

Libey Economic Outlook

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Donald R. Libey, Editor

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Libey's Twenty-Five Point Practical Protocol

Don Libey

Soon, as the year winds down, you may have some breathing room and, perhaps, time to fine-tune things a bit more to bolster the bottom line. Here are twenty-five very practical things to look at for enhancements and savings in 2008 and to 'plug the leaks' that may have drained some of your profits in 2007. This is the protocol I use in advising boards of directors and owners on performance and profitability improvements.

1. Product Relevance. One begins with the premise that product is king. The products that you sell are either relevant or irrelevant, either progressive or obsolete, either profitable or unprofitable. If you have not asked for a review of product relevance in the last three years, you are either dangerously living on the edge or potentially out of date. Your product profile moves through time; so must your products. If you have not evaluated your products against the needs, demands, and relevance of your customers today—at this moment in time—you are in danger of being lost in the past and in the 'glory age' of your past products. And that foretells a financial drain.

Product relevance is a forward-thinking element of business evaluation. Essentially, you must ask the question, "Will the products we sell still be in demand in five years?" The classic example was the audio-visual market. PowerPoint decimated the 35mm slide show market in about a week. After seeing the first PowerPoint presentation, any audio-visual cataloger would have foretold the end of a product era. That is the point where product irrelevance demands product reinvention.

I have found one of the most difficult preconceptions to change is that products are static. Too many managers fail to see beyond the *past* product relevance. The product past is of little value; only the product future has financial relevance. If the market is changing, an anachronistic product will seldom deliver a return. And the cost of marketing increasingly irrelevant products rises while the return, by definition, diminishes; the end result is self-evident.

The first thing I look at when evaluating any business is product relevance. If possible, I want to see the intensity of market demand for the product over time on a smoothed or constant basis. Either market demand is rising, remaining the same or falling; there are no other choices, and only one of those three bodes well for the future.

The measure of product relevance is usage rate. As an example, if you compared the usage rate of checks (number of checks written per capita) over the last 10 years, you would conclude that being in the check printing business is probably not high on the product relevance scale. Every product can be plotted on the product relevance or usage rate continuum. Seldom, however, do the senior managers of any catalog company have a definitive understanding of their product relevance, individually, by line or overall. And, if they don't have this elemental understanding, just exactly what are they doing?

2. Product Obsolescence. All products become obsolete; it is the end result of declining product relevance. There is an obsolescence continuum on which all products ultimately must fall. If your products are 10 or 30 or 50 percent out of fashion, your product obsolescence may be significant. In some cases, the inventory value—based on product cost—may be as much as 40 percent too high. What is sad, is the fact that most of the senior executives having a product inventory that is, for all intents and purposes partially obsolete, rarely recognize this inevitable result.

Product obsolescence is a cost. If 40 percent of a \$20 million inventory is, essentially, obsolete, the carrying cost of that obsolete inventory is \$8 million plus the present value of money. However, beyond just the actual cost in money, there is the lost opportunity cost of obsolescence. What could have been done with the \$8 million?

Product obsolescence is also a compounding loss. Today's \$8 million of obsolete inventory cost will have a value of perhaps only \$5 million in another year. Every day it sits in the warehouse the cost increases and the value drops. You must know your costs, and not just the cost of goods, but the costs of maintaining the inventory. Look at an example:

I have a small book publishing business that focuses on culinary, philosophy, poetry, and business books. A book that has a retail price of \$14.00 wholesales to Amazon or the book trade for \$6.30. The cost to manufacture the book (printing, design) is \$3.85. That leaves me \$2.45 per book sold. If I pay 15 percent royalty on the \$6.30 wholesale selling price, it is \$0.95 per book. I now have \$1.50 to work with. My warehouse cost is \$0.05 per book per month. Shipping and handling are a wash. I have a total of 30 months to sell that book before warehousing eats up all of my \$1.50, and every month I make \$0.05 less. If the book sells at 10 months, I make \$1.00 contribution to overhead. I can spend money marketing the books or I can sell them in bulk to a remainder house (like Half-Price Books) immediately for \$1.00 each.

If I have 1,000 copies of 10 books and each costs me \$3.85, I have a total inventory of \$38,500. If I sell them all at an average of six months time in inventory, I make \$1.20 per book or \$12,000. That is a 31 percent contribution to overhead. If I carry them for 12 months, I make \$0.90 per book or \$9,000, a 23 percent contribution to overhead. But, if I sell them *all* immediately upon printing to a remainder house for \$1.00 each, I make \$10,000 and that is a 26 percent contribution to overhead, no warehousing costs and no risk.

Of course, publishers never sell all the books and certainly not in six months. Publishing is the quintessential game of inventory control. And you can almost never actually make any money; the big-box retailers control the playing field and, therefore, the game. But, in business-to-business distribution, control of product and inventory is a powerful element of success; yet, it is rare to find businesses with *optimal* inventory management. There is a Rule of Thumb that I have never been able to disprove: “There is *always* fifteen percent of the inventory, or more, that isn’t selling and will *never* sell.” How much do you have right now in the warehouse? It’s a leak and it can be plugged.

3. Product Margin. Are you selling products that make you any money? It is not as simple as looking at the financial statement. What appears to be a solid margin product may, in fact, be an illusion.

If all products had identical margins, life would be simple. But, unfortunately, they don’t have the same margins. Some products are high margin, some are low margin. What you must constantly calculate is the ratio of high to low margin products and the magnitude and rate of shifts in that ratio. Are you steadily moving to a low margin product profile? If so, is it because of product cost or product selling price? Is margin erosion driven by suppliers or customers or channel? What lines are holding their own, and what lines are sinking like a rock? What are the true forces that are determining your gross margin performance?

Margin leakage is a deleterious element. If not corrected, it will pull the business under. The reality of margin erosion has been with us since the beginning of commerce. Someone always will do it better for less. If there is a recent change to this timeless reality, it is that margin erosion is picking up speed. Compare the pre-China, pre-Internet margins of the 1980s to those of today. It takes much more work to obtain or maintain a 50 percent gross margin (or less) today than it required back then. Many of you are traveling halfway around the globe every quarter just to hold on to a couple points of margin. The cost of maintaining margin has gone up significantly. In many cases, it costs 2 points to keep three points, especially with \$12,000 round trip airfares.

