Financing Food Distribution in the 1970's

Consumers Cooperative

Methods of raising necessary capital for a retail consumers cooperative

Robert Morrow, President
Greenbelt Consumer Services, Inc.

We are a consumer cooperative. By consumer cooperative I mean that we are owned by the customers, the housewives, who shop in the stores. We are the largest consumer cooperative in the United States from the viewpoint of sales volume. Now there are many very large farm cooperatives but in consumer field cooperatives are limited. However, our problems are essentially the same as the industry problem from the viewpoint of handling money and getting money. Our philosophy is that money is a commodity, to be used with maximum efficiency, to be purchased at the lowest possible cost. I want to say that again because I wish to stress it. There are many sources but the first place to look is within the business itself. I've rarely come into a situation, and I get involved in situations in many sections of the country, where there is not a substantial amount of money that can be freed, within the operation itself. If there are charge accounts take a look at the accounts receivable. Can we tighten up on credit terms; can we collect faster ? Is it a matter of merchandise turnover? Can the turnover be improved? Is there merchandise that is not producing net? Is there merchandise that's just sitting in the backroom? Can this be reduced? Are there surplus assets of any sort that can be sold? Is there any real estate that we may want to sell and lease back? Secondly, let's go on the outside and take a look. We can lease equipment. First, let's take a look at cars, which is about the simplest illustration of leasing. Leasing of course, has a cost. In fact, let me put it to you this way. Whether you lease a building or you lease a piece of equipment, you are in essence borrowing money. You are using someone else's money resources and you are paying them rent for it. Rent in the case of a building or in the case of equipment is sufficient to give them return on their capital provided for this purpose and to pay off the cost of the equipment itself. I always look at it in terms of a particular project. What is the least costly method of getting the money for that particular project? We will have, this year, sales of about 50 million dollars, roughly just over 49, probably under 50. We have a net worth slightly over two million dollars, so we are turning over our net worth 25 times. This is relatively high if you look at the banker's typical figures, yet I think it can be moved even higher than this. Now, when you talk about use of money and cost of money and return on money, there are essentially two factors involved and both of importance. One is how fast do you turnover the money. The other is what is net profit as a percent of sales. Let's look at our situation for a second. If I get sales of 50 million dollars with a net worth of 2 million, then I'm turning over our net worth 25 times a year. If I make 1% on sales I then am making 25% on net worth. Now let's take a different illustration. Let's assume that instead of having 2 million net worth, we have 4 million. We are then turning it over 12-1/2 times a year.

In order to realize a 25% return on capital, we then have to make 2% on sales. A few minutes ago a comment was made by an earlier speaker to the effect that wholesalers have reduced their turnover because they find that they can get a faster return on the money they are tying up in inventory due to inflation and to higher sales. Return on capital is the factor of the two items. You must keep them in balance. You must keep both of them in mind at all times. I had this point dramatically illustrated to me this summer. I was in Santiago Chile and they were rather pleased because, if I recall the figures, this may not be quite precise, but they'll be close, they had only a 32% inflation last year, which meant that their price levels had gone up 32% for the year. This was low. Historically, it had been much higher than that. This means that the businessman's problem is quite different. You struggle very hard to minimize the amount of money you have in the bank, you try to take all the cash out of the store and buy merchandise with it just as fast as you possibly can. If you are overdrawn at the bank, so much the better. You put your money in merchandise because you know its going to have a higher value, two weeks, 1 month or 3 months from now. Interestingly enough if you borrow money under their system and you borrow 100 thousand at the beginning of the year, that loan is revalued based upon the increase in the price index at the end of the year, so if it has gone up 32% you owe 132 thousand at the end of the year and so on and so forth. But the tax situation is a little bit better than it is here because they also permit you to write up the equipment and then you can turn around and depreciate the inflated value of this equipment. My friends in Chile tell me that once you learn how to operate within this framework a prudent businessman can actually come out very very well during the period of inflation. If you try to keep too much of your money in cash you will wind up in major difficulties, way behind the eight ball. So I just mentioned this to illustrate the extremes that you can get into in this kind of a situation.

So let's go back for a second. I have said that money is the commodity, to be used with maximum efficiency, to be purchased at the lowest possible cost. So when we have an expansion project we keep looking at what is the cheapest source of capital at that time with a reasonable cash flow for repayment. The first source I mentioned was within the business itself; then I talked about leasing equipment. Then comes the matter of net earnings after taxes. Once you pay your taxes, the earnings that you reinvest in the business are in a sense cost free in the subsequent years. Then there is the depreciation that's not spent on replacement of equipment and of course any extended terms you can get from your suppliers are all to your good. In the retail business you negotiate with the suppliers first on price. Once you think you have the best possible price you start playing for terms. If you get your terms first, then suppliers are going to raise the price to reflect the terms, I would. So you negotiate in reverse order, you negotiate your price first and then you try to get as long terms as possible. Now you can borrow on the outside of course. I would say that in the retail business where you have inventory fluctuations this is essential. We happen to be in the supermarket business, furniture business, service stations and pharmacy. Just as a matter of information we have the largest import of furniture into the United States from Scandanavia. In the furniture business we get into very sizeable seasonal increases in inventory between September and early January. Our big season in the furniture business actually begins about July. Our inventories start peaking out about October and the peak season is roughly through the end of January. A well run business should be into the banks with short term money during that period of time. If we had enough of our own funds to finance us during that period of time, we would have a surplus of capital during the balance of the year. So from the viewpoint of using capital efficiently, we expect to borrow from the banks on a short term basis for these kinds of inventory peaks. Then there is a question of intermediate loans, say under 5 years. You frequently can get this kind of funds from banks. First to be used for equipment financing. Very often we find we can finance equipment cheaper that way than we can in terms of the effective rate on leasing. Then we talk about longer terms. This is where the financial institutions come in, in terms of loans of 10 years or more. There are loans for real estate, working capital, etc. Next possibility for financing becomes stock issues, but here I want to point out from the small businessman's point of view, there is a problem of keeping control of his company. There is also the very real problem of whatever dividend rates you pay has to be doubled to determine the effective cost of capital because you have to pay income taxes before your dividends. Unlike interest, dividends come out after tax income. So if you are customarily paying a 6% dividend, if this is what it takes to float your stock issue, you can then double and quickly figure that your money is costing 12%. Uncle Sam is going to collect his 6% first. It's 6% or slightly more when State income taxes are included. Of course, there also are the problems of Securities & Exchange Commission. This involves a great deal of red tape and also in many instances, considerable expense.

