

Monica's Designer Handbags: Creative Marketing Decision-Making Based on Financial Analysis—A Case Study

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Monica learned much about the designer apparel trade as an intern with a major retailer, and started a designer handbag business, selling through independent retailers. She practiced making sound marketing decisions using financial analysis techniques learned in college. These techniques proved useful when a regional discount chain offered a deal to sell her handbags through their stores on a trial basis. She was faced with a tough decision to accept the deal, reject it, or renegotiate it on mutually acceptable terms. Students are asked to analyze case data and to advise Monica on how to proceed with the prospective deal.

INTRODUCTION

Monica, after completing an internship with a national apparel company, decided that she wanted to exercise her creative design talents and her strong entrepreneurial spirit by starting her own fashion design business. She conducted fundamental market research, as she had learned in college, and determined that there was an unfulfilled market need for her designs in the moderately priced fashion handbags at the \$100 retail price point. She also learned that the independent women's apparel stores she was targeting require a 50% retail margin, which retailers variously refer to as a "100% markup," or "key-stoning," to cover their own display and selling costs. Monica approached a number of independent local stores that liked her handbag design prototypes and her retail price point and would consider carrying her handbag line, but she was told consistently that area retailers purchased such moderately-priced fashion designer products through a particular apparel distributor. She, in turn, met with the well-established distributor, showed her designs, and discussed his operations. The regional distributor was interested in representing her line to his independent retailers, but indicated that he required a "20% wholesale margin," that is, a 20% discount off the price to the retailers. Monica realized that to be successful in her new business she would have to manage her costs and contribution margins carefully and negotiate the distribution channels and retailer relationships wisely.

Monica's Contribution Margins

Monica learned during her retail management course in college and her internship with a national retailer that she would have to generate sufficient contribution margins on her products to recover her fixed sales, general, and administrative costs of doing business, her overhead. Monica had obtained an authoritative Harvard Business School (1983) reference from her father Bill who had earned his MBA at Harvard a generation ago. In addition to this *Note on Marketing Arithmetic and Related Marketing Terms*, she used her college managerial accounting text (Whitcotton, Libby, and Phillips, 2013), as a more recent, second source. She determined that the contribution margin on each unit of product sold can be established by setting a reasonable price to the distributor and subtracting all variable, or direct, costs to provide each unit. Monica realized that the retail handbag market had pre-determined price points to the end consumer, e.g., \$100. Her price to the distributor would be the retail price net of both the retailers' and distributor's margins, which motivated these partners to handle her product through their channel. Her price to the distributor had to be at least sufficient to cover the product's variable costs, including direct manufacturing and shipping costs, and thus produce a positive contribution to overhead.

Determination of Monica's Price to the Distributor

So, Monica sat with her tablet at her drafting board and did the necessary financial analysis. She assumed that her \$100 retail price point to the end consumer was realistic, given the confirmations she received from several independent retailers and the regional distributor. Monica also assumed that the independent retailers would require a 50% margin, and thus would markup the distributor's price to them by 100%. So, her concern was what price she should set for the distributor. She calculated the retail unit price, the retailers' unit margin, the distributor's price to the retailers, the distributor's unit margin, and an acceptable price to the distributor. She drew out on her drafting board the transaction prices and margins in a diagram, showing the relationships between all the parties in this channel.

Variable, or Direct, Unit Costs

Monica had negotiated for the production of her designer handbags with a contract manufacturer, based in Vietnam, that she had come to know through her internship. She had also arranged monthly LTL (less than truckload) shipments of each season's new handbags directly from the factory to the distributor who, in turn, ensured that retailers' shelves were stocked with Monica's designs. At the volumes she projected each season, the manufacturing costs averaged \$10 per handbag. Her shipping costs, at current volumes, averaged \$5 per handbag. She extended her diagram to show these two direct costs and the relationship of the manufacturer and the shipper in the transaction flow. Monica could now determine her contribution margin per handbag.

Fixed Sales, General, and Administrative Costs

Monica had hired one salaried marketing person to assist her with all sales and promotions activities, including maintaining the website, entering order transactions, and running reports on a basic enterprise system. She had also retained an advertising agency, an attorney, an accountant, and a banker to facilitate all of her other general and administrative matters as needed. She rented a small office space near her residence for her design work, system and marketing operations, and business meetings. Monica estimated the total of all these fixed overhead expenses at \$25,000 per month. She felt that these were all necessary business expenses and that she could grow her volume substantially with this support base in place.

