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THINK TANK | BY ALAN FRIEDMAN

Wake Up & Smell the Coffin

Last year I stopped writing 'Think Tank' articles, the longer diatribes where I would address what I consider the music product industry's most-pressing financial issues. In its place, I started writing the 'Ask Alan' column where we look to you—the retailer, manufacturer, distributor—for what's most important.

Well, I'm going back to the Tank this month. There's one more diatribe that needs to be written. It's going to be long and, at times, controversial. Hold onto your hats.

'Retailers and manufacturers must start communicating with each other. I've seen the enemy, and the enemy is both of you.'

AN INDUSTRY IN TURMOIL

This sick feeling in my stomach (now migrating to my wallet due to the poor cash flow affecting our music store clients) is over an industry in turmoil.

Growing competition and shrinking margins; shrinking owner compensation and growing inventories; supply chains expanding as the qualified workforce shrinks; and increasing unit and dollar sales that are offset by a corresponding decrease in gross-profit dollars are behind my illness.

Your well-financed competition is no longer confined to Guitar Center, Musician's Friend and American Music Group. It now includes Wal-Mart, Costco and Toys 'R Us.

Are these signs indicating a slow, painful death of the music products industry as we know it? Maybe… and maybe not. Or let me give you my favorite answer to any tax question: "It depends."

It depends on whether retailers sit on their asses, bitching and moaning. The old clichés "service your customers," "educate your sales staff" and "vote with your pocketbook" are more than just rhetorical. They—along with a solid understanding of inventory turns, GMROI and cash flow management—are essential to a retailer's survival. It also depends on whether suppliers continue loading their retailers with ridiculous inventory buys for the sake of meeting sales quotas.

It depends whether suppliers continue to ignore Chinese and other foreign manufacturing alternatives by flaunting their "Made in USA" flags perched atop their ships, as those ships sink to the bottom of the music-retailing ocean.

But most importantly, it depends on whether you—retailers and manufacturers—resolve these problems together. You must start communicating with each other. I've seen the enemy, and the enemy is both of you.

The bottom line is you had better start figuring out what's going on in your store, manufacturing plant and industry. Develop a business plan and be prepared to modify it. If you don't like what's happening around you, speak up—your voice needs to be heard.

I believe the world's problems can be solved with open, honest and respectful communication. It's time we collectively start making some long-overdue changes so we can avoid watching a $7 billion industry get thrown in a pine box and buried six feet under.

My music industry friends, this is your wake-up call. If I'm scaring you, good. You should be scared. If I'm angering you, don't just sit there—do something. If I'm confusing you, don't worry—keep reading.

STARTING AT THE TOP

My harsh words are not intended solely for the supply side, but it's a good place to start.

I recently engaged in friendly debate with a few of my music industry peers who work on the dark side (a.k.a. manufacturing). They said, "It's the retail-

EXHIBIT 1 - FALLING PRICES

	WHAT WAS	WHAT'S HAPPENED	WHAT'S NEEDED
UNIT SALES	5,000	5,000	10,000
AVERAGE SELLING PRICE	$200	$100	$100
PROFIT MARGIN	30%	30%	30%
SALES	$1,000,000	$500,000	$1,000,000
COST OF GOODS SOLD	(700,000)	(350,000)	(700,000)
GROSS PROFIT	300,000	150,000	300,000
OVERHEAD EXPENSES	(300,000)	(300,000)	(300,000)
NET INCOME (LOSS)	–	(150,000)	–

EXHIBIT 2 - FALLING MARGINS

	WHAT WAS	WHAT'S HAPPENED	WHAT'S NEEDED
UNIT SALES	3,750	3,750	5,000
AVERAGE SELLING PRICE	$200	$200	$200
PROFIT MARGIN	40%	30%	30%
SALES	$750,000	$750,000	$1,000,000
COST OF GOODS SOLD	(450,000)	(525,000)	(700,000)
GROSS PROFIT	300,000	225,000	300,000
OVERHEAD EXPENSES	(300,000)	(300,000)	(300,000)
NET INCOME (LOSS)	–	(75,000)	–