As with product relevance and inventory obsolescence, margin erosion has an equally enormous opportunity cost associated with it. What could you do with the additional 5 points of margin you are *not* getting?

My investigative protocol calls for looking at the gross margin percentage for *every* product, the aggregate for *every* line, and the overall for *all* products and lines over the past five years in year-one constant dollars. In other words, what are the smoothed individual, line and overall product gross margin trends? Only by having that knowledge will you be able to make the necessary decisions and adjustments to maintain adequate margin.

This is one of the most fundamental pieces of information (I would argue *the* most fundamental) needed to optimally manage a business. It is also the one reality that may require you to consider whether to remain in your current business or whether to reinvent the business. When gross margin is unsustainable due to pressures you cannot control or influence, it is no longer a viable business. You can ‘stick it out’ as many have done, only to see the business dwindle and die. Or, you can do what is needed: reinvent yourself. The reinvention imperative is occurring much more often today than it did in the past. This is due to the faster rates of acceleration and turbulence; one changes or one crashes into the wall.

4. Market Relevance. This is difficult because we so seldom venture outside of our own operations. Market relevance demands that you know where your market is going over the short, intermediate and long term. Right now, the new home market is declining. Right now, the fresh and waste water market is growing. One market is declining due to financial reasons. One market is growing due to scarcity. Each of these two markets has different time horizons. Water scarcity is likely a decades-long growth market. The new homes slowdown is likely a partial decade slump. Both markets have relevance, however, because the population of the world will double by 2050. Read that again. In the next forth-three years, the population of the world will be twice what it is today. People need shelter. People need water. These two markets have *relevance*. Video games, electric hot dog cookers, and garden gargoyles probably have less relevance. The base necessities of a doubling world population are *very* relevant markets for the future. Given the projected global instability and the precarious financial outlook, everything else is iffy.

Markets have statistical facts associated with them. There are answers to questions such as, “How large is your market?” In every company, someone should be investigating, measuring and answering questions like, “What is the total value of our market?” More importantly, answer the question, “In 2015, what will be the size and value of our market and what percentage will we have?” These facts, statistics and projections are available through diligent research; yet, rarely do direct marketing companies—even the well-run companies—have the answers to these questions. Why not?

Market relevance is one of the first elements that should be evaluated when acquiring a company or when outlining a strategic growth plan. Market relevance is, perhaps, best understood when you reflect on this bit of market wisdom: “You never want to chase your market.” It costs money to chase the market; it costs much less when the market chases you. That difference in cost is pure profit.

5. Market Obsolescence. Market obsolescence is quite different from market relevance. Here, we must look at segments within the market and gauge the maturity of product demand within those segments. As an example, business forms is a mature market, but labels is a growth market within business forms. And, within the label market, food labeling and medical labeling are growth segments, while address and mailing labels are obsolete segments. So, while business forms is *not* a growth market, medical and food labels *are* growth markets. Multi-part invoices, checks, and mailing labels are tilting toward obsolescence, but x-ray, laboratory and organic meat labels are tilting towards rapid growth.

If a company is in the business forms market, what percentage of its market segments is obsolete? That is the crux of the market obsolescence issue. I may not think the business forms market is relevant any longer, but if I am selling only medical and food labels I may have a very relevant market for the intermediate future. Of course, that can be determined by solid analysis of where the food and medical label market is projected to go over the next 10-15 years. Once again, I like the underlying fact that people must eat and obtain health care. Additionally, the population doubling coupled with the aging Baby Boomers projects a sustained, relevant market and relevant products.

Quantifying market obsolescence is accomplished primarily by quantifying the products used by the market or markets. Volume and usage rate must be examined carefully. By example, consider checks. Usage rate is dropping, but number of purchases (and perhaps gross margin) may be growing due to more frequent buying of significantly smaller quantities of checks at higher prices. What does that mean? How does that influence margin and earnings? Is there a significant difference between business checks and personal checks? Between older people and younger people? Between Americans and Canadians? What you are attempting to do is to quantify segments of the various markets and project those segments into the future to determine whether the market potential is worth the investment risk. It also helps you understand whether you are in or out of whack. Whack has a cost. Out of whack has a much higher cost. Out of whack is leaky. Leaky is not good.

6. Market Margin. Does your market have adequate margin? Simply put, can you make any money with your market? This is different from market obsolescence which is concerned with growth and sustainable product usage. Market margin asks whether your market is able or willing to pay you enough to make it worth your effort and investment. There are markets that are simply exhausted. Think video rentals. Two movies, ten days, \$2.00. Come on. . . why bother?

Market margin is determined by market saturation and channel saturation. If you are selling commodities and have huge competition in every channel, the price will reach a point where there is no margin left in the market. The market will be dominated by “The Bigs” and you will never compete on price. You may believe you can compete on other elements, such as service, friendliness and selection, but the reality is that commodity pricing always wins. No margin in the market, no business.

Market margin requires margin comparison among the competitors at your size, in your channels, and in your market segments, as well as an understanding of where the 800 pound gorilla is going. If everyone is operating at the bone and the gorilla is winning share on even lower prices, there is no money to be made and it is time to rethink the target market.

Again, the rule here is “Never chase your market.” The difference this time, however, is never chase lower prices. You will never win because you don’t have enough money to throw at the gorilla.

7. Marketing Relevance. Are you going to market the same way you did 10 years ago? On the continuum from cutting-edge multichannel marketing to trailing-edge mono-marketing, where does your marketing relevance rank?

Marketing relevance is not only technological wizardry, it also reflects your strategic approaches, your talent pool, your effectiveness at managing outsourced services, and your fundamental understanding of your customers. In fact, marketing relevance is far more about mastery of the basics than it is mastery of the technology. You will never have technological success in the cutting-edge marketing strategies of 2008 until you understand everything there is to know about your customers and have a relevant, productive marketing strategy executed internally and externally by talented, experienced people with real track records using factual marketing data. Let your head of marketing and each of your outside marketing vendors read that last sentence and then watch for sweat.

