STRATEGIC ANALYSIS OF A SMALL RETAIL BUSINESS

by

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Ethics Approval

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ABSTRACT

This paper is a strategic analysis of a small silk underwear and sleepwear business. It has been prepared to provide the owner insight into the many factors affecting the industry and her firm's business performance. The analysis is designed to answer two key questions: Should the business continue to operate, and if so how? Could the business be sold?

The analysis revealed that, in its current financial state, the company is not an attractive purchase target. Instead, the owner must take immediate steps to achieve, sustain and improve profitability in order to minimize the amount of external financing required and to avoid a distress sale.

A niche differentiation strategy combined with a strategic focus on a reduced set of business opportunities is recommended. In addition, sound accounting and financial management practices are required in order to establish an attractive financial track record.

DEDICATION

To my husband (Michael), my daughter (Charlotte) and extended family for their support and encouragement throughout the MBA program and the writing of this paper.

ACKNOWLEDGEMENTS

I would like to thank the owner of the business for her candour and support of this project. I would also like to thank Professor Ed Bukszar for the advice, guidance and interest he provided throughout this project, Professor Alain Duncan for the assistance he provided in restating the firm's financial statements and Professor Michael Parent who acted as my second reader.

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1 FIRM OVERVIEW

1.1 Introduction

Essentials Inc. (Essentials)[1] specializes in practical silk underwear and sleepwear for men and women. The owner provides the design specifications to a manufacturer in China. The company's products are sold through a variety of retail and wholesale channels including: online "stores" in Canada, U.S. and Europe; an owner- operated retail store in an upper scale neighborhood; and approximately 70 small third-party boutiques across Canada. The company is very small, employing a total of 3-4 full time employees in the first half of 2005.

1.2 Company History

The owner started her company in 1994 with a loan of $10,000. For the first two to three years, she grew her business by "selling out of the trunk of her car" at craft sales and office parties.

In November of 1996, the owner opened a Canadian online store. She claims that she was one of the first retailers to do so. For the next six years, the Canadian operation was run out of the basement of her parents' home. Sales grew from $16,230 in 1995 to $61,023 in 1996.

In 1997 a US online store was opened. Exchange rates and duty were perceived as potential deterrents to sales. Consequently, the owner decided to remove these sales barriers by

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[1] Essentials is a pseudonym used to protect the identity of the business.

having product shipped directly to a third party U.S. warehouse for storage and shipping. Customer orders received through the U.S. online site were forwarded to the U.S. warehouse for fulfilment. The owner took her first major risk and borrowed $60,000 to stock the U.S. warehouse. Despite a slow uptake in U.S. sales, total revenues for the company reached $112,073 in 1997.

Revenues continued to grow steadily over the next several years, reaching $375,624 in 2001. The owner determined that it was time to move the Canadian operation into a larger facility. In November 2002, a combined warehouse, showroom and "drive through" in an upper scale neighborhood was opened. Revenues declined marginally in 2002, dipping to $370,567.

Undeterred, and with great expectations, the owner decided to incorporate and to upgrade her facility by moving to a retail store front in the same neighborhood. Essentials was incorporated on January 1, 2003. The owner is the sole director and shareholder. The new combined retail store, warehouse and online business operation officially opened on May 1 2003. Revenues for 2003 reached $410,143.

The owner faced professional and personal challenges in 2003 and 2004. In 2003, her General Manager felt that she had become critical to the success of Essentials and demanded a 50% share of the business. Their business and personal relationship disintegrated, resulting in a costly termination. In late 2003/early 2004, the x-employee used her severance to launch her own silk underwear business modelled closely after Essentials. Having inside knowledge of Essentials, its suppliers, customers (wholesale and online) and processes allowed her to quickly emulate Essentials' business model and to target Essentials' customer base. At the same time, Essentials had to find and train a replacement resource.

While all of this was going on, the owner was faced with dividing her energies and attention between her business and an ailing parent who subsequently passed away mid-2004. Her new General Manager was busy learning and managing the business through trial and error.

It is therefore not surprising that revenues for 2004 suffered. Revenues dropped 7.4% to $379,641 in 2004.

1.3 Financial History

Profitability has remained elusive for this small business with six of the last eleven years generating negative net income, with particularly large losses occurring in both 2002 and 2003. (Table 1) Essentials financial performance improved significantly in 2004, resulting in a small net operating profit of $5.7K.

Table 1: Financial History: Excerpts from Income Statements

	Sales	Gross Margin	Net Income (before tax)
2004[1]	$379,641	$216750	$5,756
2003[2]	$410,143	$171,477	$(52,370)
2002	$370,567	$185,406	$(25,562)
2001	$375,624	$195,264	$3,990
2000	$233,631	$131,578	**$3,447**
1999	$166,276	$88,516	$(8695)
1998	$141,443	$83,877	$32,542
1997	$112,073	$55,652	$19,600
1996	$61,023	$24,577	$3,981
1995	$16,230	$4,168	$(7975)
1994	$1,965	$-2,491	$(12653)

Source: 1994-2003 data was taken from historical business plans dated 1997 and 2003.

1 2004 financials were restated to exclude the impact of a large inventory adjustment. See Chapter 4 for a full explanation.

2 The accounting records themselves for 1994 to 2003 are in a different accounting software package, Simply Accounting. Unfortunately, with staff turnover the location of these electronic files is unknown. A new accounting system, QuickBooks was installed in January 2004. Due to bookkeeping errors, a new QuickBooks data file was created starting January 2005. Essentials was incorporated January 2003.

1.4 Project Purpose

The owner is at a decision point with respect to her business. Should she continue? If so, how? Could she sell the business? To assist her in her decision making, this paper will attempt to answer two key questions. First, how well is Essentials currently doing from a market and financial performance perspective? Second, how can Essentials be positioned and managed to achieve and sustain profitability?

In order to answer the first question, a detailed analysis of the firm and its competitors is undertaken in Chapter One and an industry analysis is undertaken in Chapter Two. The second question is addressed through a comprehensive review of Essentials internal value chain in Chapter Three and a detailed financial analysis of the firm in Chapter Four. Issues arising from these analyses are identified in Chapter Five. Recommendations follow in Chapter Six.

1.5 Products and Services

1.5.1 Product Positioning

Essentials underwear and sleepwear are simple, sensible and sensuous. (Interview with Owner, 2005) Intended for daily wear, products are sewn from knitted silk and have no frills or adornments. As a result the product is incredibly light weight and feels incredible to the touch. Design elements focus on achieving fit, feel, function and appearance. The cut, sizing and construction of garments are generous in order to accommodate customers of all sizes and shapes. A light weight knit silk is used to provide a feeling of decadence as you slip it on and is so comfortable that you soon forget it is there. The light weight silk and elastic waists and legs are designed to virtually disappear under outerwear. Silk was chosen due to its thermal properties (keeps you warm when it is cold, and cool and when it is warm) and health benefits (helpful for menopause, radiation burns and other skin ailments). Pure silk thread is used to accommodate sensitive skin.

1.5.2 Product Styles and Price Points

Essentials offers a variety of intimate wear including underwear and sleepwear styles, sizes and colours for men and women. Bras are not included in the product line.

Currently there are 21 styles (11 for women, 6 for men and 4 unisex styles) available in 5 different sizes (from small to two extra-large). (Essentials product list 2005) Certain styles have not been made available on the US and Euro on-line stores. Consideration is being given to expand into plus-sizes for women. (Interview with Owner 2005)

All styles are branded "ESSENTIALS… you need them everyday" leveraging the owner's surname. All styles are made from 100% light weight knitted silk. Cotton/silk mixes are being considered for some styles.

There were 16 different colours available in inventory in 2004: 8 "current" colours and 8 "retired" colours. Retired colours continue to be sold until inventories are cleared. The "current" colour palette includes 3 neutrals and 5 colours. The neutrals remain constant season to season while colours change according to trends in fashion outerwear, normally tailing by one season.

Retail price points range from a low of $20 to a high of $130. Retail prices are set based on Cost of Goods Sold (COGS) and competitor price points for similar silk items. (See section 1.8 Major Competitors for more information). Regular retail prices are discounted by 10% and 50% for special promotions and by 50% for wholesale to third-party boutiques. Price points, including for the US and Europe online stores are listed in Table 2 below.

1.5.3 Analysis of 2004 Sales

A detailed analysis of sales has been performed. Sales have been decomposed by distribution channel, geographic market, time of year, style, size, and colour. The results of each are described below.

Table 2: Retail Selling Prices

Styles / Retail Price Range	Canada ($)	U.S. ($U.S.)	EURO (€)	Wholesale Canadian($)
Underwear	20-40	16-32	13-26	10-20
Mid & Full leg styles	40-50	31-38	26-33	20-25
Short sleeve tops (camisoles, vests, t-shirts)	30-40	23-31	20-26	15-20
Long sleeve tops (crews, t-necks)	50-60	38-46	33-39	25-30
Sleep shirts & slips (depending on length)	60-100	46-76	39-65	30-50
Robes	130	100	85	65

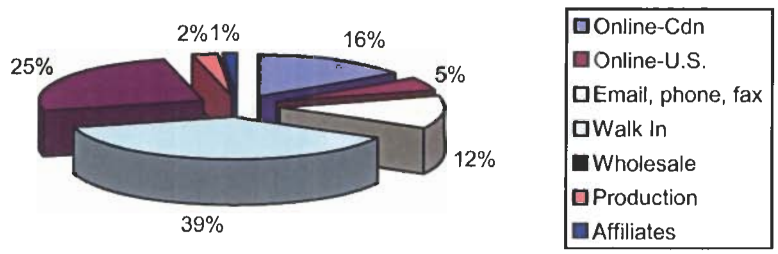
Source: Data was extracted from Essentials price lists.

1.5.3.1 2004 Revenue By Distribution Channel

Up until 2002, Essentials revenues were driven by wholesale and online channels. This situation changed dramatically with the opening of its own retail channel in 2003.

By 2004, the retail store had become the dominant sales channel representing 39% of sales revenue in 2004. Wholesaling generated 25% of revenues, online 21% (16% Canada, 5% U.S.) and sales by phone, fax or email a further 12%. Sales to production companies and affiliates represent the remaining 3% of sales.

Figure 1: Sales Revenue By Channel



Source: Essentials Manual Daily Sales Tracking Report For 2004.

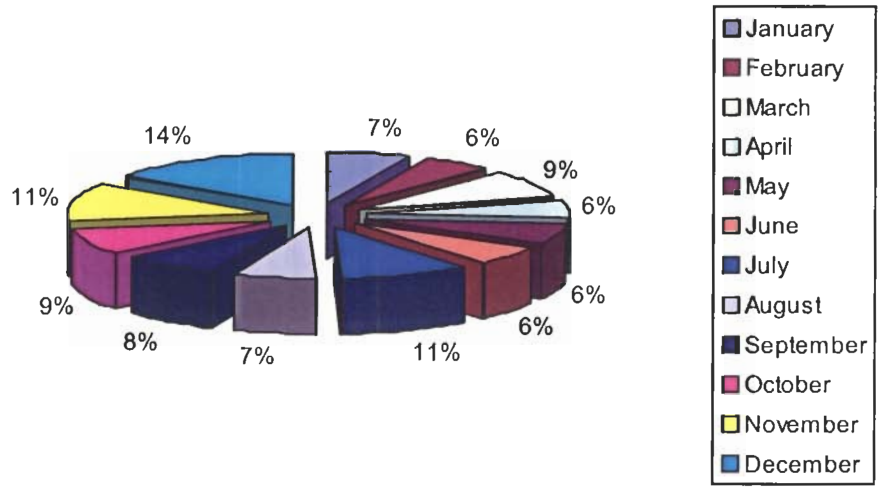
While the retail channel appears to have been quite successful, it is important to note that the level of gross sales in 2004 is comparable to 2001 and 2002. This suggests that retail sales displaced wholesale and/or online sales.

1.5.3.2 2004 Revenue By Geographic Market

In terms of geographic distribution, 5% of sales revenues originate from the U.S. and a nominal sum from Europe. Thus, 95% of Essentials' revenue stream comes from Canada.

1.5.3.3 2004 Revenue By Month

Figure 2 Revenue Distribution By Month



Source: Adapted from Essentials QuickBooks Customer Transaction Records.