EXHIBIT 3 - RISING EXPENSES

	WHAT WAS	WHAT'S HAPPENED	WHAT'S NEEDED
UNIT SALES	5,000	5,000	6,667
AVERAGE SELLING PRICE	$200	$200	$200
PROFIT MARGIN	30%	30%	30%
SALES	$1,000,000	$1,000,000	$1,333,334
COST OF GOODS SOLD	(700,000)	(700,000)	(933,334)
GROSS PROFIT	300,000	300,000	400,000
OVERHEAD EXPENSES	(300,000)	(400,000)	(400,000)
NET INCOME (LOSS)	–	(100,000)	0

EXHIBIT 4 - ALL HELL IS BREAKING LOOSE

	WHAT WAS	WHAT'S HAPPENED	WHAT'S NEEDED
UNIT SALES	3,750	3,750	13,333
AVERAGE SELLING PRICE	$200	$100	$100
PROFIT MARGIN	40%	30%	30%
SALES	$750,000	$375,000	$1,333,333
COST OF GOODS SOLD	(450,000)	(262,500)	(933,333)
GROSS PROFIT	300,000	112,500	400,000
OVERHEAD EXPENSES	(300,000)	(400,000)	(400,000)
NET INCOME (LOSS)	–	(287,500)	(0)

ers' fault that consumer prices are too low. They keep demanding more low-priced product in order to compete."

Who are these vendors kidding?

Here's a novel idea: Why don't suppliers start making "more" money by "limiting" who sells their product? By opening up every retailer and their uncle, suppliers are merely:

1. Cheapening their product;
2. Forcing retailers to (excuse the expression) whore-out their product to cope with growing inventories that choke their cash flow;
3. And letting short-term greed erode their company's long-term financial stability.

Suppliers, who are you going to sell to when the independent retailer can no longer make the necessary margins to stay in business? Haven't you learned a lesson from the MARS fiasco?

A receivable on your books is not "just like cash in the bank" (although you somehow convinced your banks to buy that load of crap). When a $100,000 receivable goes bad, it'll take at least $500,000 in newfound sales to make up that bad debt.

FOR GROWTH'S SAKE

I scratch my head when I see suppliers (and some retailers) do everything they can to grow the "top" line of their business, yet ultimately add little to their "bottom" line.

They expand their infrastructure with a larger sales force, increased office rent as well as advertising and warehousing costs that need to be fed with gross sales. And when a downturn in the economy happens, guess what hits the fan?

Instead, suppliers should build bottom-line profitability with better products and lower manufacturing costs.

I can think of two product lines—Ovation Guitars and Knilling Violins—that now incorporate innovative neck assemblies and tuning systems into their products, keeping their line fresh and competitive via manufacturing quality. I tip my hat to these companies for not taking the easy way out.

Do you think companies like Harley-Davidson and Mercedes Benz (or Steinway and Allen Organ, for that matter) achieved brand recognition and financial successes by opening up any dealer who waves enough money in their face? I don't think so.

These companies protect their retailers by taking a long, hard look at existing dealers in adjoining markets before granting their coveted lines. But many suppliers in the music product industry will open up any dealer who has a pulse, and provide competing products to their local Wal-Mart. That's right, Wal-Mart!

The rationale is the local music retailer will eventually get the string, pick, lesson and repair business if a kid sticks with the instrument. Wow, that'll almost give retailers enough net profit for a McDonald's Happy Meal.

I'm not saying all suppliers succumb to these greed-driven practices. But if the shoe fits, you better start re-thinking how you do business before you find yourself barefoot.

MAP CAN BE A LOAD OF CRAP

Manufacturers believe they are adequately protecting retailers by instituting and enforcing MAP (Minimum Advertised Price) programs. Maybe, but only to a point.