Across many companies, it is more common to *not* have this degree of marketing relevance. Many of our catalog companies have marketers who had the necessary skills 10, 15 or 20 years ago. These were Marketing Masters who are now only partially skilled, given the complexities of the channels. Marketing today requires knowledge and skill triple or quadruple that of 1990 or even, perhaps, 2000. If you are a mono-channel marketing company and go to market only with a catalog, then you need a catalog master. But, if you are going to market in two, three or more channels, then you need a multichannel master. Too many companies are either going to market in multiple channels with catalog marketers or they are hiring raw, untrained talent right out of school and giving them responsibility for everything related to today's marketing. Both approaches to talent will fail.

Marketing relevance has a cost. It is cheaper to pretend you have talent and depth, or it is cheaper to hire a blank slate, but the cost will be magnified by lack of success, cost per transaction, cost to acquire a customer and every other fundamental metric that reveals what level of talent the company has. If you want excellent marketing at the leading edge, hire excellent marketers with leading edge knowledge and proven ability. Pay now or pay later.

Marketing relevance also reflects the owner's position and view of the future. The owner who is content with the marketing strategy and approaches of 1990 and 2000 is destined to lead the company no further than 1990 or 2000. This owner is comfortable only with the past; this owner lacks the personal confidence for leading the company forward to 2015. This owner should bring in a confident, forward-looking, talented company leader and step aside to manage the financial aspects of the business while leaving the marketing to one who has future relevance. This is probably the most difficult thing to do, but it is the only way forward.

8. Marketing Obsolescence. This is dangerous. When confronted with marketing obsolescence, I find companies that are hemorrhaging money from circulation plans or catalog creative, or product merchandising that is out-of-touch, out-of-date, and simply *wrong*. Worst case, it is all the above.

Evaluating a company with obsolete marketing requires immediate triage. First, determine whether it can be saved. Then make sure it continues breathing and stop the bleeding. Finally, let the parts that are dead go, and work on keeping the live parts alive. Once triage has produced stability, hand the patient off to a competent surgeon for the repair work.

The signs of marketing obsolescence can be anything: bloated, gangrenous inventory; revolving door turnover; obscenely high cost to acquire a new customer; collapse in 12-month customer retention; plummeting dollars per catalog mailed; upside-down prospecting to customer ratio; nose-diving core product sales; lack of any verifiable marketing metrics; whacky advertising cost as a percentage of sales; too many or not enough catalogs mailed; sky-high search costs per new customer; data warehouse failure; inability to do customer selects or fundamental RFM analyses; naked stupidity; and on and on. Believe me; you know it when you see it.

When marketing has tipped into obsolescence, there is no utility or benefit for money spent. The business is not just leaking—the hold is filling with water and the ship is listing to starboard. You either plug the holes and stop the leaks, or it will soon slip under the waves to its watery grave.

This is a progressive problem. First there are symptoms of problems of marketing relevance. When those go untreated for some period of time, it all goes pear-shaped and slips into *extremis*—marketing obsolescence. It can be rapid, but usually it is a slow, insidious deterioration and can be hidden from view by autocratic owners in denial or by incompetent marketing executives who are afraid of losing their jobs. When it reaches this point, it must be faced and fixed regardless of the pain.

I normally apply my Cardinal Metrics Suite of 35 measurements to these situations to quickly determine the forensic condition of the business. With that snapshot of where things stand, the triage efforts can proceed as indicated.

9. Marketing Margin. Are you making any money with your marketing? This question is not asked very often. Most companies either don't know or are afraid of the answer. Marketing margin is the gross profit directly resulting from any marketing effort. (Net Revenue — [Cost of Goods + Cost of Marketing] = Marketing Margin).

When you compare the resulting marketing margin for each and every marketing campaign—side by side—you are able to see the comparative utility of your marketing effort. Critical to understanding this unusual financial view is the allocation of all appropriate marketing expenses to the Cost of Marketing. These include: all catalog costs including creative, pre-press, list rental, data processing, postage, freight—all the usual expenses; the allocated cost of talent including marketing-related wages and benefits from top to bottom; the allocated data-mining and data-warehousing costs supporting the marketing effort; and the allocated cost of all direct outside services, commissions, fees, etc. related to the marketing effort. The end result is the ability to look at any single marketing effort over its life and determine an accurate marketing margin and compare that result with any other marketing effort. The higher the marketing margin the better the effort.

It has been my experience that some 15 percent of all marketing efforts are best not done. One must test, take chances and try new things, but usually one can find at least 10 to 15 percent of the marketing efforts that are simply repetitive, non-productive, rote effort that are simply leaking money into the ship's bilges. "We *always* send one catalog to SIC 6520." There haven't been any profitable orders from that SIC in 10 years, but the

company's marketers insist on sending catalogs based on, "That's what we've always done."

When the owner or CEO explains to the marketers that each effort must meet a minimum threshold of marketing margin, decisions about the use of marketing dollars become more discriminating.

Marketing margin is channel agnostic. Marketing margin doesn't care if it evolves from catalog mailings, emails, retail outlets, inserts, or organic or paid search. It only matters that it be positive marketing margin and that it be the highest marketing margin possible. As an owner, it's good to be king.

Here then is a specific question that requires a definitive answer: This year, how much (a precise number) marketing expense produced too little or zero marketing margin? Then, when that question can be answered, the follow-up question is, "Why do you do that?"

The leaks in marketing margin could fill one of the Great Lakes. We could float a sizeable industry on these leaks alone. Plugging the marketing margin holes will raise the above-water earnings line. But it is hard work. It demands precision knowledge and accurate measurement. Somebody has to be on top of it every day. The leaks are in the bilges of the ship and that's where the hard work has to be done, down where it's hot and dirty. How much has leaked out this month?

10. Catalog Production Economies. I shall remain eternally in debt to my close friend and Trusted Advisor over the last 25 years, Jim Rudek of Quad/Graphics. At every step of my catalog career, Jim made sure I was exposed to proper learning and good advice from individuals who were experts at a company that engaged customers for a lifetime relationship. As a result, I enjoyed a very significant advantage in catalog production economies. The money that was added to my overall marketing margin, because of innovation, efficiencies and the dedication to my success by Quad/Graphics funded most of my expansion and investment prospecting at my various companies.

