Inventory Profit Optimization

Increase your gross profits by utilizing asset value multipliers (AVM's)

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Optimizing gross profits on inventory is one of the most important issues that anyone in the used truck business deals with. The good news and the bad news is that the outcome is almost entirely in your hands. Making informed decisions and smart trade-offs determines what you deliver to the bottom line, and consequently the financial health and success of your business. This article highlights the benefits of using a common profit maximizing technique involving asset value multipliers.

The Cost Side

During tough economic conditions, we always begin the process of managing and maintaining our profitability by examining and controlling our most obvious expense areas. With constrained top line growth, it becomes necessary to scrutinize and reduce general expenses, such as the cost to buy vehicles, the cost of reconditioning, advertising, floor plan expense, sales commissions and many more. We scour the cost side of our operations by eliminating discretionary spending, deferring expenses and reducing capital outlays. While these and other cost management initiatives are necessary, they are not the only methods that can yield the profitability results you need.

Asset Value Multipliers (AVM's)

Asset value multipliers are items that increase the *intrinsic* and *extrinsic* value of assets you already have in your possession, and ultimately enable you to drive more profitability out of them. An example of a commonly used AVM is a used truck warranty. A warranty, when added to a vehicle's purchase price increases a truck's *intrinsic* value in that the real value of the vehicle becomes higher than that of a comparable vehicle without a warranty. The warranty, which holds a NADA book value, adds both current and long term value to a vehicle, as long as the warranty is in effect. Therefore, a truck with a warranty is *intrinsically* more valuable than one without a warranty and typically can be sold for higher dollars. A warranty also increases a truck's *extrinsic* value because it increases the value perception of the truck's brand and the dealership from where it is purchased. At the same time, a warranty heightens the vehicle's salability, and increases customer satisfaction and repeat purchase likelihood. The net of all of this is that a vehicle with a warranty is more valuable, both **intrinsically** and **extrinsically** and meets the definition of an asset value multiplier. So, how can that benefit you? Using AVM's in conjunction with cost control measures can yield the greatest profitability for your dealership. Following below are two illustrations of how to use a warranty as an asset value multiplier to increase your profitability.

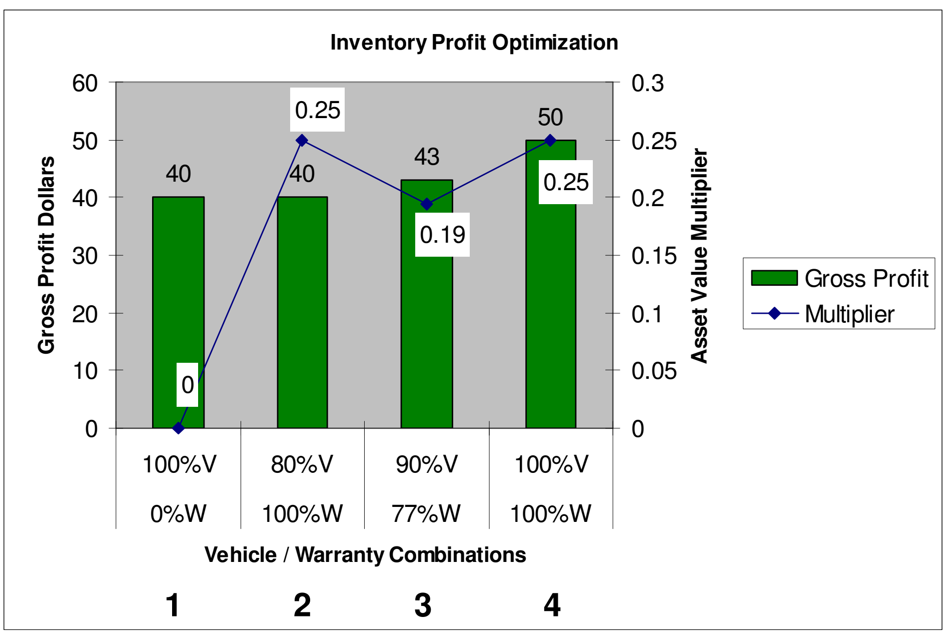
Illustration 1

In this case, assume you have10 vehicles in inventory. Each vehicle has a profit utile of 4 (that could be dollars, hundreds, thousands or whatever you choose). This means that you can earn a profit of 4 on each vehicle sold. In addition to the base profit utile, each vehicle has a **warranty profit** utile of 1 per vehicle. Therefore, if you sold one vehicle without a warranty, you would generate a profit of 4 on that vehicle. If you added a warranty to that sale you would add a profit of 1, for a total profit of 5. The utile values in this illustration were kept constant for all 10 vehicles for simplicity. The asset value multiplier (AVM) value of a warranty is computed as the percent change between the total profit value of selling the vehicles without warranties, and the total profit value of selling the vehicles with warranties. Now let's look at the four profitability scenarios shown on the graph. They are numbered 1-4 below each respective bar on the chart.