As with many retailers, sales were highest in the months leading up to Christmas. In the case of Essentials, November and December represented 25% of total 2004 revenues. The other strong sales month was July, representing 11% of annual revenue. The two weakest months were February and June. The rest of the months generated 6-9% of annual revenues. (Figure 2)

1.5.3.4 2004 Sales by Style (Units, Revenue and Gross Margin)

Sales by unit were concentrated in the top end with the top 3 styles representing 51% of unit sales, 36% of revenue and 35% of gross margin (Table 3). This suggests that the most popular styles were the items with lowest price points and margins. Unit sales for the remainder of the styles were highly distributed. Together the top 10 styles in terms of unit sales represented 81% of units, 71% of revenue and 70% of margin. (Table 3)

Table 3: ***Style Sales by Unit, % 2004 Revenue and % 2004 Gross Margin***

Style	**Unit Sales by Style**	**% of Total Revenue**	**% of Total Margin**
French cut brief	25.6%	16.4%	16.3%
Full Cut Brief	14.5%	8.5%	8.1%
Camisole	11.4%	10.7%	11.0%
Long leg pant	6.7%	10.5%	10.0%
Regular thong	6.3%	3.3%	3.5%
Long sleeve shirt	5.6%	9.1%	8.6%
Short sleep shirt	3.8%	6.3%	5.7%
Vest	3.7%	4.3%	4.5%
Low Cut Thong	3.4%	2.0%	2.1%
Men's Athletic Cut	3.3%	4.9%	5.2%
Boy short	3.2%	2.5%	2.7%
Men's brief	2.8%	2.1%	2.3%
T-shirt	2.7%	3.6%	3.55%
Long sleep shirt	2.6%	6.6%	6.4%
Mid Leg short	2.1%	3.1%	3.3%
T-neck	1.5%	3.4%	3.7%
Full slip	0.3%	1.1%	1.4%
Crew Neck	0.2%	0.5%	0.5%
Short slip	0.1%	0.4%	0.5%
Robe	0.1%	0.5%	0.5%
Men's Thong	.01%	0.00%	0.00%
	100%	100%	100%

Source: *Data was exported into excel from QuickBooks Customer Transaction Record. Product codes were then parsed in order to separate style, colour and size components. Each component was individually analyzed.*

The average selling price of each style was significantly below regular retail prices. This was due to discounts associated with wholesale and sales promotions. (Table 4) Even so, the average selling price provided healthy margins per unit (over garment costs) in both percentage and dollar terms.

Table 4: Average $ & % Gross Margin Per Style / Per Unit

Style	Regular Retail Price ($)	2004 Avg. Selling Price ($)[1]	Estimated Garment Cost @ .80$US[2]	2004 Gross Margin Per Unit (%)[2]	2004 Gross Margin Per Unit ($)[2]
French Cut Brief	20	13.08	3.38	.74	9.70
Full Cut Brief	20	11.94	3.50	0.71	8.44
Camisole	30	19.16	4.38	0.77	14.79
Long leg pant	50	32.10	9.38	0.71	22.73
Regular thong	20	10.87	2.38	0.78	8.50
Long sleeve shirt	50	33.25	9.63	0.71	23.63
Short sleep shirt	60	33.24	10.75	0.68	22.49
Vest	40	23.71	5.38	0.77	18.34
Low Cut Thong	20	11.77	2.25	0.81	9.52
Men's Athletic Cut	40	30.18	6.38	0.79	23.81
Boy short	20	15.77	2.88	0.82	12.89
Men's brief	20	15.05	2.38	0.84	12.68
T-shirt	40	26.67	7.13	0.73	19.54
Long sleep shirt	100	51.28	14.13	0.72	37.16
Mid Leg short	40	29.03	5.88	0.80	23.15
T-neck	60	47.34	9.00	0.81	38.34
Full slip	100	74.50	n/a		
Crew Neck	50	40.00	9.88	0.75	30.13
Short slip	60	50.06	n/a		
Robe	130	100.75	34.56	0.66	66.19
Men's Thong	20	0.00	2.90		

Source: *Data was exported into excel from QuickBooks Customer Transaction Record. Product codes were then parsed in order to separate style, colour and size components. Each component was individually analyzed.*

1 Average price across wholesale, online and retail customers.

2 Includes cost of garments but excludes freight, duty and brokering costs.

1.5.3.5 2004 Unit Sales by Size

Medium and large were the most popular sizes. X-large and small sizes were evenly distributed together accounting for 35% of unit sales. 2X-Large represented only 8% of unit sales.

Table 5: 2004 Unit Sales by Size

Size	% Units
Small	17%
Medium	30%
Large	27%
X-Large	18%
2X-Large	8%
	100%

Source: Data was exported into excel from QuickBooks Customer Transaction Record. Product codes were then parsed in order to separate style, colour and size components. Each component was individually analyzed.

1.5.3.6 2004 Unit Sales By Colour

2004 inventory consisted of a mix of 16 different colours (8 current and 8 retired). The neutral colours (black, nude and vanilla) were the best sellers, accounting for 58% of unit sales. (Table 6) Popularity of individual colours fell far short of the neutrals, ranging anywhere from a low of 1% to a high of 5%. The five most popular "colours" accounted for only 24% of unit sales. The remaining eight colours accounted for only 18%. (Refer to table 6)

Table 6: 2004 Sales By Colour

Color	Current Colour	%of Total Units	Top 3	2nd-Tier
black	√	24%	58%	
nude	√	20%		
vanilla	√	15%		
kite blue		5%		24%
aubergine	√	5%		
petal pink		5%		
frosted raspberry	√	4%		
pacific mist	√	4%		
navy blue		3%		
olive martini	√	3%		
chinchilla grey		3%		
roxanne ruby red	√	3%		
tangerine		2%		
mint patty green		2%		
lazy yellow		1%		
lilac		1%		
		100%		

Source: Data was exported into excel from QuickBooks Customer Transaction Record. Product codes were then parsed in order to separate style, colour and size components. Each component was individually analyzed.

1.6 Inventory Assessment

Essentials ended 2004 carrying significant inventory levels in both its Canadian and U.S. warehouses. (Table 7) Even for the majority of its most popular styles, ending inventory levels in Canada appeared to be sufficient to cover sales for the first nine months of 2005. Of particular concern is what appears to be excessive levels of inventory of less popular styles such as men's athletic cut at 52 months, boy shorts at 21 months, mid leg shorts at 23 months, crew necks at 78 months and robes at 171 months. These numbers do not take into consideration the intricacies in demand for different colours of each style, and is therefore an approximation.

Table 7: ***Estimated Number of Months Worth of Inventory for Canadian and U.S. Warehouse Operations***

Canadian Inventory Assessment (units)				US Inventory Assessment (units)		
	04 ending inventory	**04 sales**	**Est # mths worth of inv**	**04 ending inventory**	**4 Sales**	**Est # mths worth of inv**
french brf	1537	4296	4	961	483	24
full cut brief	1772	2333	9	1276	382	40
cami	1574	2003	9	1098	120	110
full leg pant	900	1163	9	279	86	39
reg thong	1493	1017	18	510	150	41
long slv shr	904	962	11	397	79	60
vest	567	646	11	238	45	63
LC thong	861	596	17	592	34	209
short slp sht	374	585	8	216	132	20
mens ath	2432	562	52	291	57	61
boy short	901	512	21	482	88	66
tshirt	387	434	11	284	74	46
mens brf	575	432	16	167	91	22
long slp sht	336	430	9	375	62	73
mid leg sht	725	375	23	138	24	69
tneck	302	264	14	132	11	144
full slip	67	53	15	30	2	180
crew neck	280	43	78	24	0	indefinite
short slip	0	25	0	0	2	indefinite
robe	285	20	171	171	0	indefinite
mens thong	469	1	indefinite	372	0	indefinite
	16741	16752		8033	1922	

Source: *Data was extracted from two different QuickBook reports.*

Inventory levels in the U.S. warehouse are far in excess of what they should be. Even for the most popular styles, inventory levels are sufficient to cover demand for an estimated 24 to 110 months.

1.7 Current Target Market

1.7.1 Demographics / Psychographics

The owner initially felt that her target market included both men and women between the ages of 18 to 92 years old. Little is known about the demographics or psychographics of Essentials online customer base or wholesale end customers. However, the market that has emerged for the retail store is predominantly female between 45 and 65 years old. The owner describes the walk-in clientele as the "grey and Gore-Tex". They are upper middle income, practical, like to travel and are price conscious. Some inquire about body shaping products.

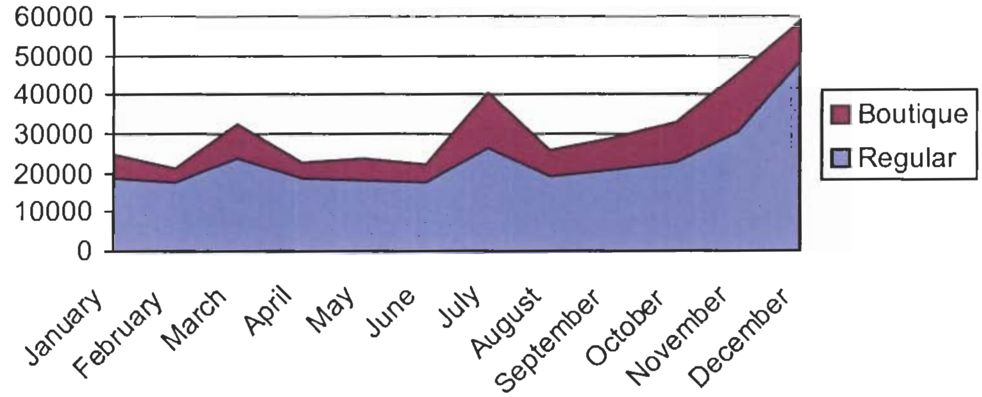
1.7.2 Analysis of Customer Base

1.7.2.1 Sales by Customer Type

There are two broad groupings of customers, namely wholesale customers (third party boutiques) and regular customers (walk-in, online, production companies, affiliates).

Figure 3 depicts the level and composition of monthly sales in 2004 by type of customer: regular and boutiques. It is interesting to note that peaks in demand occurred at the same time for regular and boutique customers, namely in March, July, November and December. This is somewhat counter intuitive since one would expect boutiques to stock up in advance of customer demand. However, given Essentials over night delivery, boutiques no longer need to carry significant inventory on hand. Demand trended upward slightly heading into the Fall period, peaking in December.

Figure 3: Monthly Sales By Customer Type



Source: *Data was exported into Excel from QuickBooks Customer Transaction Record. The customer records were then divided into two "types".*

1.7.2.2 Profile of Customer Types in 2004

A total of 2498 customers purchased from Essentials in 2004. The customer base is comprised of two basic customer groups: regular customers and boutiques. Each will be profiled according to:

- Number of customers in each group,
- Number of transactions,
- Percent (%) of total revenue,
- Average revenue per purchase,
- Average number of purchases in 2004,
- Average revenue per customer,
- Gender.

Customer loyalty was assessed for each customer type based on repeat purchase behaviour. The most valuable customers were identified and their impact on revenues determined.

1.7.2.2.1 Profile of Regular Customers

There were a total of 2427 regular customers in the 2004 database. Revenue per sale to regular customers was $72.04 (See Table 8). On average, regular customers made 1.6 purchases in 2004. Thus, the average regular customer generated $117.33 in revenue during 2004.

Table 8: Profile of Regular Customers

Customer Type	# of Customers	Total # Transactions	% of Total Revenue	Average $ Per Sale	Average # purchases	Average Revenue Per Customer
Regular[1]	2427	3953	75%	$72.04	1.6	$117.33

Source: Derived from 2004 QuickBooks Customer Database and QuickBooks class report.

1 The regular customer base includes 12 film or TV production related companies. 9 purchased once, with orders ranging from $100-$630. One purchased once for $1050. Two others purchased several times generating approximately $2200 each. Production companies receive a 30% discount off regular retail prices.

1.7.2.2.1.1 Profile by Gender

A visual scan of the 2427 retail and online customers revealed that approximately 11% of the customers are male. This is a conservative estimate since a small group of ethnic names were ignored as their gender was not immediately apparent, and names like Robin/Robyn and Terry were assumed to be female. While 11+% of the customer base is male, Table 9 reveals that only 6.3% of units sold are attributable to male-specific items such as athletic cut underwear, men's briefs, men's thongs and crew neck tops. The male-specific designs contributed 7.5% of total revenues and 8% of total margins in 2004. These are conservative numbers as they ignore the portion of unisex designs purchased by men.

