I thought "GMROI" was some new recreational vehicle manufactured by General Motors. I also used to believe that the only way to assess a retailer's inventory management skills was to look independently at their gross profit percent and inventory turns. Then I grew a brain and started using the cute little calculation called "GMROI," which is the retailer's ultimate weapon in the fight for achieving efficient inventory management.

GMROI stands for "Gross Margin Return On Investment" and measures the financial return on a retailer's inventory investment. The GMROI is calculated by dividing the gross profit dollars achieved during a period of time by the dollar amount of average inventory carried during that same period of time.

I suggest that every music retailer strive to achieve $1.50 (or better) for every $1.00 of inventory carried during the course of a one-year period. Achieving this will automatically improve cash flow by increasing sales profitability, decreasing the dollar amount tied up in idle inventory—or a combination of the two.

The really cool thing about GMROI is that it computes the "blended" effect of both gross profit percent and inventory turns into one easy calculation. This, in turn, lets a retailer calculate whether they are succeeding or failing with their purchasing, management and selling of music product inventory. To better understand this magical indicator, let's take a look at the chart for Big Al's House of Rock & Schlock on page 21.

Looks like drums are doing great with a gross profit margin of 44 percent, right? WRONG! Look at how much money the store invested in drum inventory—$150,000. There is more drum inventory on hand than was sold for the entire year, as evidenced by its $140,000 annual cost of goods sold and resulting inventory turn of 0.93 annually. That is why the store only earned a $0.73 GMROI, despite a great margin of 44 percent.

Now let's look at Big Al's guitars. Maybe you think that a 28-percent margin on guitar sales is not that great. You may be right, although that's becoming a fairly common margin these days, especially for combo/MI and pro audio retailers.

But wait. Look at the guitar GMROI. They hit my goal of $1.50—fabulous! How did Big Al do it? By not buying more than 90 to 100 days worth of guitar inventory throughout the year. Their average inventory of $55,000 resulted in an inventory turn of 3.91 times, which helped the store reach its ideal $1.50 GMROI.

Inventory turns are the name of the game when working toward achieving profitability and resulting cash flow. By turning your inventory quickly, you can buy and sell more product quicker, making up gross profit "dollars" lost by declining margins.

Let's face it, low margins are tough to fix given the competitive forces from local retailers, national chains and the internet. Even enforced MAP pricing has a limited

BIG AL'S HOUSE OF ROCK & SCHLOCK

	DRUMS		GUITARS	
Sales	$ 250,000	100%	$ 300,000	100%
Cost of Goods sold	140,000	56%	215,000	72%
Gross Profit	$ 110,000	44%	$ 85,000	28%
Avg. Inventory Carried	$ 150,000		$ 55,000	
Inventory Turns	0.93		3.91	
GMROI	$ 0.73		$ 1.55	

effect on preserving profit margins because manufacturers are setting those damn MAP prices too low.

What do you do in today's retail environment to achieve profitability and an increased cash flow? If you can't make your margins grow, increase inventory turns by either selling more or buying smaller quantities. The GMROI calculation will let you monitor your progress.

Are financial questions keeping you up at night? E-mail yours to askalan@musicincmag.com. Please include your full name and company.

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