Why do suppliers set the MAPs so low? How about at least setting the MAP at an amount that gives the retailer a shot of achieving a 40-percent or

better margin? That's the least they can do since the retailer is now losing gross profit "dollars" on each sale! Which brings me to my next question.

Why does a mixer that sold for $300 yesterday now have to be sold at $99? Does an electric guitar and amp package have to sell for $129?

If suppliers are reducing costs that much by improving the manufacturing process, why don't they and the music stores that support them keep some of the cost savings themselves—instead of passing it on to the customer with dramatically reduced sale prices? The only one winning this game of deflationary prices is the consumer, and that's just plain wrong!

Even if you feel it's necessary to drop prices, I absolutely believe those same consumers will pay $199 for that $300 mixer, for example. Both vendors and retailers need to learn how to convey "value" in the products they build and sell—and get paid for it! Come on, consumers don't expect to pay less for good quality cars each year; why are we teaching them to expect lower prices for quality guitars and audio products?

MEET THE NEW MATH (SAME AS THE OLD MATH)

Liars may figure, but figures don't lie. On page 36, you'll find four simple exhibits. In each exhibit, the first column shows how retailing prices and costs were yesterday (also known as "the good old days"); the second column shows what's happening in today's retailing market place (also known as "reality"); the third shows what today's retailer needs to do in order to offset the bad financial trend shown in that exhibit.

I hope you find these illustrations shocking. Maybe then you'll start to understand what I'm freaking out over.

WHERE'S OUR INFLATION?

It's pretty much a given that the music products industry is going through a period of deflation, not inflation, with no end in sight. We can thank the Chinese factories for that.

Powered monitors that used to sell for $600 are now sold for $200. Large diaphragm condenser microphones that fetched $500, today go for $159. Baby grand pianos that used to demand $8,000, now go for $5,995 and lower.

Some suppliers and their brainwashed retailers think a $159 "guitar/amp/strap/cable/string/pick pack" communi-

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cates "value." Ha! The only thing it communicates is "cheap"—cheap price, cheap quality and a cheap retailing attitude.

When all is said and done, both the supplier and the retailer are taking it in the shorts through lost gross profit dollars—even when there is an increase in unit sales.

Take a look at Exhibit 1 on page 36. The first column shows the good old days when this retailer could move 5,000 items at an average selling price of $200 at a 30-percent gross-profit margin and have enough to cover their $300,000 of overhead expenses, like wages, rent, adverting and (most important) accounting fees.

Today, average selling prices are half of what they used to be, as shown in the second column.

Does anyone really believe this retailer can just "double" the raw number of items he or she sells at the same margin in order to make the money necessary to cover overhead expenses (assuming those expenses won't increase a penny more) just because the price has been cut in half? If you believe that, I've got a great deal on some swampland in Northern Slabovia.

Just because the example retailer needs it to happen (as shown in the third column) doesn't mean it's going to happen. Let's face it, your local marketplace will buy only so many drumkits—even at half the original price.

> 'Both vendors and retailers need to learn how to convey "value" in the products they build and sell—and get paid for it!'

WHO MOVED MY MARGIN?

Another given in the music products industry is our current era of falling margins. We can partially thank Guitar Center, Sam Ash and MARS for that. We can partially thank certain suppliers for demanding unwarranted large opening orders from their new retail store customers without regard to that new store's marketplace or the competitor 10 minutes away who just ordered the same stuff at the same ridiculous quantities.

We can also thank the retailers who violate dealer agreements by selling over the internet and the suppliers who unevenly enforce those agreements. But most of all, we can thank the ignorant music retailers who just can't say no, buy too much, can't manage their cash and then drop prices to blow out goods just to stay alive another day.

Let's take a look at Exhibit 2. The first column shows the good old days when this retailer

could achieve a 40-percent gross profit margin. But today their average margin has dropped closer to 30 percent, as shown in the second column.