Table 9: 2004 Revenue By Gender (Based on Gender of Clothing)

Gender	%Units	%Revenue	% Margin
Women	76.2	65.2%	65.2%
Men (athletic cut, briefs, thong, crew neck shirt)	6.3%	7.5%	8.0%
Unisex (long legs, long sleeves, vests)	17.5%	27.3%	26.8%
	100%	100%	100%

Source: Categorized using company style list.

1.7.2.2.1.2 Profile of Customer Loyalty as Measured by % repeat purchases in 2004

The majority of regular customers bought only once in 2004. 32.2% of customers bought at least twice, but only 12.7% of customers purchased on 3 or more occasions.

It is important to note that since the study period was for only one calendar year, the results represent a somewhat conservative estimate of the number of repeat purchasers. In other words, customers who bought in 2003 and once in 2004 would not have been recognized or treated as repeat purchasers.

Table 10: Customer Purchase / Repurchase Pattern

Customer	% of customers by # purchases in 2004						Total
	1	2	3	4-9	10-19	20-40	
Regular	67.7%	19.6%	6.6%	6.1%	-	-	100%

Source: *Data from QuickBooks Customer Transaction Record was exported into Excel and analyzed.*

1.7.2.2.1.3 Most Valuable Customers

Customer loyalty was defined as purchasing three or more times in 2004. Repeat purchases were considered a strong indicator of customer satisfaction and loyalty. Together, a small loyal customer base of 308 regular customers (12.7% of the regular customer base) generated 31.2% of revenues from regular customers, or 24.3% of total revenues. (Table 11)

Table 11: Loyal Regular Customer Share of $ Sales

	# Customers Purchasing ≥ 3 times	% of Regular Revenues from loyal customers	% of Total Revenue
Regular	308	31.2%	24.3%

Source: *Derived from 2004 QuickBooks Customer Database.*

1.7.2.2.2 Profile of Wholesale Boutiques

A total of 71 boutiques bought product in 2004. While a minority of the customer base, they generated 25% of total company revenue. The average boutique purchase was $179.59 and the average number of purchases was 7.6. Thus, the average boutique customer generated $1,358 in revenue over the calendar year.

Table 12: Profile of Boutique Customers

Customer Type	# of Customers	# of Sales Transactions	% of Total Revenue	Average $ Per Sale	Average # purchases	Average Revenue Per Boutique
Boutiques[1]	71	537	25%	$179.59	7.6	$1358.30

Sources: *Data derived from 2004 QuickBooks Customer Transaction Record and QuickBooks class report.*

1 Boutiques are wholesale customers and receive a 50% discount off regular retail prices. There were 71 boutiques which purchased from Essentials during 2004. Several of them do not appear on the website, while many of those listed on the website did not purchase in 2004.

1.7.2.2.2.1 Estimated # Boutique Customers Buying Essentials Products

By making the assumption that the average dollar value of a retail customer is the same regardless of where they buy, it is possible to estimate the number of retail customers that purchased Essentials products from third party boutiques.

It is estimated that, on average, 19 customers purchased Essentials products per boutique in 2004. (Table 13) Multiplying that number by the number of boutiques provides an estimate of 1370 customers who purchased Essentials products through third party boutiques in 2004.

Table 13: Estimated Average # Customers Buying Essentials at Boutiques

	Average Revenue per Boutique	Estimated Retail Revenue From Essentials Products	Estimated # Retail Customers Per Boutique	Total Boutique Customers Buying Essentials Products
Boutiques	$1358.30	2263.83[1]	19.3[2]	1370[3]

Sources: *Data derived from 2004 QuickBooks Customer Transaction Record and QuickBooks class report.*

1 Average retail revenues for each Boutique generated by Essentials products are calculated by dividing the average annual sales per boutique by the 50% discount rate.

2 The average number of Essentials customers per boutique is estimated by dividing the average retail revenue from Essentials products by the average purchase of $117.33 made by regular customers at Essentials. This assumes that the purchase patterns of customers are the same regardless of whether they buy from Essentials or from a third party boutique.

3 71 boutiques x 19.3 customers = 1370 total customers.

1.7.2.2.2.2 ***Profile by Gender***

No information is currently available regarding the gender of the end customer who purchased Essentials products from third party boutiques. It is considered likely that the profile resembles that of Essentials regular retail customer base. (See Table 9)

1.7.2.2.2.3 ***Profile of Boutique Loyalty as Measured by % repeat purchases in 2004***

Boutique customers bought far more frequently than regular customers in 2004. While 21.1% of them bought only once, 78.9% bought two or more times. (Table 14) In fact, 59.1% ordered small volumes anywhere from 4 to 40 times throughout the calendar year. This practice is possible due to Essentials keeping inventory on hand and providing over night delivery.

Table 14 *Customer Purchase/Repurchase Pattern*

Customer	% of customers by # purchases in 2004						Total
	1	2	3	4-9	10-19	20-40	
Regular	67.7%	19.6%	6.6%	6.1%	-	-	100%
Boutiques	21.1%	11.3%	8.5%	33.8%	18.3%	7%	100%

Source: Derived from QuickBooks 2004 Customer Transaction Records.

1.7.2.2.2.4 ***Most Valuable Customers***

Boutique loyalty was defined as purchasing three or more times in 2004. Repeat purchases by boutiques were considered a strong indicator of boutique satisfaction and loyalty to Essentials. However, it is not possible to determine repeat purchase behaviour of their end customers. Together, 48 boutiques bought three or more times in 2004. The 48 boutiques represented 67% of the boutique customer base but generated over 94% of wholesale revenues, and accounted for 22.4% of total revenue. The remaining 23 boutiques accounted for an insignificant 5.7% of boutique revenues.

Table 15: Loyal Boutique Customer Share of $Sales

	# Boutiques Purchasing ≥ 3 times	% of Boutique revenues from loyal customers	% of Total Revenue
Boutiques	48	94.3%	22.4%

Source: Data derived from QuickBooks 2004 Customer Transaction Record.

1.8 Major Competitors

Underwear and sleepwear are widely sold through a variety of distribution channels including traditional brick and mortar and online sources. A literature search was conducted to try and determine consumer preferences and trends regarding the type of distribution channel used to purchase underwear and sleepwear. Only one study was identified. According to the 2001 study of 75 post-mastectomy women, department stores and discount stores were the most popular channels for purchase of sleepwear. Intimate apparel stores were preferred by only 11.5% of respondents. Statistics for underwear were not included in the study. (Paek n d)

Table 16: Consumer Channel Choice for Sleepwear

Channel Choice for Sleepwear	Percent of respondents
Department Store	35.6%
Discount Store	27.6
Catalogue	12.6%
Intimate Apparel Specialty Store	11.5%
Apparel Specialty Store	9.2%
Other	3.5%
	100%

Source: Paek n.d.

On the upside, indications are that specialty stores are experiencing an increase in market share. Two different reports were found reporting that department and mass merchandisers were losing sales of intimate apparel to specialty stores and family clothing stores. (Scardino 2004; Specialists in Business Information 1997)

1.8.1 Lingerie Retail Competitors

The owner concurs with the above finding that department stores appear to have the largest share of intimate apparel sales. Major competitors in Canada would include the Bay, Sears and Walmart. They tend to have very broad product lines and concentrate on major brand names in cotton and man made fibres (nylon and polyester). 100% silk is normally not included in their product lines.

There are no intimate apparel specialty stores in the immediate area. However, there are lingerie chain stores like La Vie En Rose and La Senza in malls around Vancouver.

1.8.1.1 La Vie En Rose

La Vie En Rose changed ownership in 1996 and claims to have doubled its revenues and net sales since then. It has 98 stores and 1300 employees across Canada. Its website claims that it has "Canada's most complete selection of intimate lingerie". Its entire product line is private label. Its website describes its market as "the contemporary woman". While no age range is provided, a visit to one of their stores indicated a focus on a young female adult market emphasizing fashion, colour, and smaller sizes. For example, all underwear and bathing suits were low cut, and a size large is estimated to fit a size 10-12. No performance products like long underwear are carried. Sizing and styles do not appear to suit a more mature, fully figured market. None of their product line was made from silk. Price points are significantly lower than Essentials with panties selling in the $3-5 range.

1.8.1.2 La Senza

La Senza became a publicly traded company in 1993. Prior to that, it was Suzy Shier Limited. According to information on its website, La Senza is "one of the leading specialty retailers of women's lingerie and apparel". La Senza targets "tweens" between the ages of 8 and

14 through its La Senza Girl stores and women through its La Senza Lingerie stores and nationally and internationally. La Senza Lingerie targets women 18-35 years of age and offers a "full range" with "innovative merchandising techniques and designs" to attract customers. Sizes range from XS to XL (equivalent of a size 16). Price points are a lot lower than Essentials with panties selling for $5 and sleepwear for $30-40. Common fabrics include cotton, satin and lace. Styles do not seem to be designed or targeted for full figure proportions. La Senza's product line does not include more functional items such as long underwear etc. There are 218 La Senza Lingerie stores in malls across Canada. Equal emphasis is placed on daywear and sleepwear. La Senza's stated growth strategy includes adding big box stores, licensing the La Senza and La Senza Girl Tween concept internationally and expanding into the Eastern portion of the U.S.

1.8.1.3 Independents

There are also a number of independent specialty retailers in relatively close proximity to Essentials (10-20 minute drive) including Sugar, Above Average (plus sizes) and Romantique. All carry a wide variety of underwear and sleepwear in a variety of fabrics. Romantique carries Essentials' brand line.

1.8.1.4 Conclusion

While there are a number of retail outlets within reasonable proximity to Essentials, none of them appear to focus exclusively on the 45+ market or carry 100% silk items.

1.8.2 Online Competitors

There is a dizzying array of online underwear retailers. A Google search using the search string "underwear retailers in Canada" resulted in a list of 485,000. Removing the reference to Canada increased the numbers to 1,040,000. Narrowing in on "silk underwear online retailers in Canada" generated a list of 90,000 with Essentials listed in sixth position. Removing the reference to Canada increased the length to 219,000, with Essentials in eleventh position. Since Essentials sells only silk apparel, it is appropriate to narrow in on silk underwear and sleepwear providers.

While Victoria's Secret specializes in underwear and sleepwear for men and women, silk is not widely used in their product-line and thus Victoria's Secret is excluded from this analysis. LLBean was found to have a very small product line of silk apparel (2 items for men, 10 items for women). Due to the limited selection, and the fact that most of it was outerwear, LL Bean was excluded from the analysis.

Based on an interview with the owner, and Google searches, three online U.S. competitors have been identified for comparison purposes. They include: Wintersilks, Mary Green, and Irissilks. Only one Canadian competitor has been identified, Kim Allan Silks. The U.S. analysis will be done using Essentials U.S. prices. The Canadian analysis will be done using Essentials Canadian prices. Competitors are compared on nine criteria including: positioning, target market, fashion-ability, breadth of product line, fabrics, use of colour/print, Size range, recommended care instructions and price points on a selection of underwear and sleepwear styles. Table 17 compares Essentials to US Online silk underwear retailers. Table 18 compares Essentials with its strongest direct Canadian competitor, KAS.

Table 17: Comparison of U.S. Online Silk Underwear Retailers

Item	Essentials	Wintersilks	Mary Green	Irissilks
Positioning	Simple, sensible, sensuous; under and sleepwear	Practical, casual underwear and outerwear	Young, sexy, fun, underwear (including bras), outerwear and scarves	Emphasizes "sets" such as underwear & camisoles
Target Market	Primarily women, age 40+	Younger men & women age 30+	Young, sexy	Youngest, sexy
Fashion-ability	Low	Moderate – some adornment	High – lots of adornments (lace, ruffles etc.)	Trendy
Breadth of product line *(# of styles)*	Low	Very High	High	High
Fabrics	100% knit silk	17 different silk fabrics (some cotton/silk blends)	100% silk (does not specify type(s))	100% silk (does not specify type(s))
Colour / Prints	Consistent colour palette across styles	Wider colour selection, varies by style	Bold colour / lots of patterns	Bold Colour / some patterns
Size Range	Small to 2 XL	Petites, XS to XL	Up to 3XL	Up to 3XL
Recommended Fabric Care	Hand wash	Machine Wash	Hand wash, caution dry cleaning	Machine or hand wash, dry cleaning recommended
Price points (USD)				
Women's panties	$16.00	$10.00-12.00	$11.00-16.00	$18.00-25.00
Men's briefs	$16.00	$14.00	$20.00	$13.00
Men's athletic	$32.00	$20.00	$22.00-25.00	$20.00
Turtlenecks	$46.00	$20.00-25.00	$41.00	n/a
Long Pants	$38.00	$21.95	$38.50	Set of long sleeve & long pants $46.00
Camisoles	$23.00	$20.00	$21-47.50	Sold in sets with panties $35-37
Vest	$31.00		$34.00	n/a
Robe (short-long)	n.a.-$100.00		$71-110	$63.00
Long Sleeve shirt	$38.00		$37.00	See long pant bundle
Sleepshirt short	$46.00	$20.00-30.00	No comparable product	n/a

Sources: Competitor websites including www.Essentialsonline.com, www.wintersilks.com, www.marygreen.com, www.irissilks.com.