The first bar in the chart, #1 below, assumes you sell 100% of your vehicles (100%V), but none of them with warranties (0%W). The gross profit is 40. Since no warranties were sold, the asset value multiplier is 0. Now look at the fourth bar in the chart labeled #4. This assumes you sell 100% of the vehicles (100%V) and warranties on all of them (100%W). This bar has a profit of 50 and a multiplier value of .25. Compare this to bar #1 and you see that adding the warranty to the sale increased the profit by 25%. Hence the multiplier value of .25. The higher the multiplier value, the better the outcome. This case is fairly straightforward as you clearly see the opportunity to generate pure profit by using the warranty AVM.

Now, let's compare bar #1 to bar #2. In bar #1 all vehicles are sold (100%V) and no warranties are sold (0%W). In bar#2, only 80% of the vehicles are sold (80%V) but warranties are sold on all of them (100%W). The gross profit is the same at 40. **However, you can sell 20% fewer vehicles *with* warranties, and generate the same profits you would have, if you sold all of your vehicles without warranties. Take note, this is particularly important in times when inventory turns are slow and you need to generate additional profitability.**

Illustration 1



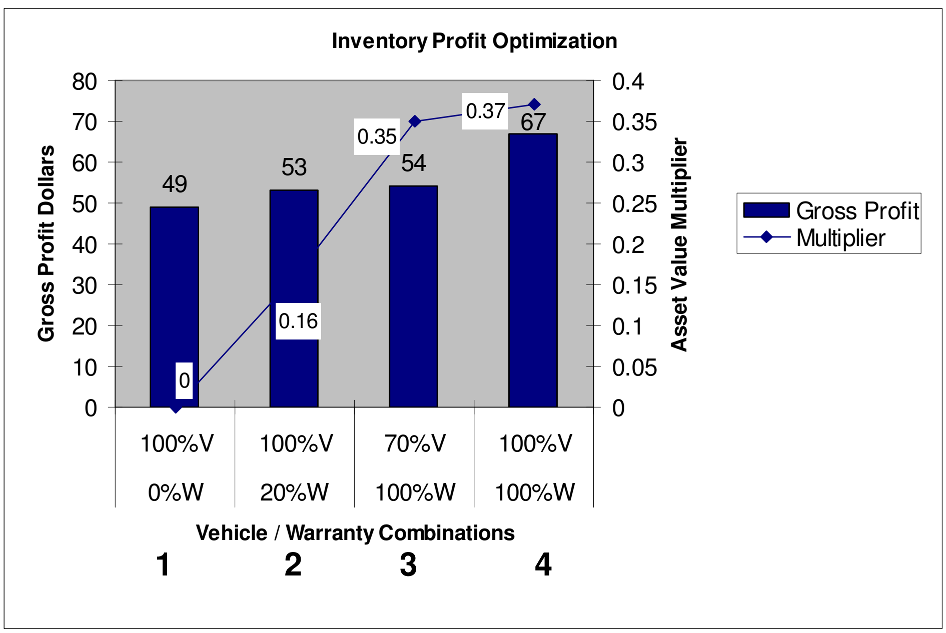
Now continue examining this by looking at Bar #3. This depicts another interesting scenario; In this case, you can actually generate more gross profit than in either of the prior two scenarios (43 vs. 40) and that is accomplished by selling only 90% of vehicles (90%V), with only selling 77% of them with warranties (77%W). Again here, **using the warranty as an asset multiplier generates more profitability.**

Illustration 2

In this illustration, the utile values were varied to better reflect the inconsistencies you find in a real life situation. Interestingly, the logic and the results from illustration 1 remain the same. In this illustration, the vehicle profit utiles ranged between 1 and 8 and warranty utiles were either 1 or 2. The combinations were chosen randomly.

In this example, some of the same outcomes described in the first illustration still hold true even though different values were used. Looking at bar #3, you see that the use of the warranty AVM will enable you to generate greater profits (54 vs. 53 or 49) and in this case, when selling only 70% of the vehicles. It is important to understand that the results for any given dealership will obviously vary based upon cost structure, overhead and your unique operating variables. However, if you refine this model by taking into consideration all of the real costs associated with selling a truck, and subtract them from the potential profitability on a given vehicle, the AVM value will likely increase. That is because the principles of using AVM's are always valid regardless of profit levels. It also validates the fact that you can optimize (improve) your inventory profitability by using a warranty as an asset value multiplier.

Illustration 2



Summary

- Asset value multipliers are items that **increase the *intrinsic* and *extrinsic* value of assets** you already have, and ultimately enable you to drive more profitability out of them.
- A **used truck warranty** is an example of a commonly used asset value multiplier.
- Selling a warranty with all vehicles in your inventory enables you to **maximize your gross profit potential.**
- Using the warranty as an asset value multiplier can enable you to **generate the same or more profitability** than you would by selling all your vehicles without warranties.
- As our current economy has created challenges in the truck industry and caused inventory velocity to slow, **including a warranty on every vehicle you sell can boost your profitability.**