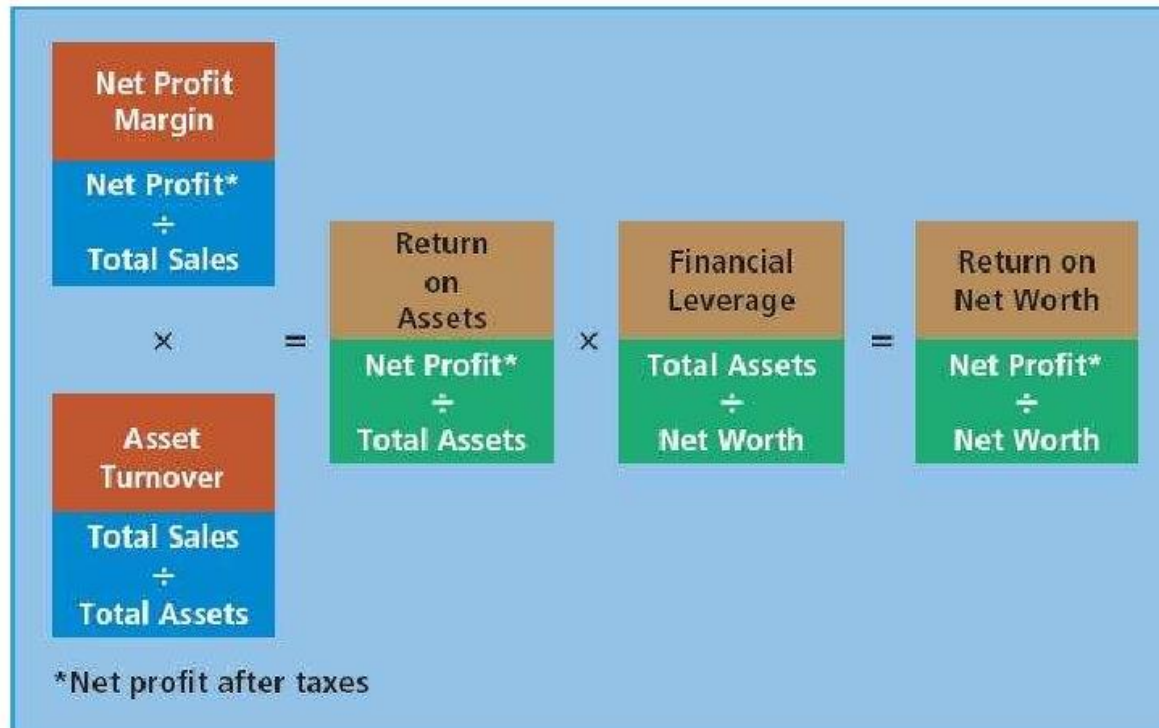


**SOS POLITICAL SCIENCE AND PUBLIC  
ADMINISTRATION  
MBA FA 406(B)  
SUBJECT NAME:  
FUNDAMENTALS OF RETAIL  
MANAGEMENT**

**TOPIC NAME: STRATEGIC PROFIT MODEL**



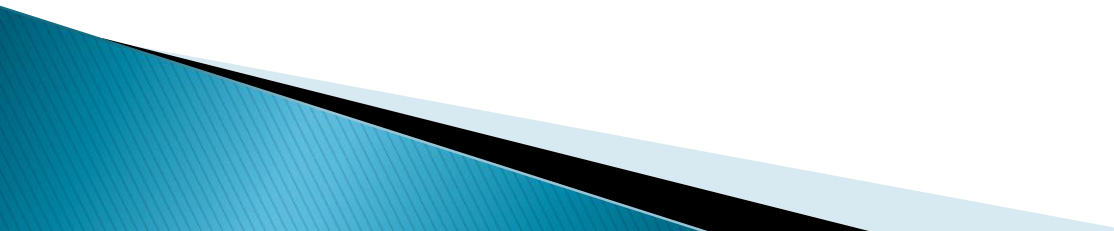
# Strategic Profit Model



# STRATEGIC PROFIT MODEL:

- ▶ The strategic profit model, another name for the DuPont Equation, provides one method for calculating the return on equity. Return on equity refers to a business's profit relative to shareholder equity or, put another way the effectiveness of the business at turning assets and investments into profit.
- ▶ Strategic Profit Model a tool used to assess a firm's profitability; return on equity is calculated by multiplying the net profit margin by the asset turnover to obtain the return on assets which, in turn, is multiplied by the financial leverage.