Breakeven Volume and Market Share

Monica next determined the minimum volume of handbags that she would have to sell in order to cover her overhead expenses, which her seasoned accountant referred to as her "nut." She divided her monthly overhead expense by the contribution margin per handbag, which she had calculated earlier, to determine her breakeven volume in units. She next extended this breakeven volume by her wholesale price to determine her breakeven sales volume, measured in dollars.

However, Monica also wanted some confirmation about the reasonableness of her breakeven volume expectations, and therefore sought to estimate what share of the retail market she would have to achieve in order to breakeven. Her earlier research found that the total U. S. retail market for moderately priced (that is, about \$100 at retail) fashion handbags was \$120,000,000 per year. Based on her findings, she calculated the total number of such bags sold at retail in the U. S. in an average month. Monica then divided her monthly breakeven volume by one-twelfth of the total annual U. S. retail market, to determine her minimum market share to breakeven.

Profit Impact

Monica, however, would not be satisfied by achieving only a financial breakeven for her enterprise. She had not taken a salary from the business so far and had invested her own capital to get the business started. She reasoned that her time was worth money and the alternative of returning to her previous employer would involve the advantages of a stable healthy income and benefits, and considerably less risk. Monica wanted her business to generate a sustainable profit, so that she could reinvest in growing her enterprise and take a steady income. She set an ambitious, initial goal of earning a profit of \$50,000 per month and sought to determine what volume she would need to sell in order to reach that bottom line target. If selling the breakeven number of units per month covered the \$25,000 monthly overhead expense, Monica considered how many handbags she would have to sell to generate a \$50,000 monthly profit impact, beyond the breakeven.

Trade Discounts and Terms of Sales

Monica had negotiated with the distributor for a 2% discount for payment at end of month, with net amount due in 90 days. The distributor generally did not take the offered discount, but rather paid at the end of each season, as was typical in the seasonal apparel trade.

Profit Margin

Monica was soon able to achieve her goal of an average profit impact of \$50,000 per month on sales to the distributor of \$1,440,000 per year. She also was interested to know what the average profit margin, expressed as a percentage, of her expanded business might be, for comparison purposes.

A Grand New Opportunity

Monica next set an ambitious goal to grow her business into a \$2 million company in annual sales to distributors. Soon, her sales assistant approached her while she was seated at her drafting board with some good news! A buyer for Grand**Mart*, a very large regional discount retail chain, who had seen Monica's handbag designs on her website, e-mailed an invitation to propose a contract. The Grand**Mart* buyer, however, was specific about several conditions for Monica's proposal. Monica was excited about this prospective new customer, which in addition to her independent retailer business would help achieve her new total sales goal.

Sales and Profit Impact of the New Deal

Grand**Mart* would initially receive 2,000 handbags per month for three months of seasonal designs similar to Monica's most popular handbags and stock them in 20 test stores outside Monica's traditional territory, handling all of the transportation from the overseas factory and all of the distribution to their stores in the U. S. Grand**Mart* indicated that they would pay within 90 days, as the handbags sold through their stores. They also would substantially increase their order to a minimum of 10,000 handbags per month during the second quarter, based on the success of the initial trial, and would consider carrying an "exclusive" line of Monica handbags in Grand**Mart*'s entire chain, including all 100 stores. They proposed that a wholesale price of \$20 per handbag would be acceptable to them under the terms and conditions, beginning with the first quarter. Grand**Mart* extended an invitation to Monica to call on their Mobile, Alabama headquarters during the next week and to propose her "best and final offer" to their buyers.

Monica realized that this one initial deal would achieve larger scale and her set goal of becoming a \$2 million revenue business! However, she was concerned that Grand**Mart*'s suggested wholesale price was low relative to the wholesale price she received in the independent retailer channel. Monica calculated that the proposed price would cover her present direct manufacturing cost and eliminate her direct shipping costs. However, she estimated that she would have to double her existing \$25,000 per month overhead expenses just to meet the initial required level of customer service that Grand**Mart* specified for first quarter store advertising, customer support, and returns handling. She drew out Grand**Mart*'s suggested transactions and relationships between parties in another diagram. Again, she sought to determine the unit contribution margin and the profit impact that the initial 2,000 bag per month deal, as proposed, would bring to pay the incremental overhead and drop to her bottom line each month.