We pay a 5% dividend on stock and have paid this for every year, but on going way back to the earliest history of the organization. We figure this is a little better than 10% money. In fact when we figure the bookkeeping cost, 11.3% is about what it costs us. Right now that's cheaper than it is to lease equipment, but 3 years ago it was much cheaper to lease equipment than it was to sell stock. At that point leasing equipment was very appealing. Let's talk for a minute about the general question of owning real estate vs. leasing real estate. In the retail business most of the large retailers lease. There are few exceptions to this, but most lease. The reasons for this are rather simple. First is the feeling, which may or may not be correct, that a larger return can be realized by putting capital dollars in the retail business as such, in inventory and equipment. But there is a second aspect to it. If with a given level of capital you want to develop a maximum dollar return, dollars now, not percentage, you can do so by getting the largest possible volume, assuming you can operate the additional stores successfully. By operating successfully the largest possible volume with minimum net worth, you will realize the largest dollar return. If on the other hand you want to realize the largest percentage return on a given capital base you probably will come out better by owning the real estate, but you will not grow nearly as fast, nor will you make as many dollars. As a general rule we would favor leasing and as I illustrated before, let's not kid anybody, this is in essence borrowed money but it is borrowed money that does not appear on your balance sheet. And, therefore, in reality the leases should be taken into account. In practice the typical retail chain would end up with a tremendous ratio of borrowed capital if the leases were capitalized. The ratio of long term debt, if you counted leases as a debt, (if you count the money that is tied up in real estate as equivalent to debt), would be fantastic. However, I think this is just plain good money management because as I said in the beginning; I regard money as a commodity, to be used with maximum efficiency, to be bought at the lowest possible cost. Let's talk a little bit about a hypothetical supermarket. It's possible to open a supermarket with very little capital, once you become established and once you get accepted in a given community. We require here in this area a 3 to 1 parking ratio. In other words, we have to have 3 sq. ft. of land parking for every square foot of store. So if we talk about a 20,000 sq. ft. store, we're talking about 80,000 sq. ft. of land needed for that store. The price is going to vary, of course, depending upon the location in an urban market and location is a vital key to the success of the operation. But for a quick rule of thumb I will use the figure of $200,000 for land. A building of 20,000 sq. ft. based on the cost of today's market, depending upon how elaborate the buklding is, somewhere in the vicinity of $12.50 on up per sq. ft. Again, for the sake of ease of figuring, we will use $12.50 per sq. ft., so we're talking about $250,000 for the building so we have land and building at $450,000. The inventory in such a store depending in general upon the mix of non-foods to foods will range from 50 to 70 thousand dollars and can run as high as 80 thousand or even 90 thousand where the store has a very heavy non-foods operation. So let's assume $70,000 as a typical figure. Pre-opening expenses will vary depending upon the operation, depending upon how much initial promotion is done for a particular store and also what the arrangements are for insurance, prepaid taxes, and all this sort of thing; figure as a rule of thumb again and allow about $30,000. On this basis we have a total project cost of $550,000, not counting equipment. So we rent the land and the building. We don't invest that $450,000. Fixtures and equipment in the store of 20,000 sq. ft. in today's market will run between $125,000 and $150,000. Now if we assume we lease the fixtures and equipment, assume we lease the building, then we have to finance only the inventory and the pre-opening expenses. Inventory, can be carried by suppliers once you become established with them. We figure, as a quick rule of thumb, that we can end up with two weeks' sales in accounts payable. In other words, if we can do $40,000 a week in a store, we will end up with about $80,000 in accounts payable. So if we operate with a $70,000 inventory, we actually are ahead by about $10,000 at that point. What I am trying to say, what I am trying to get at in this particular illustration is that it is possible to finance a supermarket, once you become established, with very little cash. I want to stress this. It is possible to finance a supermarket doing two million dollars a year with about $30,000 for pre-opening expense and initial development, making some allowances for the possibility of initial losses. Well, with this kind of a situation you can get a fabulous return on your capital. Of course there becomes a point at which you can't do this, but it can be done for quite a while. This is the reason we take a hard look at the whole question of owning vs. leasing, especially of real estate but also the same general questions come up in respect to equipment. It is all a matter of effective interest rates. Sometimes you are better off borrowing from the bank, depending upon what the interest rate picture is, depending also upon the cash flow. When you borrow from the banks you usually have to pay it off in a 4 to 5 year period. If you leased the equipment you normally would lease it for 8 years. So while you are paying a higher rate of interest, from the viewpoint of cash flow, you're paying for the equipment over a longer period of time. I would say financing is always a difficult problem. It's a problem that doesn't necessarily have easy answers. It's one in which the retailer must be flexible. What is the answer on financing today is not necessarily the answer on financing a year from now or two years from now. We keep looking at it in terms of what's happening to the costs -- how they are shifting from year to year from month to month, from time to time. We keep looking at it from a viewpoint of financing each project by whatever device will give us the lowest possible cost and a cash flow that we can handle. That's our philosophy for financing.