Because Jim Rudek made me attend the early Camp Quad adventures, I learned how catalogs were made from the actual people who make them—pressmen, graphic artists, plate makers, binders, paper buyers, plant supervisors, gravure engravers, printing accountants, even the legendary Larry Quadracci himself.

In an amazingly short number of years, we created the first electronic Mac-produced catalog, the first multi-catalog co-mailing, the Roto-Mail concept, multi-positional ink-jetting, and dozens of what I came to call "never been done before." By opening our minds and our trust, we did things that no one had ever dreamed of and we found economies and financial advantages worth their weight in gold.

Yet, I evaluate a catalog company—even after all these years of our knowing this is the only way to manage a printing relationship—and what do I find? Habitual vendor-bending for another cheesy 1.5 percent; moving round-robin from printer to printer based entirely on the last quote; never making a commitment to a long-term supplier relationship; never sharing any information helpful to the printer about the catalog performance that someone might "reveal" to a competitor. I find another 15 percent of

production costs being wasted due to archaic, foolish attitudes rooted in paranoia and cheapness.

Catalog print production is not a contractual event. It is a discipline with a huge number of expensive variables. It is a discipline with a huge amount of highly specialized knowledge and technology that can be marshalled to work to your advantage or ignored to your detriment. It is a massive economy of scale industry and one where penny-pinching in the production process will bite you right where it hurts. Today's efficient and skilled printer is no longer about ink on paper; they are about the entire catalog advertising spectrum, particularly data warehousing, analytics and postage modeling. If a catalog company is just buying printing, that catalog company is 15 years out-of-touch. Their competitors are buying *marketing advantages* from this multi-faceted entity known as "the printer." In another 10 years, the printer will be the center of everything that is direct marketing, including all channels. The printers are the only ones with sufficient economies, funding, size and market share to pull off the massive investments needed for the future of multichannel direct marketing. Pay them now or pay them later, but you better be in bed.

Forging a relationship of substance results in uncovering and plugging leaks so the catalog can survive, enabling the printer to grow. Printers are not interested in your 1 or 2 percent squeezes; they are interested in client companies who understand and clearly see the future big picture needs and who want to invest in a partnership where *both* companies can grow. The days of printer as supplier are gone; printer as partner is the future.

11. Catalog Efficacy. After several decades of doing in-depth critiques and reviews on hundreds of catalogs, I can state unequivocally that certain catalogs perform better than others based on creative and structural techniques and aesthetics. Catalog efficacy is the art of making good catalogs. Catalog efficacy may be worth 10-15 percent of sales one way or the other, maybe more.

Just how good is your catalog? If you are a \$40 million catalog, after all these years, I'll wager I can find an additional \$4-6 million in sales simply with enhanced catalog creative and structural techniques.

Catalog efficacy is not just a 'makeover.' Efficacy is an economic concept similar to utility or benefit. It is the maximization of benefit in cause and effect. If the catalog has a higher degree of causation (creative excellence) it will produce a higher degree of effect (sales). The difference, however, is in the quality of the creative excellence. There is creative that is okay; creative that is good; and creative that is excellent. All produce a differing level of effect measured in sales. Only the highest level of creative efficacy will produce the maximum level of sales. Perhaps the weakest part of most catalogs is photography; yet, logic tells you it is the most important part of the merchandising of the product. The photo is the substitute for physically holding the product.

The problem is finding the efficacy that is specific to your customers' behaviors. That is where the skill comes in. You don't simply write descriptive copy and take a photo. Products—particularly business-to-business—have to be presented *through* the customers' points of view. That takes a unique understanding, a lot of hard work, and excellent creative execution which is expensive. But, if your present catalog efficacy

costs (add as many 0s as you wish) \$4 and produces \$32 (a 1 to 8 ratio), would you be better off spending \$9 to produce \$90 (a 1 to 10 ratio)? In this example, catalog efficacy increases by 25 percent.

Catalog efficacy must be balanced with catalog margin. The point of the exercise is to create a cost/benefit analysis that places a value on enhanced creative and structural techniques and aesthetics. Only when you are able to value your creative in terms of efficacy will you be able to make an informed decision as to the extent of creative enhancement. It is possible that you have a product line and market that will respond only a small amount to enhanced creative. There may be a low catalog efficacy gain. On the other hand, you may have a product line and market that would respond very positively and increase your sales by 40 percent. There may be a high catalog efficacy gain. I know of one company that did everything I suggested in a 45-page review of the catalog and they doubled their sales the first year from \$8 million to \$16 million. They did nothing else; only the creative and structural enhancements. There was no magic on my part; that catalog was just horrible; *anything* would have been an improvement. But, what it does point out is that creative is a complex and powerful causation that directly influences the degree of effect.

So, if you invested \$1 in your catalog efficacy, what do you think you would get back? \$1.25? \$1.50? More? Do you have confidence enough in the supremacy of your creative to *not* invest in enhanced catalog efficacy?

If, as with most catalogs, sub-par catalog efficacy is causing a 10 percent leakage, what could you do with the extra money if you plugged that hole?

12. Catalog Circulation. Ah. The 1,200 pound gorilla. How much of your circulation is wasted or how much more should you be doing? For most catalog companies this is the big hole. You can never know enough about your circulation performance or your customer potential to arrive at the optimal circulation plan. There is *always* 10 percent in circulation efficiencies to be gained.

Even analytic techniques as simple as RFM can add to the efficiencies of catalog circulation. With advanced customer modeling and optimized RFM plus product, additional circulation advantage can be obtained.

The often unfortunate finding, however, is that catalog companies all too frequently are *not* sophisticated in their circulation planning, modeling, or understanding of the interplay of response, spend, frequency and media. For some, it is just easier to use a blanket circulation approach: everyone gets six catalogs a year. For these catalogers, the 'active customer' definition may be five years, even when there has been no purchase in that period of time. Those customers also get six catalogs a year. And the list of circulation shortcomings extends for yet another year and another 10 or 15 or 20 percent of circulation ineffectiveness.

Sub-optimal circulation strategy and planning results in a higher new customer cost-to-acquire and a lower marketing margin for customers. Often, customer retention is also lower than normal, an indication that circulation may be out of synch with customer behavior.