Monica, who was an optimist at heart, also was tempted by the prospective Grand**Mart* order increase for the second quarter, if the initial trial quarter was successful. She envisioned the advantages of selling 10,000 handbags per month exclusively to Grand**Mart*. She estimated that her overhead expenses, attributable to Grand**Mart*, would grow substantially to \$75,000, or three times the amount required for the initial 2,000 handbag deal. But she also wondered if she could then achieve the same profit impact just from exclusively supplying Grand**Mart*, while dropping the independent retailer channel.

A Time for Serious Reflection

Monica looked at the existing and new diagrams and realized that she had some key decisions to make. She needed to decide if a) She should propose the initial 2,000 bag per month Grand**Mart* deal, on the terms that they suggested, including their wholesale price; b) She should take a pass on the Grand**Mart* deal, and stay exclusively with the independent retailers' channel in which she has had success; c) She should go to Mobile and renegotiate the initial 2,000 bag per month deal, offering a "best and final" price that could be acceptable to both parties; or d) She should propose the exclusive deal to Grand**Mart*, based on a successful trial and a minimum order volume of 10,000 handbags per month, beginning in the second quarter. And, importantly, she wondered what other financial and non-financial considerations (such as, cannibalization, or even loss, of her independent retailer channel by the exclusive Grand**Mart* deal) she should contemplate before getting on a flight to Alabama.

*Monica's Further Research on Grand**Mart**

Monica promptly went to three local Grand**Mart* stores, thoroughly inspected the handbag sections, and recorded the prices of similar merchandise on the shelves. She also sent e-mail inquiries to several of her industry colleagues who knew the discount chain and the discount fashion trade well. From her field research, she garnered that Grand**Mart* probably would price her handbags at \$45 each, and that they would require at least a 33-1/3% contribution margin on their retail price (which also could be expressed as a 50% markup on their wholesale costs). With this intelligence, Monica was able to estimate the maximum wholesale price, after incurred costs, that Grand**Mart* might be willing to pay for each handbag. With both her minimum breakeven price and their maximum wholesale price in mind, Monica was in a better position to make a decision about her "best and final price" offer alternatives. She could also estimate the incremental profit impact of her possible deals with Grand**Mart*.

QUESTIONS FOR STUDENTS TO ANSWER

1. At what price does Monica sell her handbags to the independent retail channel distributor?
2. What are the unit contribution margins (in dollars per handbag) for the distributor and the independent retailers? (Show the transaction prices and margins to each party in a diagram and label it *Exhibit 1- Independent Retailers' Channel*.)
3. What is Monica's unit contribution margin (in dollars per handbag) after direct manufacturing and shipping costs?

4. How many handbags must Monica sell per month in order to breakeven, if her overhead expense is \$25,000 per month?
5. What share of the moderately priced (i.e., ~\$100 at retail) designer handbag market, estimated at \$120,000,000 per year, must Monica achieve in order to breakeven?
6. How many handbags must Monica sell per month in order to achieve a bottom-line profit impact of \$50,000 per month?
7. What is Monica's profit margin (expressed as a percentage), if she generates \$600,000 in profits per year on \$1,440,000 in sales to the distributor per year?
8. What is Monica's unit contribution margin (in dollars per handbag) on the Grand*Mart initial deal, using their suggested wholesale price of \$20, after incremental direct expenses? (Diagram as *Exhibit 2 - Grand*Mart Discount Channel*.)
9. What is the incremental profit impact (in dollars per month) of the suggested initial Grand*Mart 2,000 bag deal to Monica, after the increased overhead expense of \$25,000? What is the incremental profit impact of the prospective 10,000 bag order, after increased overhead expense of \$75,000?
10. What are Monica's other key financial and non-financial considerations (such as, cannibalization of the independent retailer channel) for the suggested Grand*Mart deal?
11. Should Monica propose the Grand*Mart deal as suggested? Or should she take a pass and stay exclusively with the independent retailer channel? Or should she renegotiate the initial 2,000 bag deal for the first quarter? Should she offer Grand*Mart an exclusive 10,000 deal for the second quarter?
12. What is the maximum wholesale price that Grand*Mart could be willing to pay Monica, given their probable retail price and typical margin requirements? If Monica decides to renegotiate the initial Grand*Mart deal as of the first quarter with volumes of 2,000 bags per month and incremental overhead of \$25,000 per month, what "best and final" price should she propose that would be acceptable to both parties? What is the revised incremental profit impact?
13. If Monica decides to offer Grand*Mart an exclusive deal as of the second quarter at minimum volumes of 10,000 bags per month with overhead expenses of \$75,000 per month, what "best and final" price should she propose that would be acceptable to both parties? What is the profit impact of this exclusive deal?