Table 18: Comparison of Canadian Online Silk Underwear Retailers

Item	Essentials	KAS
Positioning	Simple, sensible, sensuous; under and sleepwear	Owner left Essentials and established competitive product line emphasizing comfort and sensible underwear and loungewear. Copied many of the styles. Introduced new loungewear designs.
Target Market	Emerging retail market - Primarily women, age 40+	Primarily women, younger (mid 20's to mid 40's)
Fashion-ability	Low	Low
Breadth of product line *(# of styles)*	Low – 21 styles	Low – 20 styles High overlap with Essentials designs
Fabrics	100% knit silk	100% knit silk
Colour / Prints	3 neutrals + 5 colours – Consistent colour palette across styles	4-5 colours, no neutrals except for black
Size Range	Small to 2 XL	Small to 2 XL
Recommended Fabric Care	Hand wash	Hand or machine wash
Price points (USD)		
Women's panties	$20.00	$20.00
Men's briefs	$20.00	n/a
Men's athletic cut	$40.00	$40.00
Turtlenecks	$60.00	$65.00
Long Pants	$50.00	$50.00
Camisoles	$30.00	$40.00
Vest	$40.00	$40.00
Robe (long)	$130.00	$150.00
Long Sleeve shirt	$50.00	$50.00
Sleep shirt short	$60.00	$70.00

Sources: Competitor websites: www.Essentialsonline.com, www.kimallansilk.com.

1.8.2.1 Competitive Analysis – U.S. Market

According to the owner, Essentials primary competitors in the U.S. are Wintersilks, Mary Green and Irissilks.

Essentials positioning as the provider of simple, sensible, sensuous under garments targeted to women aged 45+ is fairly distinct from its U.S. competitors. (Table 18) Mary Green and Irissilks are targeting more feature rich products (adornments and patterns) to a younger, sexier, female audience. The exception is Wintersilks which provides practical and casual silk underwear and outerwear to what appears to be the 30+ market.

Of the four competitors, Essentials brand is the least "fashionable", using plain knit silk fabric with no adornments or patterns, providing sizes for real proportions, and a fairly narrow range of colours. Essentials size range is slightly narrower than competitors, in that it does not carry XS or 3XL sizes.

With the exception of Wintersilks, all competitors recommend hand washing. It is unclear what it is about Wintersilks products that make them more durable and thus machine washable. This may be an important benefit.

In terms of price points, Wintersilks provides the most affordable silk underwear and sleepwear with prices significantly below those of Essentials, Mary Green and Irissilks. Price positioning is not absolute however and varies according to style. Essentials has the highest price points for men's athletic cut (or equivalent), turtlenecks and sleep shirts. Essentials is competitively priced on panties, men's briefs, long pants, camisoles, vests and long sleeve shirts.

1.8.2.2 Competitive Analysis – Canadian Market

There appears to be only one other active silk underwear competitor in Canada, Kim Allan Silk (KAS). KAS is owned and operated by an x-employee of Essentials who duplicated Essentials business model with a few modifications. KAS is a pure online and wholesale operation. KAS does not have an owner operated retail outlet. Based on the website, KAS is only targeting the Canadian market.

KAS appears to have copied most of Essentials underwear styles and has introduced a second product line of loungewear. Consequently both competitors have a comparable number of styles, size range and fabrics. KAS carries a slightly narrower colour range than Essentials, and does not carry the same range of neutral colours. This may provide Essentials with a competitive advantage, as neutral colours are the most popular sellers.

Based on the images and styles on its website, KAS is targeting a younger market (mid-20's to mid-40's). KAS has for the most part matched Essentials pricing, but is slightly more expensive on a few items including turtlenecks, camisoles and short sleep shirts.

Upon leaving Essentials employment, the owner of KAS appears to have taken copies of boutique, online and retail customer lists and contact information and has made active attempts to raid Essentials boutique and regular customer base. According to Essentials, they are aware of two different instances when KAS direct mailed to Essentials regular customer base. Lawyers tell Essentials that they have no effective legal recourse.

1.8.2.3 Impact of KAS on Essentials Boutique Base

According to the website, KAS products are distributed through 75 boutiques across Canada. Twenty-one of those boutiques appear in Essentials list of boutique distributors – either as active customers in 2004, or as a boutique on the Essentials website but with no corresponding revenue in 2004.

What is interesting is that only six of the 21 boutiques common to both companies appear to have stopped buying from Essentials. Three appear to have migrated 100% of their business away from Essentials, presumably to KAS, prior to January 2004. The remaining three stopped buying from Essentials at some point during 2004. Last orders for each occurred in April, July and August indicating that Kim Allan was actively targeting Essentials boutique distributors throughout 2004.

What is surprising is that six of Essentials' top 10 boutiques, in terms of revenue in 2004, are listed on KAS website as carrying her product. This suggests that KAS used information gained as an employee of Essentials to target Essentials best performing third party distribution channels.

The remaining 17 boutiques recruited by Kim Allan have remained at least partially loyal to Essentials, continuing to buy through Q4 2004. Thus, it appears that KAS has had only limited success in raiding Essentials third-party distribution channels.

1.8.2.4 Evaluation of Essentials Online Capability

1.8.2.4.1 Online Attraction and Conversion Process Model

To be successful online competitors must first drive traffic to their website and subsequently to convert those hits into interactive visits and ultimately into purchases and repeat purchases. (Berthron, Pitt and Watson 1996) The two key questions for online retailers are therefore "How can I reach my online target audience?" and "How do I attract traffic and convert hits to visits, purchases and repurchases?"

Online retailers are competing in an increasingly crowded and noisy marketplace. Spending on online advertising is growing rapidly with internet advertising revenue reaching $4.6B for the first half of 2004, up 39.7% over the first half of 2003. (Maddox 2004) Prominent advertisers are dramatically increasing the allocation of their advertising budgets to online from 4% in 2003 to 7% in 2004 and to a forecasted 9% in 2005. (Morgan 2005) In terms of the dominant online advertising mediums, search (pay per click) accounted for 40% of online advertising in Q2 2004. Display (or banner ads) were down, at 20% of total online ad revenue.

(Maddox 2004). Unfortunately, Maddox's article did not identify the mediums accounting for the remaining 40% of online advertising spending.

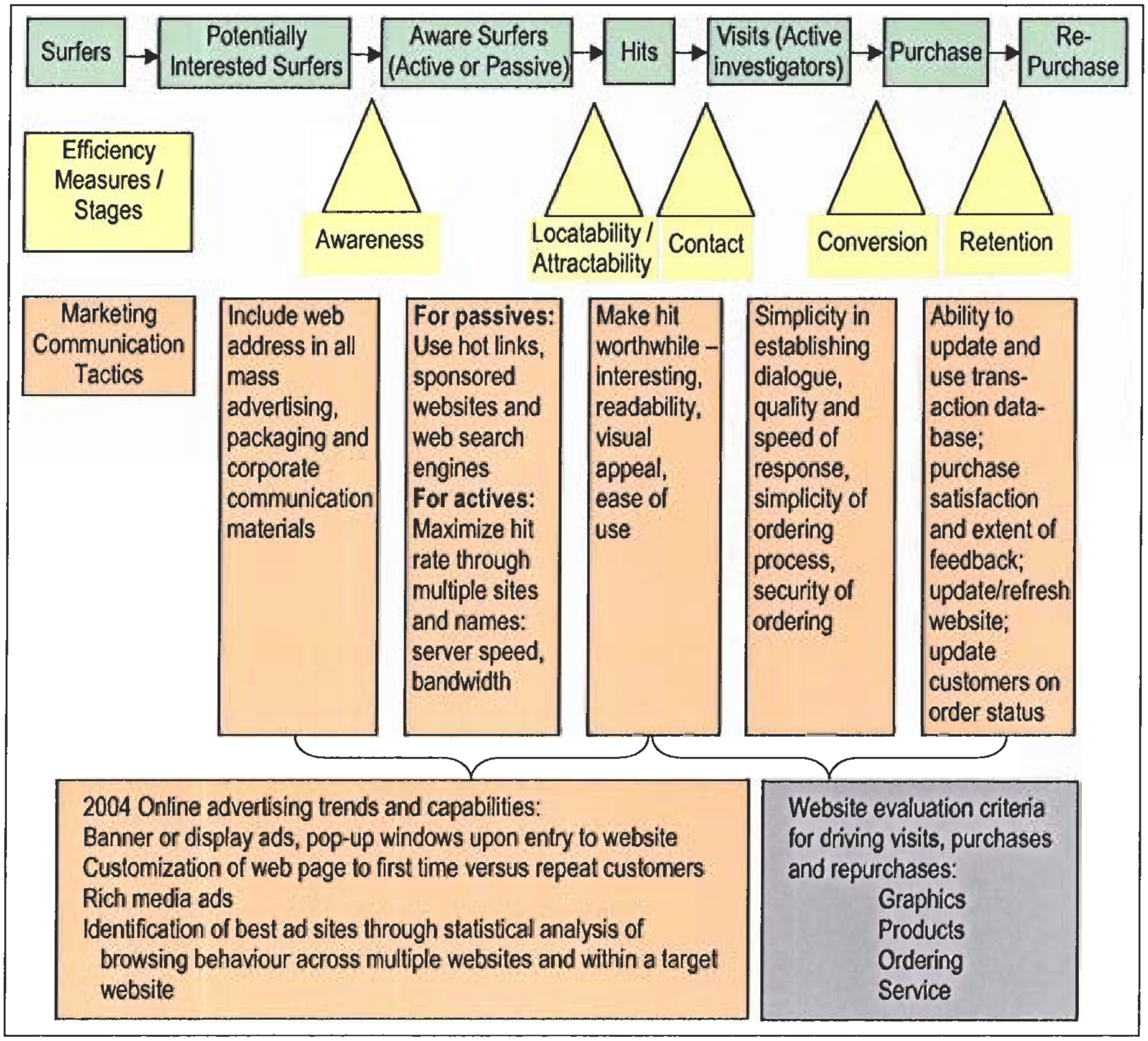
Berthron, Pitt and Watson (1996) developed a model for the conversion process on the web. (Figure 4) It involves five stages and provides associated measures of efficiency and marketing communication activities. The first two stages are associated with driving traffic to the target website and are measured in terms of awareness efficiency and locatability / attractability efficiency. A distinction is made between hits that arise from active information seekers (those aware of the website and purposely looking for it) and passive information seekers (those aware of the website but not purposely trying to locate it). A potential weakness of this model is that it does not explicitly discuss surfers who are unaware of the target website to begin with, but through search engines happen to click through to an online retailer. The third stage involves successfully converting the hit to an interactive visit and is measured by a contact efficiency measure. The fourth stage involves converting the visit to an actual purchase. The final stage involves the ability of the retailer to generate repeat purchases and corresponds to a retention efficiency measure.

Each of the five stages has an identified set of marketing communication tactics associated with it. The authors describe the use of traditional offline marketing tactics, such as including the web address in all mass communications, in order to build website awareness. A number of tactics are also identified to help drive traffic (hits) from both active and passive seekers such as the use of hotlinks, sponsored websites, sponsored web search engines, multiple sites and names, and adequate bandwidth and speed. Converting the hit to an extended visit requires an attractive and functional website that is interesting, visually appealing and easy to use. Research indicates that the online retailer has only 10-30 seconds to do so. Purchase is facilitated through capabilities such as simplicity in establishing dialogue, quality and speed of response, and the simplicity and security of the ordering process. Finally, online retailers can stimulate repeat purchases through the capture of information (customer information, transaction data and customer feedback), the use of that information in on-line marketing campaigns (e-blasts, new products, customized screens based on customer transaction history etc.), the provision of online order status information for customers, and the ongoing updating and refreshing of the website to maintain its attractiveness to customers.