The extreme complexity of circulation, all of its nuances, all of its interconnected measurements make it the domain of an expert. Companies who approach circulation as the province of the Director of New Customer Acquisition on the prospecting side and the Director of Customer Retention on the house side tend to place individuals in those positions who are highly experienced, totally up-to-date, comprehensive in their knowledge of the circulation and list industry, and who have proven themselves capable of designing, building and managing a circulation strategy that produces strong marketing margin.

The saddest approach is when companies hire entry-level, fresh out of school people and give them full responsibility for circulation without their having ever created a circulation plan or being able to define 'response list.' I have seen the chaos and havoc that these neophytes create. Their first move is to turn the entire circ plan over to another entry-level individual with no experience working for a membership co-op with a 'system' that churns out a manufactured circulation plan and an endless miasma of names generated out of a 'black box.' It's easier this way and cheaper. What this really describes is a gigantic hole through which huge amounts of money falls and equally huge amounts of opportunity is lost.

You can slice and dice the metrics of circulation a thousand different ways. Each company has unique determinants of circulation measurement. Each requires an expert to decode and interpret in order to discover the optimal combinations that deliver the optimal marketing margin. That is very difficult, very complex and very focused work. It requires years of experience. Such experience can only be found in people who have done it time and time again and who have learned the nuances, the pitfalls, the hidden twists and turns that circulation analysis presents. At the same time, it requires someone who understands the precision nature of direct marketing. These are your Trusted Advisors in the list brokerage firms. They become your partner in the same way that your printer has become your partner for the future. You need their expertise and their hard-won talents. To ignore them in favor of the 'easy' or the 'black box' approach to blanket circulation planning is to court disaster and financial ruin. This is a business of precision, testing and analytics. Giving up that capacity internally places you in the position of flying blind.

Of all the holes through which profits leak, this one has been the most consistently nagging offender. There have been many fortunes that have drained out through this hole. Even now, with all of our technological and analytic sophistication, circulation is still, by and large, mediocre. The amount of work to be done in improving catalog circulation is great. The amount of money to be redirected to the bottom lines is even greater.

13. Catalog Prospect : Customer Ratio. How many catalogs do you mail to customers versus prospects? This is one of the cardinal ratios in the catalog world. Get this one wrong by five or ten points and all of your earnings will evaporate.

In the beginning, every mailing is a prospect mailing; there *are* no customers. Fifteen years later, there is a logical ratio of customer to prospect catalog mailings. The idea is to retain existing customers and add new customers; both require catalogs to be mailed.

There is a normal progression: 100 percent prospect mailings, then 95 percent prospect and 5 percent customer; later, new customers have been gained and mailings go from 5 percent customer to 15 percent while prospect mailings go from 95 percent to 85 percent. The prospect to customer ratio is now 85 : 15.

Over time, the catalog company reaches maturity and mails 60 percent to customers and prospects with 40 percent of the catalog mailings. The prospect to customer ratio is now 60 : 40. This is fairly normal; however, some companies have a product line or market where the repeat sales are more of a 'one off.' These types of companies have a much lower repeat sale rate and must constantly bring in new customers who never buy again (or do so only at a low rate). This may require a reversal of the prospect to customer mailing ratio to, say, 40 : 60.

The optimal ratio less the existing ratio results in the 'whack factor.' If the whack factor is high, the company is out-of-whack' and is leaking money into the bilges again. If the whack factor is low, the company is relatively leak-free, at least as far as the prospect : customer mailing ratio goes.

This is a very difficult element to get right. The optimal ratio is a product of repeated testing and measurement and can take years to determine. Also, over time, the market can erode or become more loyal and that will change the ratio.

What is inexcusable, however, is not knowing. If customer retention is high—say 80 percent—and prospecting is 80 percent of the mailings, it may be possible that prospecting can be reduced by half and customer mailings increased from 20 percent to 60 percent and a *whole* lot more money can be made. If so, then you have just plugged—not a hole—but a gigantic tear in the hull reminiscent of the Titanic.

14. Database Relevance. How relevant is your approach to database marketing? How does the structure of your database and your ability to extract and analyze information translate to profits? What is the utility of your database in terms of added profits; in other words, how much more earnings are driven by the relevance of your database sophistication?

If you simply marketed to prospects and customers *without* database segmentation, analytics and modeling, what would you earn on the bottom line from just rote mailing of the catalog? And, if you are a sophisticated or semi-sophisticated database marketing organization, what is the earnings differential owing to that sophistication? That difference is your database relevance margin.

Of course, there is a cost to that relevance, and you must be able to calculate that cost. To do that—to answer the question, "How much earnings benefit do I get from investing in advanced database marketing initiatives?" you must have accurate costs and accounting protocols.

Where the gaping holes are often seen is in catalog companies that have only rudimentary database abilities and capacity. Many of these invested in the then-new frontier called 'database marketing' back in the 1990s but never moved beyond the initial investment. Now, in 2008, faced with catalog, online, email, insert, retail, and search

channels, these companies have failed to keep pace and are database *irrelevant*, for which there is a terrible cost.

Database relevance also is concerned with the degree to which outside database enhancements are made. Database modeling is done primarily on the house list, but increasingly, prospect modeling in the form of proprietary databases and other applications are routine indications of database relevance. Most of this work is being done by list brokerage firms having the necessary talent and relationships with large data processing companies to do the work effectively and at an acceptable cost. A catalog company that is not actively refining its data to create improved marketing, product, merchandising, management, financial and retention performance is, in all likelihood, leaking profits and opportunities to its detriment.

Additional areas that define database relevance include back-up provisions for data interruption or lost data due to systems malfunction. The justification of cost here is only recognized when you don't have the safety net and you lose your data. A similar relevance measure is how data is protected, especially sensitive data that, if compromised, will lead to industry censure by regulating bodies. The recent outbreak of 'lost laptops' containing massive amounts of private data points to failures in this essential area of database control.

Perhaps the starkest depiction of database relevance comes when the owner or CEO simply sits quietly and alone with a pencil and a piece of paper and writes down a reasoned and honest appraisal of the company's current database relevance based on the truth. Is that solitary appraisal an 'A' or a 'B' or a 'C' or a 'D' or an 'F'? What is the cost of the holes and the leakage?