# COMPONENTS OF STRATEGIC PROFIT MODEL:

- ▶ Profit Margin
  - ▶ Asset Turnover
  - ▶ Leverage
  - ▶ Return on Equity
  - ▶ Other Considerations
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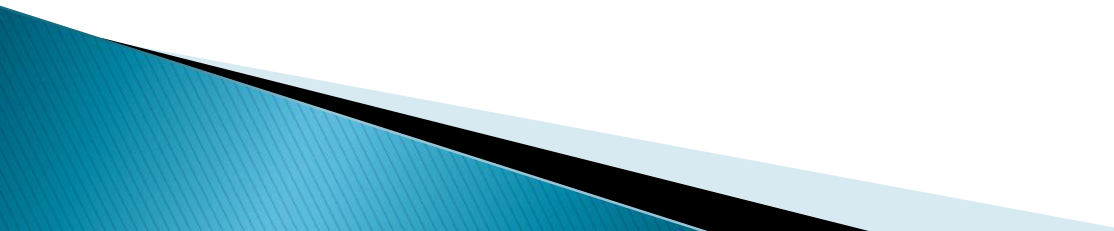
# PROFIT MARGIN:

- ▶ The first key component of the strategic profit model is profit margin. Determine profit margin by subtracting total costs, such as materials, from the total sales to arrive at net income. Then divide your net income by your sales revenue to arrive at a percentage. That percentage represents your net profit margin. For example, say your company achieved \$1.5 million in sales last year with total costs of \$1 million. Your net income equals \$1.5 million minus \$1 million, or \$500,000. Dividing that figure by \$1.5 million leaves you with a profit margin of approximately 33 percent. Higher profit margins result in higher return on equity.

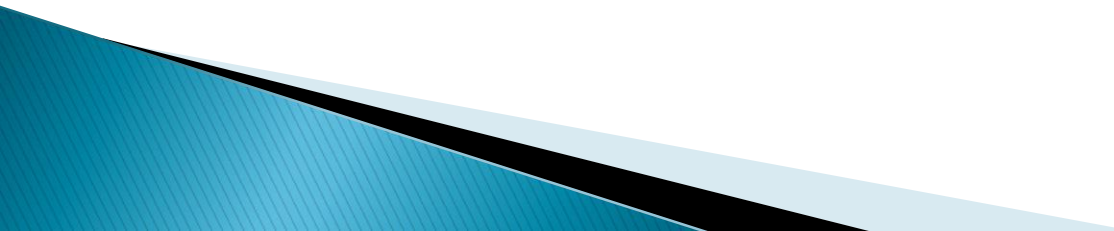
# Asset Turnover:

- ▶ The second key component, asset turnover, measures a business's efficiency at creating revenue from its assets. Calculate asset turnover by taking your sales revenue and dividing it by your total assets. Say your company generates \$1.2 million in sales with \$4.6 million in assets. You divide \$1.2 million by \$4.6 million to determine your asset turnover hovers around 26 percent. If asset turnover decreases, the return on equity decreases.

# LEVERAGE:

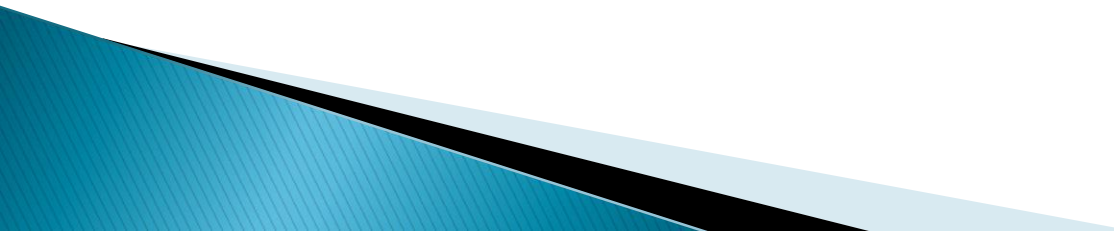
- ▶ Leverage represents the final component of the strategic profit model. In essence, leverage refers to the debt-to-equity ratio, or how much debt you take on relative to your business's equity. Calculate leverage by taking your total liabilities, such as mortgages and revolving lines of credit, and dividing them by your total equity. If your business's total liabilities equal \$2.2 million and your business's total equity is \$5.9 million, you wind up with leverage around 37 percent.
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# RETURN ON EQUITY:

- ▶ Determine return on equity by multiplying your net profit margin, asset turnover and leverage. If your company holds a 36 percent profit margin, a 40 percent asset turnover and 37 percent leverage, you end up with a return on equity of approximately 5 percent. A return on equity of approximately 10 percent to 12 percent represents the norm.
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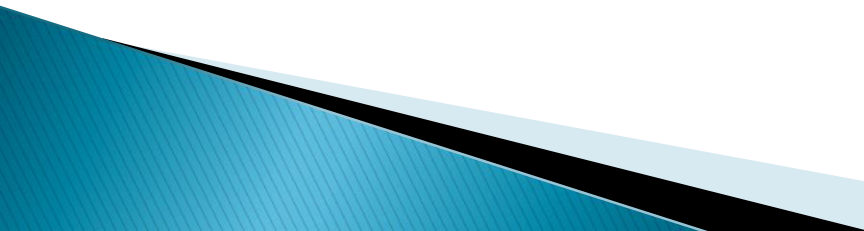


# OTHER CONSIDERATIONS:

- ▶ The strategic profit model lends itself to a visual format, making it an excellent tool for demonstrating how changes in profit margins, leverage or asset turnover impact the business. It also provides a simple way to see and evaluate changes over time. The strategic business model suffers from the problem that the results only prove as reliable as the original data. If your business does not maintain accurate records, the numbers you get from the calculations provide little value.
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# APPLYING THE STRATEGIC PROFIT MODEL IN THE REAL WORLD:

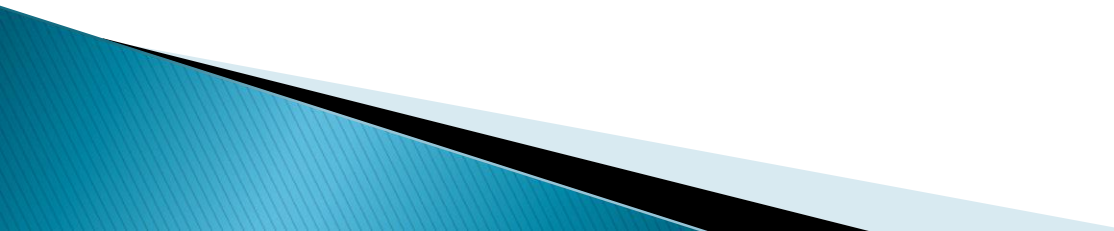
## 1. Driving profitability

- ▶ Profitability analysis and assessment of the fundamental drivers of profitability are critical components of evaluating the financial performance of a greenhouse business. Performance measures like operating profit margin, asset turnover ratio, return on assets, and return on equity and more importantly how they are impacted by marketing, production, investment and financing decisions are extremely valuable to a greenhouse manager, particularly in time of economic stress.
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## **2. Improving performance**

- ▶ A standard measure of financial success for any business, greenhouse or otherwise, is return on equity (ROE). Assuming a grower has an accrual adjusted income statement to obtain net income and a cost-basis balance sheet to obtain owner equity, the ROE is an easy metric to calculate using the simple formula of net income divided by owner equity. However, viewing the ratio separately, rather than in combination with other metrics, does little to inform management on how to improve performance.

### **3. The income stream**

- ▶ Initially, most growers may be concerned more with the income stream than the investment stream because the production decisions made in a greenhouse business usually have a more direct effect on the variables in the income stream. These income stream variables include selling price, production-related expenses, net sales, profit margin and the use of assets.
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## 4. The investment stream

- ▶ The second approach to improving ROE, through the investment stream, culminates in the financial leverage multiplier (assets divided by equity/net worth). Increasing financial leverage means that a company uses more debt financing relative to equity financing. Interest payments to creditors are tax deductible, but dividend payments to any shareholders are not. Thus, a higher proportion of debt in a company's capital structure can lead (mathematically) to a higher ROE.