Over the nine years since Berthron, Pitt and Watson's article, new online marketing and advertising capabilities and trends have emerged that are being used to drive traffic to websites, and to facilitate the conversion into visits, purchases and repurchases. Kumar and Shah (2004) identified a number of these including the decline in the use of banner ads and pop-ups due to user blocking capabilities, the ability to identify users as either new or repeat customers and to present them with customized web pages, the increased use of rich media ads (animated with music), the increased use of statistical analysis of browsing behaviour (both within a target website and across multiple websites) in order to determine best sites to place advertisements and cross-sell/upsell messages, and the increased use and sophistication of metrics (click throughs, cost per click, cost per sale, conversion rates, ROI, customer lifetime value).

Berthron et al (1997) identified four key determinants of website effectiveness. It is assumed that graphics, product, ordering and service characteristics significantly contribute to converting hits to visits, visits to purchases and purchases to repurchases. Each dimension is broken down into sub-elements as described in the Table 19.

Figure 4: Online User Attraction and Conversion Process



Source: Based on Berthron, Pitt and Watson (1996), Berthron et al (1997) and Kumar and Shah (2004).

Table 19: Web Site Evaluation Criteria

Dimension	Sub-Elements
Graphics	Website interface Quality of text, graphics, video etc. Ease of use and navigation Degree of interest and enjoyment whilst navigating the site
Products	Breadth of product Availability nationally / internationally Quality Value (price) Ability to see pictures of the products Extent of information about each product
Ordering	Ordering, payment and delivery – simplicity and flexibility Alternative methods of payment Security features Delivery guarantees
Service	Additional related services offered (company/industry specific)

Source: Berthron et al (1997).

1.8.2.4.2 Company Website Statistics

Table 20: Company Website Statistics January-June 2005

Measure	Measurement
% of searches using variations of brand name	10%
# hits[1]	234396
# sessions[2]	4368
# visits (> 30 seconds in length[3])	1123
# hits per visit	208
# visits per unique visitor	1.23

Source: Derived from company specific web reporting site.

1 Hits includes requests for files (e.g. .jpg images and html pages)

2 A session is counted when a unique IP accesses a page. Duration of session is measured in increments from 0 seconds to 1+ hours. 75% of sessions on the company's website are 0-30 seconds in duration.

3 For purposes of this analysis, a visit is defined as when a unique IP address accesses the website for 30 seconds or longer. 25% of sessions qualify as "visits".

1.8.2.4.3 Effectiveness and Efficiency of Essentials website

The efficiency and effectiveness of Essentials website has been assessed using the above model, criteria and website statistics. The results are summarized in Table 21 below.

1.8.2.4.3.1 Awareness

Surfer awareness of the Essentials brand and website is negligible. Essentials has limited financial resources to apply to building its brand and website awareness levels. Word of mouth plays a key role in growing the base of Essentials customers. Thus, it is not surprising that only 10% of the key phrases used referenced Essentials brand name.

1.8.2.4.3.2 Locatability / Attractability

Essentials locatability / attractability is considered to be low due to the reliance on free search engines to drive traffic to its sites. The overall numbers of hits and sessions year to date are low at 234,396 and 4368 respectively.

This can be explained by the fact that Essentials does not use online advertising mediums such as hot links, sponsored sites or sponsored web search engines, banner (display) ads, or rich media ads. Nor does Essentials use statistical analysis techniques to understand and leverage the browsing behaviours of its customers across different websites or within its own website. Instead, Essentials relies on an intuitively generated list of search words on free search engines such as Google.

Locatability/attractability of the website is not actively managed as current staff members do not know which search engines Essentials is registered with, nor the current list of search words. Consequently, traffic to the site is fairly low and sporadic.

Essentials does have multiple sites and adequate server speed and bandwidth.

1.8.2.4.3.3 Contact

In terms of converting hits to visits, Essentials website converts only one out of every 208 hits into a visit lasting more than 30 seconds. Relative to competitor sites, Essentials is very basic and lacks interesting, readable, visually appealing content.

Customers must make an extra "click" in order to select the appropriate currency before proceeding to the home page for that currency. The home page includes several call to action buttons such as "buy more and save", "become a member" and "gift certificates" which take visitors to more detailed pages. Navigation tabs include "Shop", "About Us", "Our Stores", "Q&A" and "Home". There are also standard tabs for administrative services such as "customer service", "view your cart", "email signup" and "contact information". The "Shop" and "Our Stores" tabs are populated with information specific to that currency site. For example, the available items on the U.S. site reflect the selection of styles available in the U.S. warehouse. Thus, product lines vary somewhat site to site. The "Our Stores" tab includes a list of the third party boutiques that carry Essentials product line in that currency (i.e. boutiques in the U.S., Canada or Europe).

Images in the shopping catalogue are organized in two horizontal rows, with up to 12 images per page. Each image is small, approximately two inches long by 1 inch in width. The images reflect every day people in yoga-type poses. The images do not have a backdrop and appear to float in white space. There is no anchoring or illusion of a physical vertical catalogue page. Each image has the style and price in text underneath it. Essentials does not use pop-ups to entertain and cross-sell.

1.8.2.4.3.4 Conversion

Conversion rates of visits to purchases are not available in the website report. However, each unique visitor apparently visited the website 1.23 times indicating at least moderate interest in the website.

The shopping and purchase process is intuitive and easy. By clicking on the image, a larger 5 inch by 1.5 inch image appears where the visitor can easily select size, colour and quantity and add the item to their shopping basket. Upon selecting "add to my shopping basket" a confirmation window appears. The window is a little confusing as it appears with an image of a person dressed in white long underwear. This causes the customer to double check the style description in their basket to insure that they have not made an error. The customer can choose to continue shopping or proceed to the checkout.

The customer is asked to identify themselves as either a new customer or as a returning customer. The latter short circuits the data collection necessary, prompting the returning customer to only provide their email, password and promotion code (if applicable).

This distinction in treatment was not evident on the other competitor websites. This could be either because the competitor's website automatically identified the author as being a new customer, or the sites default to collecting full details on each customer order.

When Essentials has "picked, packed and shipped" the customer's order, an email confirmation is sent to the customer and payment is processed. A personal thank you note is written on the back of a Essentials postcard and included in the mailing package along with care instructions.

1.8.2.4.3.5 Retention

Essentials is weak in terms of its retention efficiency. While the percentage of repeat customers is unknown, the online reports engine estimated that 2.1% of visitors add this site to their list of favourites. (http://reports.dynamic.net)

With the exception of blanket e-blasts to registered customers, Essentials does not analyze or use transaction data to drive targeted marketing campaigns and repeat purchases. Customer satisfaction and feedback is not proactively gathered, although there is a lengthy list of customer testimonials listed in the "About Us" tab. Due to limited human and financial resources, updates to the website are infrequent and are normally minor in nature. Therefore, the web contents are relatively static over time. Essentials website does offer a simple online order tracking capability.

Table 21: Evaluation of Essentials Online Attraction and Conversion Process

Stage and Rating	**Marketing Communication Activities**	**Essentials Evaluation**	
Awareness (Low)	Website included on all mass advertising, product packaging and corporate communications	10% search with brand name	Yes - Limited brand and website awareness levels due to small mass advertising budget.
Locatability/ Attractability (Low)	Passives: Use of hotlinks, sponsored sites &/or search engines		No -The website can be found using different search strings on a number of different search engines. However, no paid online advertising is used.
	Actives: Multiple sites and names; Server Speed and bandwidth		Yes -There are three different currency sites; Yes - Third party provider, speed and bandwidth appropriate.
	New capabilities and trends: Banner or display ads; Customization of page to reflect status of customer (new or returning); Rich media ads; Statistical analysis of browsing behaviour to identify best sites to advertise at, and where to use "pop ups" in website for cross-selling		No - Proactive online advertising or marketing is not used; Web pages are not variable or customized; Essentials has not experimented with rich media & given its product line probably wouldn't benefit from it; Essentials does not perform any analysis of browsing behaviour that drives customers to their site, or on browsing behaviours within their site
Contact (conversion of hits to visits) (low)	Interesting, Readability, Visual appeal; Graphics (interface, quality of text, graphics, video; ease of use and navigation; degree of interest and enjoyment while navigating); Products (breadth, availability, quality, value(price), pictures, extent of information available)	208 hits / visit > 30 seconds	Relative to competitor sites, Essentials is very basic and lacks interesting, readable, visually appealing content; Customers must take extra step up front, selecting the website according to currency; Home page for each site includes several call to action buttons including "buy more and save", "become a member" and "gift certificates"; Images are small, "float" in white space; Yoga-type poses used by models (arranged horizontally, rather than vertically, the format used by others); Site relatively easy to navigate; Refer to 1.8.2.for detailed analysis of Essentials product line relative to online competitors.
Conversion (unknown)	Simplicity of dialogue Quality and speed of response Simplicity and security of ordering Related Services		"Add to shopping basket" and "checkout" functions appear simple and easy to use; Checkout data collection process is short circuited by customer identifying themselves as returning or new customer (this feature not evident on most competitor sites); Response times are good; Shopping and ordering processes simple to use; No related services (gift wrapping) appear to be offered.
Retention (Low)	Update and use transaction database Gather satisfaction / feedback Update/refresh website Online customer order status	1.23 visits per unique visitor	No-Records are kept of customer online transactions but with the exception of e-blasts to registered customers is not analyzed or used; Customer feedback is not actively solicited; Due to limited human and financial resources, updates to the website are limited; Online order tracking capability is offered.

Source: Using model presented in Figure 4.

2 INDUSTRY ANALYSIS

2.1 Intimate Apparel Market Overview

2.1.1 Industry Definition and Size

A distinction is made between manufacturers, major brand marketers and the retail outlets that sell branded and private label products. This analysis focuses on the latter, the retailing of intimate apparel in Canada and the United States.

Dollar market growth in intimate apparel has been strong since 1990. For the period 1990 to 1995, the CAGR in the U.S. was 10.2% and in Canada it was 12.5%. (Specialists in Business Information 1997) According to statistics published in the U.S. Women's Undergarment Market Trends Report of 1997 (U.S. Women's), dollar market growth in Canada was 13.3% of U.S. sales in 1996. Strong growth continued, with intimate apparel sales in the U.S. estimated to have increased 7.5% 2003 to 2004, hitting $9.1B. (DSN Retailing Today March 2005) Applying the ratio derived from the U.S. Women's report, intimate apparel sales in Canada reached $1.2B in 2004.

2.1.2 Product Categories

There is no consistently used categorization process for the intimate apparel industry. In order to be comprehensive, the following product categories are a compilation from several sources. The categories carried by Essentials are indicated with a check mark.

Table 22: Intimate Apparel Product Categories

WOMENS	Essentials	MENS	Essentials
Brassieres		-	
Basques, bustiers, garters, corsets		-	
Camisoles, slips, tops	√	Tops -T-shirts, vests etc.	√
Panties, briefs, thongs, g-strings	√	Briefs, trunks, boxers, thongs	√
Shapewear – full leg, body, panty		Thongs with "straps" to accentuate	
Hosiery		-	
Swimwear		Swimwear	
Sleepwear	√	Sleepwear	
Loungewear		Loungewear	
Long Underwear	√	Long Underwear	√

Intimate apparel product categories for women include: brassier-like garments, panties, inner layer (camisole, slips etc.), shapewear, hosiery, swimwear, sleepwear, loungewear and long underwear. Intimate apparel for men include tops, bottoms (briefs, trunks etc.), support garments, swimwear, sleepwear, loungewear and long underwear. Intimate apparel are made from a variety of different fabrics.