15. Database Productivity. This assumes you have database relevance to begin with. What we now must determine is to what degree this capability has been optimized. Or, to say it another way, "How much is our database relevance earning, and can it earn more?" Think in terms of a bag of golf clubs. If you have the best \$4,000 set of clubs available and Tiger Woods has the same bag of clubs, how much more will Tiger earn than you? Productivity is a function of talent, time, and execution. If you are not getting maximum productivity from your database bag of clubs, is it because of lack of talent, lack of effort, or lack of execution?

I have never seen a company that is obtaining a 100 percent rate of productivity for its database initiatives. I *have* seen a couple that are getting over 90 percent, but they are rare. Most appear to be at the 50-60 percent level, and there are way too many at the below 50 percent level. If you are at 60 percent of database productivity, what is the cost of the missing, say, 25 to 30 percent enhancement that *could* be obtained? Equally important, what is the cost of obtaining the additional 25 to 30 percent of productivity? Which is greater—the beneficial gain or the cost to gain that benefit? This answers the question of diminishing returns relative to database investment and database productivity. However, if you can show that a \$1.00 additional investment produces a \$2.00 benefit, it may be worth spending the money.

One thing is very clear to me: The issue of *internal* versus *external* database productivity is critical. Do you buy outsourced productivity or do you develop it internally? There are costs both ways. You must know the costs. Internal capability adds

valuation to the corporation. It also can be significantly more costly. Whether the cost is offset by the difference in valuation at the time of sale of the company is the true question. A talented staff of database experts and the cost of software and hardware over time adds up. Can you rent that talent at a lower cost and is the resultant loss of internal capability value at the time of sale material? Also, what is the risk? Can you accept outsourced risks to what is, arguably, your greatest corporate asset?

16. Circulation Optimization. This is the unique evaluation of the combined level of database productivity and circulation planning. Simply stated, it is the degree of formulaic circulation optimization driven by empiric database knowledge. If there is good database relevance and database productivity, but poor circulation planning and management, then circulation optimization is compromised. Said another way, circulation optimization is how much you are *not* flying by the seat of your pants.

It is a curious thing, but many catalog companies have one, two or three fully-furnished elements of database relevancy or database productivity or circulation planning, but are unable to link all three to produce a similarly fully-furnished circulation plan. As a consequence, catalog mailings under perform.

I tend to set an artificial level of circulation optimization; after all, you have to aim at something or start somewhere. With that lofty goal described, I then measure where the company is presently in relation to that goal and do all the resultant financial calculations. The difference between what is and what could be is the circulation optimization differential. With that differential converted into lost revenues, one can then project what improvements could be had with a 5, 10, 20, 40 percent or more improvement in circulation optimization. The trick, of course, is to know where and how to *obtain* that improvement. It may come from enhancing database relevance, improving database productivity, or injecting knowledge, talent and experience into circulation management and planning. With a little luck, it will not require all three.

Optimization of circulation simply means the business is getting all of the possible mileage out of the tank full of catalog mailings. If the valves, spark plugs, air mixture and carburetor are all functioning optimally, then the greatest possible mileage is obtained and the engine hums along nicely. If not, then there will be lurches and knocks and poor mileage.

If you think about it, this is *the* key determinant of a successful catalog company. Change channels, if you will, and substitute the term Search Optimization or Foot Traffic Optimization or Insert Optimization. Regardless of the channel, it is the combined optimizations of database knowledge and *some* marketing vehicle or media. This *is* what we do.

17. Order-Entry Efficacy. Having now navigated through 16 elements of preparation, we get to the actual order itself. From here on out, it is pretty straightforward.

Efficacy of order entry is simply the optimal cost for entering an order. That does not mean *lowest* cost necessarily. If you are selling \$400,000 diamonds, you may want to spend more on order entry than if you are selling a \$2.00 pair of socks. The optimal cost for entering an order is a mix of people, communication, accuracy, technology, speed and

measurements. When those elements are proper for the business, at the level that produces optimal customer retention, then you have reached the state of order entry efficacy.

Where I look for holes and leaks is in order entry procedures and components that cost customer satisfaction as well as money. This may be in lost good will, lost repeat business, excessive returns, migration to competitors, apathy, or disappointment for any number of reasons. The reasons for lack of order entry efficacy can always be discovered by carefully auditing the order entry people, communications, accuracy, systems, speed and outcomes of measurements. If the problems are not found there, then they are either in the product or the market itself.

Once the barriers to order entry efficacy are identified, the next step is to quantify the cost of the holes and the leaks that are resulting from the sub-optimal performance. With that knowledge in hand, a cost : benefit analysis will help define the proper solution. The solution and the investment in problem-solving will depend on whether the barrier is systems, people, management or, sometimes, facilities.

Order entry productivity (the other way of describing this element) is a science. In the large call centers and customer service centers it is generally well-quantified. Good systems and good communications coupled with good people, good measurements and good management, leads to a high level of efficacy and good customer satisfaction driving higher customer retention and a lower cost to replace customers. In the smaller operations, however, this quantification is seldom in-depth or constant. It is semi-administered from time to time and the level of efficacy varies depending on seasonality or levels of staffing. What is wanted is to smooth the productivity to as constant a level as possible to achieve the optimal cost (in all regards) for entering an order.

18. Order Fulfillment Efficacy. This is the efficacy of the warehousing and shipping operations. There are numerous areas for leaks here, including labor, supplies, space and facilities, freight and contract negotiations, management, technology, inventory management, inventory handling and storage, dunnage, pick-pack-ship procedures, and on and on. To determine the extent of leakage, it is necessary to evaluate each of these elements individually and then in the aggregate.

This is actually one of my favorite areas. In my experience, there are two levels of operations directors: people who are *really* good at this stuff and people who are *really* bad. For some reason, there are not many managers in between. Both can be fun to work with. One teaches you even more and shows you new ways to reach optimal operations; the other is a festival of improvement potential and gives you the satisfaction of actually doing beneficial work.