TEACHING NOTE

This teaching note is made available to professors as part of the case study. The authors often distribute it in classroom or on-line situations only after students have attempted to answer the previous questions as independent homework and/or in group discussion.

Audience

This brief case is a refresher exercise in quantitative financial analysis in support of marketing decision making skills. It is intended for use in undergraduate marketing courses, including retail management and product management, and MBA marketing courses, including marketing management and product management. It is suitable for online or traditional classroom settings.

The case seeks to redress quantitative analysis skill deficiencies, particularly those found among undergraduate marketing students, which are frequently observed by occasionally frustrated marketing instructors. The case progressively guides all marketing students through a multi-step process to build their critical thinking by restoring knowledge of fundamental accounting terms, then comprehending relationships between key finance and marketing concepts, applying accounting formulae to realistic retail situations, analyzing computed results in the context of case marketing conditions, synthesizing derived findings and facts to frame a central business issue, and evaluating the integrated outcomes to arrive at creative marketing decisions. If used early in the course as an individual homework assignment,

as suggested by the authors, it will benefit marketing students as a review of financial terms and accounting/ marketing relationships, followed in the next classroom session by a collaborative team-building review exercise. As a lead-off exercise it will pay dividends in improved critical thinking by students throughout the course session, and may be referred back to frequently by the marketing instructor.

The case illustrates the financial and other business implications of four alternatives relative to pricing a deal. It illustrates the effect of retailer and wholesaler expectations, along with fixed costs, contribution margin, and profit impact. Scenarios progress through an initial startup, a subsequent expansion opportunity, and a change to a different distribution channel.

Learning Objectives

After reading this case and solving the problems posed in the Questions, students should be able to calculate and explain the following concepts: wholesale price, contribution margin, markup, breakeven, and profit margin, thus demonstrating an understanding of retailer and distributor margins, fixed costs, profit impact, and market share. They should also be able to evaluate the financial impact of alternative scenarios, a potential expansion opportunity or changing from one distribution channel to another, and develop realistic, acceptable counter offers. The following table shows the student activity required for preparing the case in terms of Bloom's taxonomy (Bloom, 1956).

**TABLE 1
BLOOM'S TAXONOMY OF LEARNING**

Bloom's Taxonomy	Bloom's Definition	Student Actions
Knowledge	Remember previously learned information	<ul style="list-style-type: none"> • Recall financial ratio formulae • Describe formula results
Comprehension	Demonstrate an understanding of facts	<ul style="list-style-type: none"> • Locate financial ratio formulae • Identify facts from the case to use in calculations • Recognize relevant information from the case to use in addressing various scenarios • Classify costs appropriately (fixed vs. variable) • Explain meaning of results
Application	Apply knowledge to actual situations	<ul style="list-style-type: none"> • Compute financial ratios • Interpret results of calculations • Manipulate formulae to calculate missing information
Analysis	Break down case content into parts, provide evidence to support generalizations	<ul style="list-style-type: none"> • Diagram cost flows • Analyze ratio results • Calculate impact of new information • Compare results obtained under various scenarios • Breakdown impact of variables as they change in scenarios • Model outcomes for multiple options • Critique proposed alternatives
Synthesis	Compile component ideas into new whole or propose alternative solutions	<ul style="list-style-type: none"> • Synthesize information into recommendations • Prepare counter offers • Theorize potential consequences
Evaluation	Make and defend judgments based on internal evidence or external criteria	<ul style="list-style-type: none"> • Debate alternatives • Argue in support of chosen course of action • Defend recommendations

AACSB Skill Areas and Learning Objectives

Furthermore, scholarly academics, who are engaged in AACSB accredited business programs, are aware that AACSB standards 1 through 6 recommend the following general knowledge and skill area learning experiences for undergraduate degree programs (AACSB, 2013):

1. Communication abilities
2. Ethical understanding/reasoning abilities
3. Analytic skills
4. Use of information technology
5. Multicultural/diversity understanding
6. Reflective thinking skills

This case is designed to provide knowledge and skill area learning experiences in 1) Communications abilities, in the students' response to specific questions; 2) Ethical abilities, in the students' decisions about pricing and channel selection; 3) Analytic skills, in the students' quantitative analysis and decision-making; and 6) Reflective thinking in the students' integration of analytic outcomes and drawing conclusions.