The owner of Essentials classifies products and competitors into seven groupings:

- Boudoir: non-silk, high use of colour and lace, short-term use e.g. La Senza;
- Sporty: designed for active wear, constructed of cotton and micro fibres e.g. Jockey, Hanes;
- Essentials: every day wear at affordable price, e.g. 3 pack of Stanfields at the Bay;
- Fun: e.g. Joe Boxer;
- Shapers: intended to improve appearance of the body under outer layer, targeted to 30-70 year olds, e.g. Spanx, Bodywrap, Nancy Ganz;
- Maternity: comfortable, functional, customer life cycle of 3-9 months;
- Decadent Utilities: upscale daily wear e.g. Essentials, KAS, Donna Karan, Mary Green.

2.1.3 Competitors

The U.S. and Canadian undergarment market is concentrated among several large branded marketers. (Specialists in Business Information 1997) In the U.S., the top seven represented 77.1% of total 1996 sales. The remaining 22.9% was divided amongst 130 companies who sell primarily private label or unbranded merchandise. In Canada, Canadella is the market leader with brands such as Playtex, Wonderbra, Daisyfresh and Hanes Her Way brands.

The largest marketers in both countries are increasing market share by introducing new products, up-scaling product lines, merchandising to all market segments, making strategic acquisitions and growing internationally. (Specialists in Business Information 1997)

Intimate apparel is sold across many channels (retail, online, direct sales, home shopping, catalogue sales). Retailers typically use a multi-channel distribution strategy (brick and mortar, catalogue, online). Intimate apparel is sold through department stores, mass merchandisers, specialty chains and independent boutiques. Department stores and mass merchandisers tend to concentrate on major brands and to some extent private labels, whereas specialty chains and independents concentrate almost exclusively on private labels. According to the U.S. Women's report, department and mass merchandisers were losing sales of intimate apparel to specialty stores and family clothing stores.

2.1.4 Customer Segments

A minimum set of under garments (underwear or panties, bras, sleepwear) are essential items for every man, woman and child in North America. Intimate apparel manufacturers and retailers segment the market in a variety of ways based on age (children, tweens, teens, 20-30, 30+ etc.), purpose (daily, bedroom, maternity, shaping, sport), and price sensitivity.

The U.S. and Canadian populations are highly diverse in terms of ethnicity, age and regional style differences. Populations are aging. The number of Canadians over age 50 will soon out number those under age 50. Thus intimate apparel retailers must focus on the demands of ethnic, aging and regional markets. (Euromonitor 2004)

According to the Global Market Review for Lingerie and Intimate apparel, women increase their spending on undergarments as they age. (Newbery 2005) Spending normally peaks when women reach 45-54 years old, with the average female in this age range spending 41.8% above the norm on undergarments in 1995. This age group represented 25.3% of total undergarment spending by females over the age of 16.

2.1.5 Product Trends and Innovations

2.1.5.1 Materials

Intimate apparel is primarily made out of cotton, with cotton having increased to 70% share by 1997 while manmade and other materials declined. The U.S. Women's report mentions the start of a shift to non-cotton natural materials beginning in the 1990s. Elastane and micro fibres have come to the forefront of product development to shape and smooth curves of larger women.

Silk is only .2% of the global textile fibre market output and appears to be losing ground to synthetic fibres. The actual trading value of silk and silk products is not insignificant, totalling in the multi-billions of dollars. In terms of value per unit, the unit price of raw silk is twenty times that of raw cotton. (International Trade Centre (ITC) n.d.)

Silk comes from rural areas in developing countries and transition economies. It is environmentally friendly (few fertilizers and insecticides are used). Primarily made of proteins, it is close in composition to human skin, making it extremely comfortable to wear. Silk has lost market share to new synthetic fibres like viscose and polyester which look and feel like silk and are easier to take care of. (ITC n.d.) Arguably, these fibres do not provide the thermal properties, and thus the comfort, of silk.

According to the ITC, the image of silk was damaged by the 1990s boom in sandwashed silk. Today, silk lacks visibility as a material of choice for intimate apparel. Efforts need to be made to reposition it as an environmentally friendly luxury product and to capitalize on new technologies and changing market demands. Silk blends are one way to address the challenge of synthetic fibres. (ITC n.d.)

Imports of silk goods to the U.S. were valued at about $2B in 1997 (10% was for home furnishings). Unlike European consumers, Canadian and US consumers do not have a long tradition of using silk. Silk does not have the same "aura" as in Europe. However, inroads are being made by Chinese knitted silk products including thermal underwear, elegant casuals like t-shirts, and polo neck sweaters. In order to effectively compete in these markets, silk must have easy care properties of other fibres. (International Trade Forum n.d.)

2.1.5.2 Product Mix

The industry product mix is changing to address the plus sized market. In the U.S. over 50% of 55-64 year olds purchase plus sizes. While Canadians are not as over weight as Americans, plus sizes are also important to this market.

In addition to plus sizes, new products are being developed to enhance a woman's shape and to smooth out curves, while at the same time being made of materials providing comfort and fit. (Specialists in Business Information 1997)

2.1.5.3 Underwear as % of Intimate Apparel Unit and $ Sales

In 1997, underwear represented the majority of intimate apparel unit sales at approximately 74%. However, underwear's share of dollar sales remained flat at 42%. This trend was forecasted to continue through 2002 (Specialists in Business Information 1997). This indicates that underwear are relatively high volume, low price point, products.

2.1.5.4 Price Points

Price points depend on branding, fashionability, styling and fabrics. Price points are expected to change little through 2010 as a result of intense retail competition. (Newbery 2004)

2.1.6 Buying Trends and Behaviours

2.1.6.1 Intimate Apparel Share of Apparel Purchases

Undergarments captured an increased share of total U.S. women's apparel purchases – increasing from 4.7% in 1984 to 5.4% in 1997. (Specialists in Business Information 1997) The oldest age categories have allocated the largest share of their apparel budget to undergarments. Statistics for more recent years have not been found.

Lingerie is one of the better clothing sectors to be engaged in due to consumer loyalty to brand, fit and comfort. (Newbery 2004) According to DSN Retailing Today (March 14 2005), intimate apparel experienced the healthiest overall category increase in years...women are looking for sexy intimates for everyday, special occasions and to suit different moods.

2.1.6.2 Intimate Apparel Are More than Function

Once thought of as functional basics, under garments have emerged to be a mix of both function and fashion. Women are driven by fashion concerns such as which undergarment styles and colours look right under which outer clothes. (Newbery 2004)

U.S. Women's reported that per capita female undergarment purchases in the U.S. would rise from 8.4 items in 1980 to 13.9 items in 2002. Malcolm Newbery reported that the average woman buys two bras and five pairs of briefs per year. In total, the average wardrobe consists of six bras and eight pairs of briefs. While the consumer does not need this many, demand is driven by many of the factors discussed above including the role of intimate wear as a fashion item, aging populations and the growing demands of plus-size consumers.

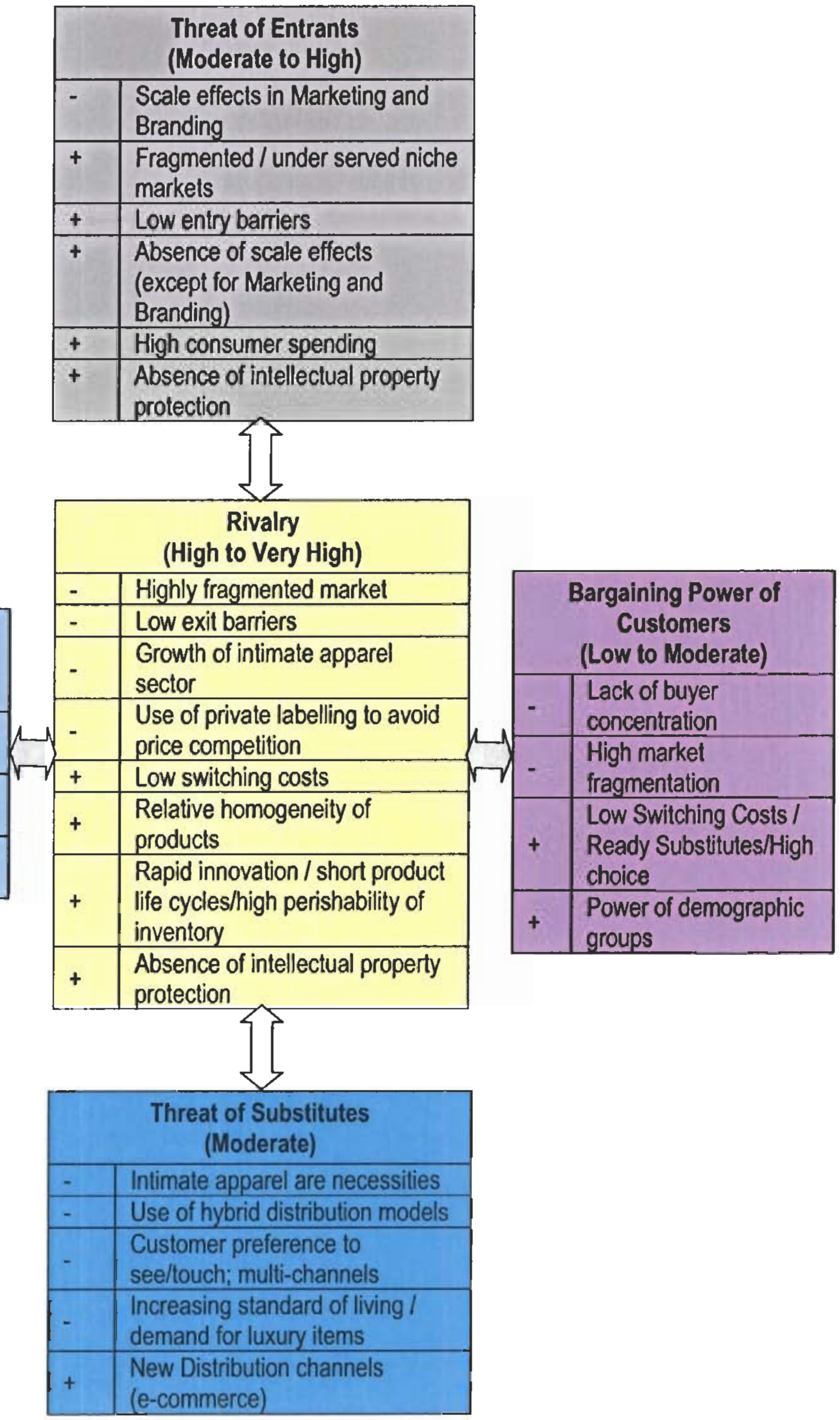
2.1.6.3 Merchandising

Retailers began improving merchandising of intimate apparel and the customer's shopping experience in the early 2000's. (DSN Retailing Today 2000) Consumers have less time for shopping, and retailers wanted to make it easier for them. The visual chaos due to sheer number of styles, colours, and sizes did not facilitate a pleasant or rewarding shopping experience. Many customers opted to shop at specialty stores. Some of the merchandising techniques that retailers have tried include:

- Fashion colours being placed at the front with basic colours at back for shoppers to see "fun" first;
- Tags around hanger necks for easier size reference;
- Packaging that reflects lifestyle or end use, using "real" models with cut outs in the packaging so that customers can feel the fabric;
- Matching merchandising to shopping behaviours – Placing tops and bottoms in separate displays, but close together, in order to satisfy two dominant shopping styles – some prefer to match tops and bottoms while others look for separates.

2.2 Five Factor Analysis

Figure 5. Five Factor Analysis



Adapted from Porter (1979) and Bukszar (2005).

2.2.1 Bargaining Power of Customers (Low to Moderate)

There is a lack of buyer concentration, and thus the bargaining power of consumers in the intimate apparel industry is low to moderate. The market is highly fragmented with diverse customer needs and wants. On the other hand, consumers have a lot of options in terms of products and retail channels, low switching costs, and thus ample opportunities to find products, prices and sales channels that meet their needs.

While consumers have relatively low bargaining power individually, they do have tremendous influence in groups. Demographics and immigration will change the composition of the Canadian consumer base, creating niche markets. For example, older segments purchase considerably more intimate apparel than do younger segments with spending peaking in the 45-54 year old age group. (Specialists in Business Information 1997)

2.2.2 Rivalry Amongst Existing Competitors (High to Very High)

Rivalry among existing competitors is rated as high to very high. Retail profit margins are low. In an effort to meet the diverse needs of consumers, the sale of intimate apparel is highly fragmented with a wide assortment of competitors using a variety of different channels (retail, online, catalogue, home shopping and direct sales), products, price points and service levels.