There is not a lot of magic to fulfillment efficacy. It is all about managing your costs, time and labor to achieve the lowest cost of fulfillment consistent with the products and the market. You begin with each element and work your way through in an attempt to discover the holes and the associated costs of those holes. In one recent warehouse, I found 26 different sizes of cartons where only 4 were needed. By shifting to an adjustable size carton (scored for different fill levels), a 45 percent reduction in the cost of custom made cartons was made. Not a big deal, but it dropped about \$110,000 to the bottom line.

On a 6+ times multiple of earnings basis of valuation, that is worth around \$700,000 in added valuation which makes my consulting fee a bargain.

By the time you get through the UPS and FedEx invoices, the cost of paper or peanuts dunnage versus air, the reduction in labor possible by rearranging the pick stations, the benefits of narrow aisle, high racking, the savings from cubing or from dedicated space for up-stock, and on and on, you come to a tally of the holes and the leaks. Often, the solutions can be self-funded directly from the immediate savings.

Some of the brightest and most talented people I have met at catalog companies have been the warehouse managers and directors. There is just something genuine and straightforward about these professionals, especially when contrasted to the marketers who almost never land on the ground, preferring as they do the near-constant soaring above on the rising thermals. The warehouse folks deal in facts. Facts are good.

19. Shipping & Handling Efficacy & Optimization. What are you charging for shipping and handling and is it the optimal strategy?

This is tough. The online ‘net-gnats’ are eating your lunch with their free shipping offers. For those who are owned by European companies (U.K. excepted), those boards of directors believe free shipping is a customer right and a strategic opportunity and they want you to just ‘Do it!’ without delay regardless of the amputation of your bottom line.

Well, here is my little piece of heresy. I look for the leakage coming from not charging *enough* for shipping and handling. Particularly in business-to-business, the customer expects to pay and the amount is secondary to the need for the product. That said, however, there is a balance and a point of optimal cost versus speed.

I am impressed with the Amazon approach. Some products qualify for free shipping; some for two-day shipping; and I can choose to pay an upfront \$75 a year and get all of my shipping two- or three-day free, or for just a dollar or two more, I can have overnight delivery. I have *choices*.

The principle of efficacy requires that you be able to put a value and a cost on those choices—and on the lost opportunity of *not* offering those choices. The decision, at that point, becomes self-evident: which combination of cost and value wins for retaining customers and maximizing earnings?

20. Packaging Efficacy. I touched on this above. The state of efficacy is having optimized cartons, dunnage, cubics, sealing, labeling, needed inventory and speed of re-supply (owning cartons and supplies for the least possible length of time), inbound freight and outbound freight management and costs; in short, everything to do with the boxed order costs and productivity. Take \$.50 out of the costs on 400,000 orders a year and it is \$200,000 to the bottom line and \$1.2 million in corporate valuation. If it is there to be had, then it is a \$200,000 leak.

21. Facilities Administration. Do you really need all that space? At that price? If you were to do a facilities needs assessment, what would it reveal? Is the strategy of centralization costing you market share and excess shipping costs? Would a decentralized, multiple warehouse strategy assist you in your growth?

The physical needs of the business are almost directly determined by the growth plan and the future exit strategy. If the business is generational, facilities are long-term investments. If the business is going to be sold in three years, facilities are viewed differently. If the business is going to remain a regional business, then centralization of warehousing is reasonable. If it is going to be national, then decentralization may be a better long-term approach. If the business is expanding internationally, facilities becomes a much more important component of the strategic plan.

Regardless of the strategy, there may be leaks in the existing facilities. These can come from space utilization to utilities; from fork lifts to inefficient racking; from location versus work force drawing area; from insurance; from maintenance; from land-banking; and from dozens of related consideration.

22. Talent versus Longevity. This is a very difficult and sensitive part of the overall effectiveness and efficiency of the business. In short, what is the average age, cost and talent quotient of the employees? Are you paying too much for too little, or too little for not enough? Are you too generous, or are you too tight? Are you developing talent or are you housing mediocrity? What are the *costs*?

23. Guidance and Strategic Direction. In an autocratic company where all decisions are managed by the owner or CEO, at some point in the growth of the business, there is a point where it can no longer be managed effectively. Things begin to stall, fall through the cracks, and suffer from ‘shifting priorities.’ Again, we have the leaks associated with cause and effect.

Almost every company reaches a point where monarchical management is no longer possible. Delegation must take place and senior-level outside talent must be imported. The alternative is to maintain the company at the level at which the monarchy still works and forego growth. That is not a bad thing. In fact, one of the most frequent questions I ask owners is, “Why not just stay this size, do a great job at this size, and continue to take out your \$2 million a year and enjoy life?” The answer is almost always one of ego-need. It simply is not possible for many entrepreneurs to accept that they have limits. Work is life.

But, at least have the good sense to understand that there are costs associated with monarchy. If there are leaks developing that are costing money, focus on the causation. This is the one area where *only* the owner can plug the leaks. Even the most salty outside advisor can only go so far in calling these deficiencies into being.

24. Investment. Too little? In the right places? Too much? In the wrong places? Is investment prospecting covered? Will there be sufficient customers to sustain the business?

The leaks stemming from investment, or lack thereof, are legion. Nearly every business failure I have witnessed is as a result of being under capitalized. Yet, if you analyze the use of capital, most of the investment capital has been wasted or, at best, used inefficiently.

These leaks are the most serious and often require near-confrontation to arouse a sense of reality. There is one truism, however, that is worthy of stating: *When the management of the investment is poor, it is near-impossible to get any more.*

25. Board of Directors. Read #24's italics above. That is why a good Board of Directors is necessary. In fact, the entire reason for the Board of Directors is to hold your feet to your own fire by constantly causing you to evaluate Numbers 1 through 24 above.

* * * *

This then is *Libey's Twenty-Five Point Practical Protocol* for the strategic management, growth and profitability of a catalog company. I hope you will find one or two things that will be of value to you in your business.

Go forth and multiply!

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The First Quarter 2008 Economic Outlook

As of late October, the economic outlook slips another small notch with a weak dollar, overburdened debt, a negative Federal current account balance, a record- high Federal debt ceiling, record oil prices and ongoing global instability.