Once again, the retailer has to sell 1,250 more units or 33-percent more units at the same price and overhead to cover a drop in margin of just 10 percent, as shown in the third column.

MORE IS LESS

Real estate taxes increase, so your rent goes up. Media need to be innovative, so your advertising costs go up. Milk, bread, gas and cars are more expensive, so employee wages go up. Taxes and your business operations are more complicated, but your accounting fees stay the same. Wait, that's definitely wrong. Of course professional fees are going up. These are just some of the many overhead expenses that are, to a large degree, beyond our control. So what do you do? Uhhh… sell more, I guess.

Let's look at Exhibit 3. The first column shows the good old days when this retailer only had $300,000 in overhead expenses. But like everything else (except musical instruments), inflation causes prices to increase every year. Now our retailer has $400,000 in rent, wages, advertising, insurance, payroll taxes, professional fees, supplies, utilities and all the other expenses that comprise overhead, as shown in the second column. Our retailer now has to sell 33-percent more units to simply cover this increase in overhead.

WHEN ALL HELL BREAKS LOOSE

Each one of these bad financial trends (decreasing sales prices, shrinking margins and increasing overhead), by itself, is almost manageable. But when they all occur at the same time—as they often do in real life—their combined effect can be lethal.

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Let's look at Exhibit 4. Life was good in the good old days (first column). But then prices got cut in half, margins dropped by 10 percent and expenses increased by a third (second column). The combined result? Our troubled retailer now has to almost "quadruple" unit sales just to stay even (third column). Here is the proverbial final nail in the coffin. Goodbye Mr. Retailer, it's been nice knowing you.

SOME FINAL THOUGHTS (OR 'MY MIXED MESSAGES')

I know some of you think you're hearing mixed messages in my ranting and raving. Am I in favor or against imported products from China? Am I saying you can or can't make-up gross profit dollars by holding out for price? Am I implying you can sell more products while attempting to reduce inventory levels? What the hell am I saying? As simple as I can say it, here's my "easier said than done" thoughts on these complex issues.

First, low-priced imported product (whether from China, India, Korea or elsewhere) is here to stay. For retailers to not carry this cheaper product is as stupid as manufacturers not embracing the opportunities to lower labor costs by having product built abroad.

Holding out for only "Made in USA" product only may be noble, but you're cutting off your nose to spite your face. If some of your customers want the cheap stuff, sell them the cheap stuff; it might as well be you instead of your local Wal-Mart. Maybe retailers should keep these products where they belong—in a "toy" instrument section of the store.

More importantly, what suppliers and retailers should be doing is building and carrying, respectively, different strata (cheap, better, best) of product. When a customer comes into your store, educate them to the benefits of the higher-quality (and bigger margin dollar) product. Explain the playing benefits and better warranty as well as service they'll receive by investing in a higher-quality product. Most customers will not only appreciate the time you take to educate them, they'll probably pay you for that education by buying the better product.

Second, in an era of shrinking margins, you can help offset its detrimental affect on cash flow by buying smaller quantities more frequently, coupled with getting better payment terms from your vendors.

Reread that last sentence. I'm not saying to buy less. What I am saying is it's all about turning inventory enough times to generate the gross-profit dollars needed. I couldn't care less how many millions of dollars of sales you're doing or whether you're doing it at a 20-percent or 40-percent gross profit "dollars," as long as you generate enough gross profit to cover your overhead expenses and earn a decent living.

Last, retailers and suppliers need to look up the word "partnership" in the dictionary. Both need to begin communicating in an effort to build "win-win" business relationships. It has to work for both retailer and supplier alike, not one at the expense of the other.

Let's put greed, double-standards and a lack of communication in the coffin instead, nail it shut and bury it next to some 35,000 square foot abandoned MARS music store. Let that image be a constant reminder of the immortal words, "Those who do not learn from history are condemned to repeat it."

God forbid. **MI**

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

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