In order to avoid price competition and lessen rivalry, competitors struggle to establish a unique value proposition (product, price, service, brand) in an environment where there are low switching costs and ready substitutes. Some are more successful than others. Due to the mixed results, intimate apparel products tend to be somewhat homogeneous in nature.

While the shelf life of many intimate apparel products is longer than for outerwear garments, perishability of inventory is a major concern for intimate apparel retailers. Due to the absence of intellectual property protection on intimate apparel designs and retailing and rapid innovation, short product life cycles are the rule.

There are a few factors mitigating extreme rivalry. They include low exit barriers, existence of niche markets and growth in the intimate apparel sector. Exit barriers are relatively low for small specialty retailers. Obviously, exit costs for intimate apparel chain stores like La Senza and La Vie En Rose would be higher. Major department stores and mass merchandisers can exit intimate apparel brands or categories easily.

In addition, diverse customer needs provide underserved niche markets for small independents to target. Over the last 10-20 years, intimate apparel has moved from a "basic" to a "fashion" item, even crossing over into outerwear. For this reason, demand for certain intimate apparel products and categories is growing. Opportunities exist for specialty retailers that have strategies tuned to specific, well understood target markets.

2.2.3 Threat of New Entrants (Moderate to High)

The threat of new entrants is considered to be moderate to high. As mentioned earlier, the existence of fragmented markets creates underserved niche markets for new entrants to target. Entry barriers, at least for small independents, are low. Entry requires establishing a sales channel (retail store, online, catalogue) and purchasing and storing of inventory. There is an absence of scale effects, with the minimum efficient scale being a single small independent boutique. However, scale effects associated with marketing and branding are barriers to large-scale entry.

The Euromonitor report "Retailing In Canada" predicts that a strong economy, high consumer confidence, low interest rates and low savings rates will continue to drive healthy retail spending. The forecasted growth in retail sales revenues will be associated with an increase in both the number of retail businesses and their associated outlets. While the report does not address the intimate apparel sub-sector, it does forecast that the number of clothing store businesses will increase by 9% by 2008. It is reasonable to assume that intimate apparel retailers will grow at the same rate.

Niche oriented boutique stores will play an important role in the growth of retail outlets, benefiting from both the strong economy and weaknesses of larger competitors to serve niche/localized markets. According to several industry sources, consumers are shifting from buying intimate apparel at department stores to specialty stores and that this makes it easier for small start-ups to enter the market.

A further factor contributing to ease of entry is the absence of intellectual property protection on intimate apparel designs and retailing. This permits new and existing competitors to easily copy each others products and price points.

2.2.4 Bargaining Power of Suppliers (Low to Moderate)

For the most part, bargaining power of suppliers is low, particularly where product design is done by a party in the value chain other than the manufacturer. Brand houses and retailers often design the product, and contract out the manufacturing. Thus, manufacturing has become a commodity with few distinguishing features with which to command a premium price. Globalization and free trade have opened markets world-wide, resulting in a highly fragmented market and a glut of manufacturing capacity. (Poon 2005)

Other suppliers include e-commerce suppliers and retail workers. With respect to e-commerce suppliers, the market is highly fragmented and individual suppliers have little power. There is on a adequate supply of retail workers, a relatively low skilled position. Thus resources can be easily found and replaced.

2.2.5 Threat of Substitutes (Moderate)

The threat of substitutes is considered moderate from the perspective of both products and channels. Every consumer requires a minimum set of intimate apparel, with relatively few choosing to do without them. Designs will continue to change rapidly, and new fabrics will emerge. Even so, it is unlikely that silk will be displaced as a desired luxury item. As standards of living increase, one would expect continued demand for silk apparel products.

The emergence of new distribution channels, primarily online shopping and home shopping, will continue to displace demand through retail stores. Sales through these alternative channels are expected to continue at a slow, but steady rate. (Euromonitor 2004)

Most retailers have evolved to use a hybrid distribution model, combining catalogue, online and retail store fronts. While this practice adds cost, it reduces the threat of substitution.

While shopping over the internet will continue to grow, a large portion of the customer base will continue to prefer a physical shopping experience where they can browse, see, touch and try on intimate apparel items.

2.3 Attractiveness of Intimate Apparel Industry Sector

Participation in the intimate apparel, or any apparel sector for that matter, is not for the weak of heart. Competition is intense and will remain so. A steady stream of new entrants is expected. Incumbents will fight vigorously on all fronts. Lucrative niche markets will continue to emerge due to changes in demographics creating regional and local opportunities for independents. E-Commerce will increasingly erode sales from retail outlets.

2.4 Key Issues Facing Firms in the Intimate Apparel Industry Sector

1. Perishability of inventory.
2. Understanding niche customers needs and developing tailored strategies.
3. Need for an on-line presence to be competitive.
4. Supply chain management is critical due to small margins.
5. Solid financial management is critical due to small margins.
6. Need for hybrid distribution models to remain competitive.
7. Difficulty building private label brands.
8. Dependence on continuation of strong consumer spending.

3 INTERNAL ANALYSIS

3.1 Apparel Industry Value Chain Overview

The apparel industry value system (Figure 6) involves six steps. (Abernathy and Dunlop n.d.) The textile manufacturers source thread and weave or knit it into fabric. Apparel manufacturers traditionally design, cut, sew and distribute their design collections. Importers/ exporters match distributor demand with manufacturer designs and production capacity. Brokers facilitate overseas shipment, duty and delivery to distributors. Retailers or distributors are responsible for inventory management, marketing and merchandising, selling and providing pre and post sales service to end customers.

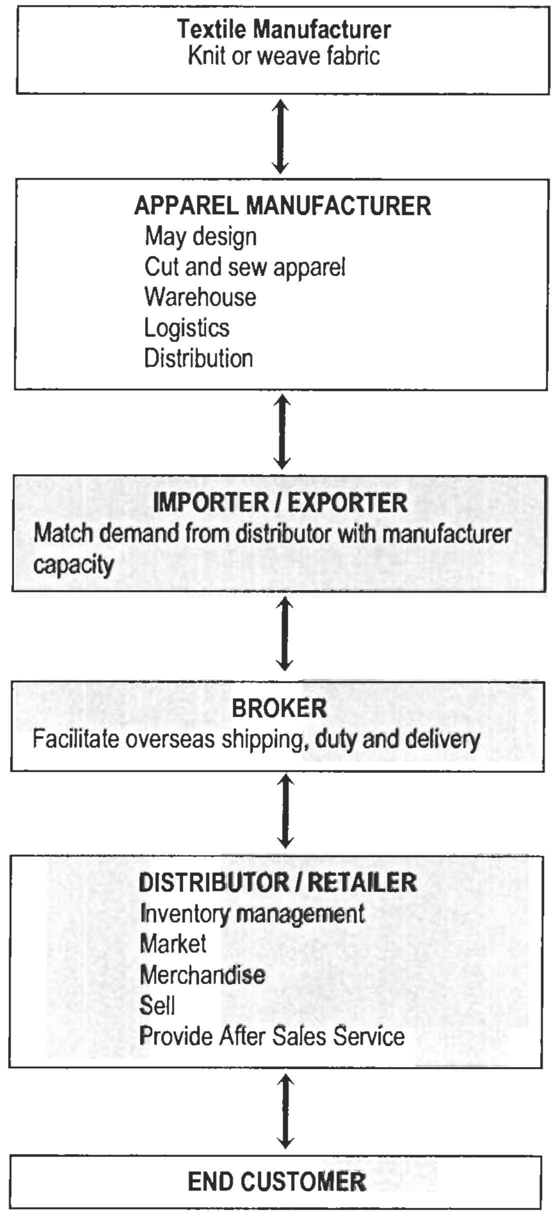
Until fairly recently, brand houses with manufacturing arms (like Warnaco) held most of the power in the value chain. Manufacturers designed, manufactured, branded and marketed their "collections". They were in a position to dictate long lead times which permitted them to procure inputs and produce based on pre-specified orders from retailers. Retailers typically ordered large quantities, far in advance, and held the apparel in inventory in order to be able to meet customer demand throughout the selling season. With the balance of power in their favour, brand houses (and their manufacturing arms) had a great deal of certainty with respect to their customer demand. Retailers on the other hand carried the inventory, associated costs and risk of perishable products. (Abernathy and Dunlop n.d.)

Over the last twenty years, the balance of power has shifted significantly from the brand house (and associated manufacturing arm) to large retail buyers. The power of buyers increased as a result of consolidation, globalization and technological developments (bar codes, scanners, EDI and automated distribution centres) that have enabled more detailed and timely information on customer buying trends. These factors have contributed to the rise of a "lean retailing" strategy, which involves reducing risk by constantly adjusting the supply of consumer products at the retail outlet to match actual, rather than forecasted, levels of demand. Retailers are now demanding the ability to order much closer to the selling season, in smaller initial quantities, with the ability to replenish throughout the season based on real-time customer purchases. These practices help to maximize the productivity of their inventories and to reduce their risk. (Abernathy and Dunlop n.d.)

As a result, the role, value proposition and profit structure of brand houses and manufacturers have changed. Manufacturers carry more inventory and procure and produce based on anticipated, rather than actual, demand. They have also re-engineered their production processes to reduce production volumes and lead times, and have begun to perform some services typically done by retailers (such as affixing bar codes and prices). (Abernathy and Dunlop n.d.)

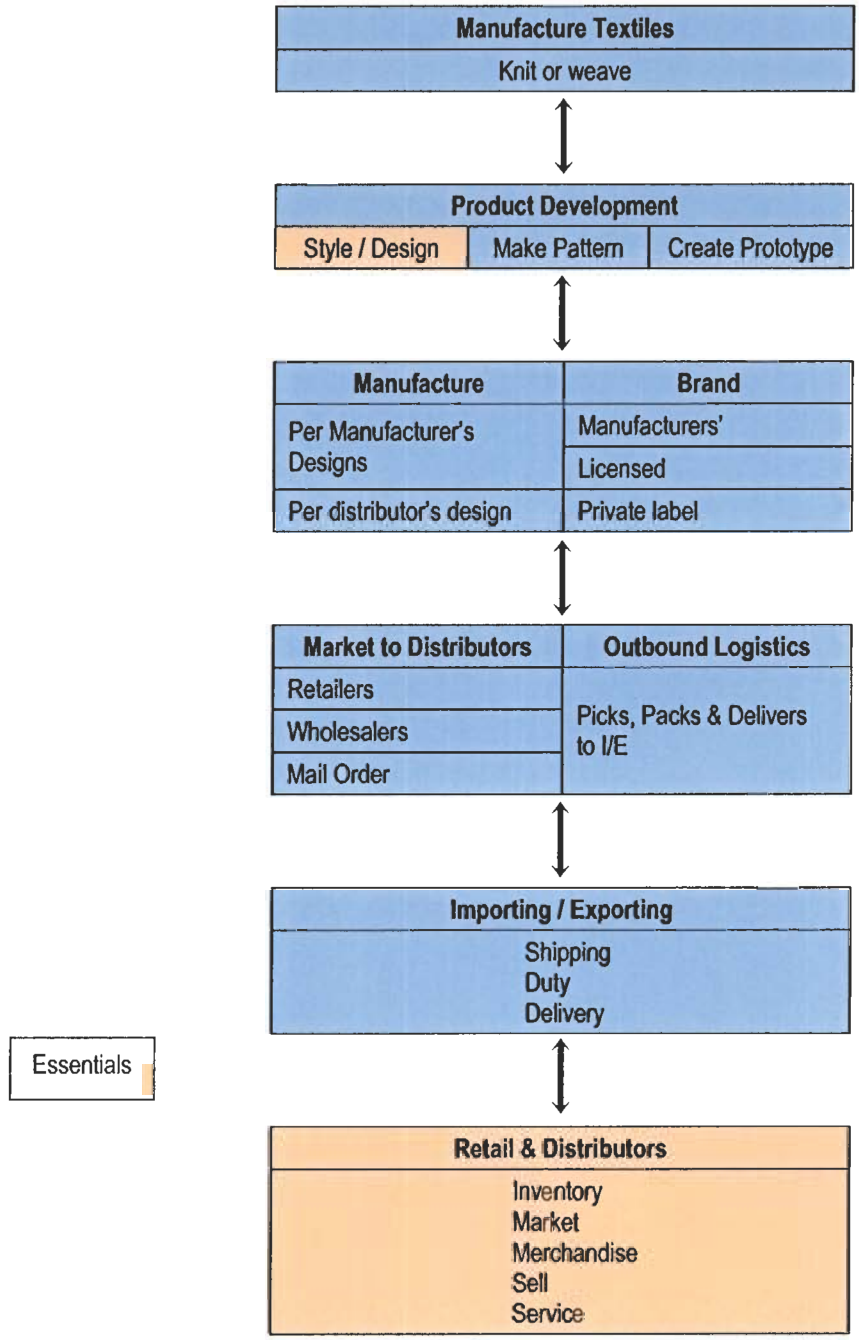
The second major development that contributed to the shift in power from brand houses and manufacturers to retailers was the "taking over" of the design function by retailers. Retailers learned from the major brand houses that the early stages of product development (namely design) added value. By designing their own private labels, retailers have increased their power and profitability. Retailers, specialized chains and brand-name designers simply subcontract the latter stages of product development (pattern making and prototype) and production. (Lefebvre and Vervaeke 2002)

Figure 6: Apparel Industry Value System



Source: Adapted from Porter's Value System.