The reasonable conclusion is that the first quarter will be a bit sobering. With fourth quarter results, post-holidays, likely to be flat to barely increased, the proof will dawn on the markets in January, and it is likely the national mood will dip further. It is clear that a majority of Americans has lost all confidence in the government and is becoming increasingly pessimistic. Yet, the economy continues to grow, although at a slow but steady rate.

The bright spot continues to be direct marketing's performance in an otherwise slow growth economy. Our catalog and multichannel businesses tend to have seen about a 6 percent gain for the year; not bad for a difficult 2007. Fewer companies are posting the 15-25 percent gains of past years, but 6 percent is better than 1 percent. To be sure, there are catalog companies (well-run companies) that are showing over 20 percent growth, but they are rare. Indeed, for every one of these excellent companies, there are several poorly run businesses that have negative growth for 2007. So, if you have 5 or 6 percent growth, you have done fairly well; keeping it going, however, is going to be a bit more difficult in 2008, I believe.

My view for the fourth quarter has, again, not changed much from the last issue. The holiday season will be constrained for consumers. Less money will be spent this year as the petroleum prices increase seasonally. And don't deny the fact that \$100 a barrel oil is going to be a problem—a big problem. The housing market sinks deeper and recovery

moves further off. The difference this coming quarter is that consumer spending is probably going to slow, perhaps abruptly. Never lose sight of the fact that consumer spending is some 70 percent of the nation's economic momentum.

The balance of 2007 remains slow. I will adjust with my call for a 2% to 3% growth in the economy, when all is done, downward to 1.5 percent or a bit less. I would not pull back on mailings or prospecting in the first quarter of 2008. Income maintenance is going to be a concern; decreasing mailings will create a spiral; lowering costs is essential, but it must be achieved in areas outside of circulation.

Signs of Regional Stability or Status Quo

Region One (CT, ME, MA, NH, RI, VT)

Region Two (NY, NJ, CT, PR, VI)

Region Four (OH, KY, PA, WV)

Region Six (GA, AL, FL, LA, MS, TN)

Region Seven (IL, IN, MI, WI, IA)

Region Nine (MN, WI, ND, SD, MT, MI)

Region Ten (KS, CO, MO, NE, NM, OK, WY)

Flat or Slower

Region Three (PA, NJ, DE)

Region Five (KY, MD, TN, VA, NC, SC)

Region Eight (MO, IL, IN, KY, TN, LA, AR)

Region Eleven (TX, LA, NM)

Region Twelve (CA, UT, AZ, NM, OR, WA)

Evaluate individually

Louisiana

Mississippi

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The First Quarter 2008 Circulation and Prospecting Outlook and Recommendations

Synopsis

The short-term economic outlook for the catalog industry in the first quarter of 2008 remains relatively positive. The intermediate-term outlook remains positive for the first half of 2008 and the long-term outlook for the last half of 2008 remains positive. While positive, the outlook continues to show slower growth than that seen over the last three years.

Investment Prospecting

For planning purposes, turn your attention to the second half 2008 circulation planning. Even with the signs of slowdown in the economy and in overall business, we recommend maintaining normal strategies for circulation and investment prospecting plans, but we remain with our recommendation of not more than 10 to 15 percent increases. The economy is likely to slow further in the first quarter as sobering economic news emerges and into the first half of 2008, but there are, as yet, no valid reasons for reductions in either prospecting or customer circulation, or both, in the first half of 2008.

Forewarning: Begin now to solidify your paper and production contracts, as the market is likely to become tight in 2008. Paper supply could become critical; it already has in the U.K. and Europe, and capacity is being reduced. This could be extremely serious in 2008. Stay on top of it and plan well in advance. Some are segmenting their customer lists on an RFM basis and mailing the lower performing deciles catalogs printed on less expensive paper.

Nation at a Glance

We will stick to our mailing recommendations for the first half of 2008. We caution against decreasing prospecting or customer mailings except for normal hygiene and mailing frequency improvements. Do not fall into the trap of reducing mailings; the end result is always diminished customer acquisition performance. Changes are in **bold**.

State	Mailings		
		Kentucky—East	Normal
		Kentucky—West	Normal
Alabama	Normal	Louisiana—North	Evaluate locally
Alaska	Normal	Louisiana—South	Evaluate locally
Arizona	Normal	Maine	Normal
Arkansas	Normal	Maryland	Normal
California	Normal	Massachusetts	Normal
Colorado	Increase	Michigan	Normal
Connecticut	Normal	Michigan—Up. Pen.	Normal
Connecticut-Fairfld	Normal	Minnesota	Normal
Delaware	Normal	Mississippi—North	Evaluate locally
District of Columbia	Normal	Mississippi—South	Evaluate locally
Florida	Normal	Missouri—North	Normal
Georgia	Normal	Missouri—South	Normal
Hawaii	Normal	Montana	Normal
Idaho	Normal	Nebraska	Increase
Illinois—North	Normal	Nevada	Increase
Illinois—South	Normal	New Hampshire	Normal
Indiana—North	Normal	New Jersey—North	Increase
Indiana—South	Normal	New Jersey-South	Increase
Iowa	Increase	New Mexico—East	Normal
Kansas	Normal	New Mexico—West	Normal

New York	Normal	Tennessee—West	Normal
North Carolina	Normal	Texas	Normal
North Dakota	Normal	Utah	Normal
Ohio	Normal	Vermont	Normal
Oklahoma	Normal	Virgin Islands	Normal
Oregon	Normal	Virginia	Normal
Pennsylvania—East	Normal	Washington	Normal
Pennsylvania—West	Normal	West Virginia—East	Normal
Puerto Rico	Normal	West Virginia—West	Normal
Rhode Island	Normal	Wisconsin—North	Increase
South Carolina	Normal	Wisconsin—South	Increase
South Dakota	Normal	Wyoming	Normal
Tennessee—East	Normal		

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Libey Incorporated

Advisors, Intermediaries & Recruiters to Multichannel Direct Marketing

811 Church Road Suite 105
Cherry Hill, New Jersey 08002
Tel: (877) 903-9448 Fax: (866) 221-8346

Tel: (515) 537 2307 (Don Libey's Direct Number)

E-mail: libey@libey.com
www.libey.com