Founding Theories

This case utilizes cost-volume-profit (CVP) analysis from managerial economics and cost accounting. CVP focuses on the relationships among product price, units sold, variable and fixed costs, and profit (Whitcotton, Libby, & Phillips, 2013). Basic assumptions of CVP analysis relevant to this can be accurately categorized as either fixed or variable, changes in total costs are a function of changes in the number of units produced, and sales and production are equal. Within the CVP model, variables may be manipulated to estimate their impact on profitability (Whitcotton, Libby, & Phillips, 2013). Relevant formulas may be found in many marketing, managerial economics or cost accounting textbook.

Strategies for Face-to-Face or On-line Course Use

The case can be included in a traditional face-to-face or on-line classroom setting, as the instructor may choose. A brief review of the cost-volume-profit model either through assigned reading (see reference) or an instructor lecture would be helpful before starting the case.

The case may be assigned for either individual or team completion. In the case of an individual assignment, all students' preparation of the discussion questions in advance is essential to successful classroom discussion. The authors recommend individual assignments that are scored, with scores included in course grades.

In the case of team assignment, an effective format that has been adopted in the first author's classroom is that of individual case preparation, followed by team consensus building. Individual students prepare written answers to the case questions before class and bring their answers to class. Their answers in signed, hardcopy format are submitted at the end of class and given a score, which counts toward their individual grade. Individuals are then assigned to teams and asked to formulate consensus team answers to the case questions. The instructor then goes around the classroom asking each team to answer one question in order. Suggested answers to each question are available to the instructor upon request. The remaining teams are asked if they agree with the answer given, and, if they do, the instructor proceeds to ask the next question of the next team. The first author finds it helps the class discussion, if he draws the diagrams of the transaction flows and partner relationships on the board to solicit teams' consensus. While student teams tend to agree on the answers to the first nine questions, differences in answers are typical for questions ten through thirteen. The instructor encourages teams with different answers to defend their reasoning, which often leads to energetic debate. This is especially true in MBA courses and senior marketing courses that foster a healthy spirit of competition.

Enthusiastic students and teams will raise numerous non-quantitative issues, in addition to cannibalization of the independent retailer channel, as part of their solutions to elements of the case.

Examples include: Can Monica somehow differentiate the handbags she provides Grand*Mart from those she provides independent retailers? Will the independent retailers seek greater price concessions similar to Grand*Mart's price? What will happen to Monica's fixed overhead costs if she pursues both channels simultaneously? Can Monica renegotiate a lesser manufacturing cost, based on her greater unit volume with either offer? Will Grand*Mart incur the same shipping costs as Monica, or will they spend substantially less per unit? Is there a risk the Grand*Mart will bypass Monica and purchase similarly designed handbags directly from the manufacturer? While such non-quantifiable issues may be solicited by the instructor, and discussed in class as time allows, the student teams should be encouraged to make reasonable assumptions and routinely be brought back to how each raised issues effects the solution to the case, as presented. The first author finds that the use of the case as a first exercise in a Marketing class sets the tone for quantitative thinking for the remainder of the course. The instructor can introduce additional variables as they reflect course content. In particular, this could be employed to increase the level of difficulty for MBA students. On the other hand, the case can be abbreviated, if necessary, by treating the thirteenth question as extra credit. This single change may reduce substantially the amount of time required for thorough class discussion of the case. However, regardless of whether used for undergraduates or MBAs, the case is sufficiently brief to be assigned in one class period and discussion completed in a second.

Decision Points/Discussion Questions

Students are given 13 discussion questions which typically require some application of the cost-volume-profit model and a subsequent interpretation of the results. These are the kinds of questions retailers and product managers should address frequently. Students will be required to recall and/or locate the appropriate CVP formulas (see Founding Theories section). All price, cost, unit, and profit considerations are described in the body of the case, and an Answer Key is provided to the instructor upon request. As the case progresses, students will be asked to develop counter-offers and proposals for which there is no single "right" answer. Issues such as channel competition, product cannibalization, and efficiencies of scale may emerge in team discussions. This allows students to think critically, strategically and creatively about potential outcomes.

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Answer Key to Questions:

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