Figure 7: The Apparel "Fibre to Retail" Value Chain



Source: Adapted from Ed Bukszar's 2005 class notes.

3.2 Essentials Participation in the Fibre to Apparel Value Chain

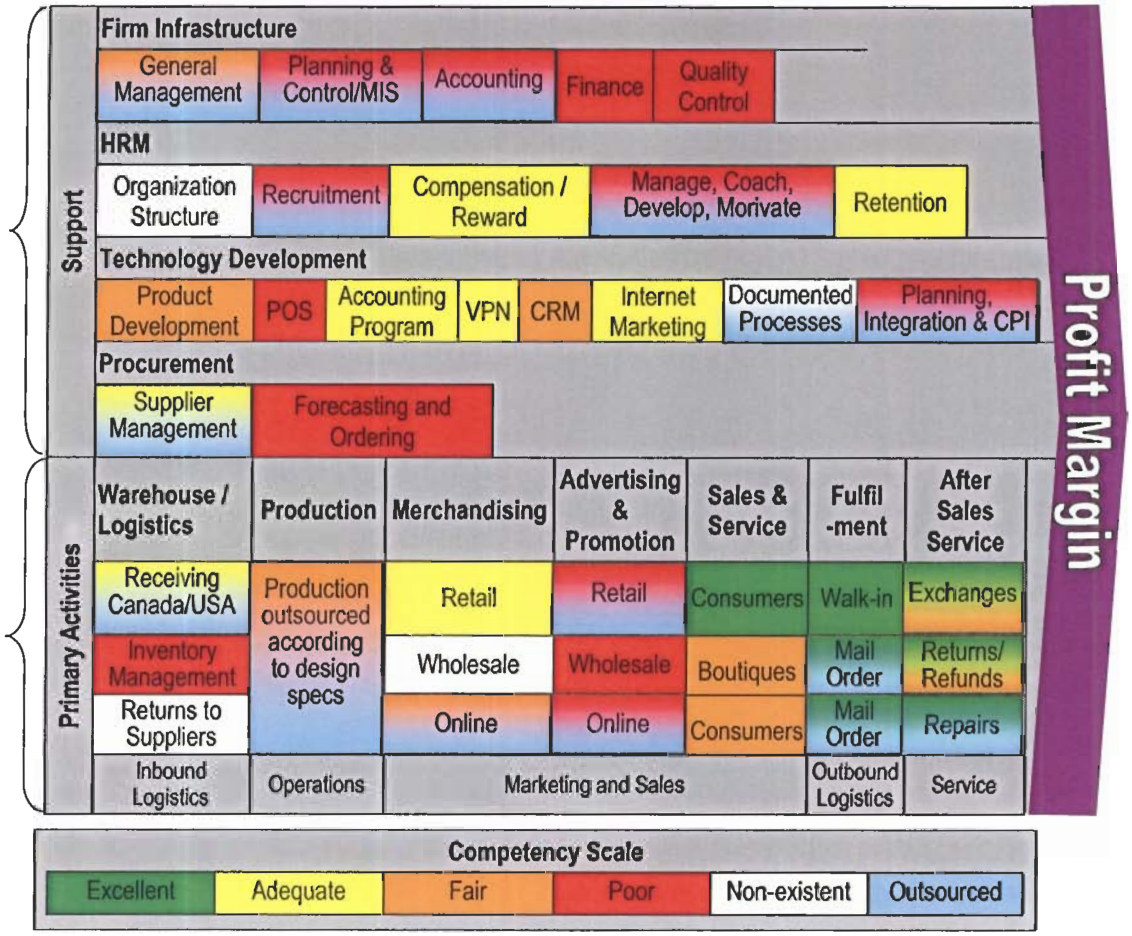
Essentials participates in the product development and retail stages of the value chain (Refer to Figure 7). Each of these will be discussed below.

Essentials performs part of the product development stage (determining style, design and sizing) and brands the garments under the "ESSENTIALS-you need them everyday" tag line. Designs are selected by observing competitors and tailoring designs to meet the personal tastes of the owner for practical, no-nonsense, comfortable underwear and sleepwear. As a result, there is a strong consistency in design across all styles.

Essentials has been doing business with the same manufacturer in China since its inception 11 years ago. Essentials specifies the designs, desired silk weight (known as mummy), colour and thread. Essentials relies on the manufacturer to manufacture the silk (source the thread, knit and dye the silk), to make the patterns/prototypes, and subsequently to manufacture, brand and tag the garments.

Essentials currently acts as a traditional retailer ordering large quantities of inventory, in advance of each selling season, and warehousing the inventory to meet customer demand throughout the season. Essentials uses multiple channels to promote and sell its apparel including: a company owned and managed retail outlet, online "stores", and third party "boutiques". Walk-in retail customers receive their garments on the spot, whereas fulfilment of online and wholesale orders is performed through over night service delivery from Canada Post. Essentials completes the value chain by providing both pre and post-sales service.

Figure 8: Essentials Internal Value Chain



Source: Adapted from Porter 1985 and Bukszar 2005.

3.3 Essentials Internal Value Chain

As with many small businesses, Essentials does not have a clearly defined business strategy. Instead, the owner has been following her intuition and has managed to achieve mixed success. The company started off with a low cost strategy 10 years ago, gradually evolved into a hybrid cost/differentiation strategy, and is beginning to adopt elements of a focused differentiation strategy. (Porter 1980)

At the moment, the business appears "stuck in the middle", unable to achieve the economies of scale for a low cost strategy and lacking the resources to pursue a clear differentiation strategy. According to strategy theory, the firm is unlikely to be hugely successful over the long term by straddling cost and differentiation. Given the lack of scale and resources, a focused differentiation strategy may be a much more successful strategy for the firm.

3.4 Support Activities

Not surprisingly, Essentials has concentrated its efforts and resources on customer-facing primary sales activities. As a result, there are many weaknesses and gaps in portions of its primary activities and throughout its support activities. Support activities will be discussed first. (Figure 8)

3.4.1 Firm Infrastructure

3.4.1.1 General Management (Fair)

General management of the firm is considered fair. The owner has learned about business by trial and error, but lacks many of the skill sets necessary to grow and manage the business. Her intuition and foresight are the key skills that have contributed to her success to date. She recognizes her weaknesses as an entrepreneur, and wants to get the right skill sets in place in the organization. She is eager to hire and delegate to a "general manager", but has not yet achieved the financial strength to do so. As a result, the owner has resorted to hiring various consultants.

Her delegation is more like abdication. She does not know how to monitor and hold others accountable for business results. Consequently, she is vulnerable to being taken advantage of, and to the loss of knowledge associated with staff turnover.

It is also appropriate to recall the personal dimension. 2003/2004 were difficult years both personally and professionally for the owner.

The management team was expanded in early 2005 to include a third individual, bringing the total full time staff to two (excluding the owner). Both are very hard working and learn quickly, however they lack the core skills for their positions. The first has been with Essentials since early 2004 and has recently been appointed to the position of Marketing Manager and the second was hired in late January of 2005 as the Office Manager. The operation will continue to stabilize as these individuals develop in their positions.

3.4.1.2 Planning and Control / MIS (Poor)

Proactive planning and control are poor, as are the underlying management information systems. There are no budgets, and only rudimentary tracking is performed such as inventory, daily sales volumes and bank balances. While there is a lot of "data" available from the bookkeeping program, there is little massaging of the data into information, and even less fact-driven, as opposed to intuition-driven, working knowledge. The only management report that is produced is a profit and loss statement. It is produced when required to satisfy bankers and potential investors, but other than that it is not used as an active management tool. Bottlenecks and problems in the bookkeeping function have prevented these reports from being made available on an accurate and timely basis.

3.4.1.3 Accounting / Bookkeeping (Poor)

The accounting/bookkeeping function has been rated as poor. Significant effort has been invested over the last few months setting up a clean data file for the 2005 calendar year, correcting bookkeeping errors in 2004 and training staff. An office manager has recently been hired, and is receiving training on bookkeeping. Methods and procedures are being developed to ensure adherence to GAAP going forward. This function needs to improve to at least an adequate rating over the next few months.

Accounting problems originated from three sources. First, the bookkeeper in place at the time of incorporation in 2003 failed to start a new set of books. Second, Essentials decided to change from its Simply Accounting program to QuickBooks mid-fiscal year 2004 in order to seamlessly work with its new internet storefront provider StoreSense. Third, untrained staff subsequently made significant bookkeeping errors. For example, shipping and duty costs were added to COGS and expensed at the time of sale instead of being expensed as they were incurred.

A replacement bookkeeper was brought on board February of 2004 to correct problems with the transition from Simply Accounting to QuickBooks and to get the financial records in order for the fiscal year ending July 31 2004. Bookkeeping complications from incorporation, the transition between accounting programs, the subsequent errors in bookkeeping entries, and the lack of rigorous accounting processes represented quite a challenge. The solution was to launch a new QuickBooks data file starting January 2005 (again mid-fiscal year), allowing additional time to clean up 2004 financial records. The situation was further exacerbated by the limited availability of the bookkeeper.

As a result, this process took much longer than it should have. Financial records for the calendar year 2004 were initially finalized in early May 2005. Only then was the owner able to see financial statements for 2004 (profit and loss and balance sheet) and to know whether the business had generated a profit or not during the calendar year.

In June, the author discovered an error of approximately $42.7K in the valuation of inventory assets on the 2004 balance sheet. This was corrected and a new 2004 balance sheet were issued June 24, 2005.

Credit card fraud has never been properly accounted for on the company's books. Instead of appearing as a line item reducing net income, with offsetting transfers from COGS to inventory shrinkage to reflect stolen inventory, the bookkeeper was simply treating credit card fraud charge backs as bank charges. This was because no one could understand the monthly reports from their third party online credit card processing provider Paymentech. The author contacted the company, located reports that detailed the daily credit card bank deposits (sale price - charge backs, commissions and fees), and arranged training for the staff and bookkeeper. Presumably records can be corrected retroactively for 2005.

Bookkeeping records for 2005 are currently in disarray. There are sizable "undeposited funds" appearing on the Balance Sheet and "uncategorized expenses" appearing on the Income Statement. Monthly bank reconciliations have not been performed year to date. This in turn means that accurate financial statements have not been available. Lack of timely and accurate financial information is a major issue for any small company, especially those with low or negative profit margins. This situation can not continue, especially since fiscal year end (July 31) is rapidly approaching.

3.4.1.4 Finance (Poor)

The owner is the only shareholder of Essentials. The owner's financial resources are fully drawn upon. New sources of financing have proven to be both hard to come by and expensive. Thus, there are limited available resources to cover further operating shortfalls or to grow the business.

Total debt has climbed to approximately \$300K, of which \$200K is personal debt and \$100K is associated with the business.

Cash flow is a constant challenge for this small business. Cash flow statements are not prepared. Payments are determined according to the bank balance at the time, as opposed to an understanding of forecasted cash commitments.

Current assets are used to cover business expenses and to pay off a \$35K U.S. loan which dates back to 2003. According to the current bookkeeper, this loan was never recorded properly as a liability on the company's books.

A thorough financial analysis, including the \$35K U.S. loan, can be found in chapter 4.

3.4.1.5 Quality Control (Poor)

Quality control is a weak point in the operation. Historically, quality problems are identified only after production and shipment to Canada. Thus, quality problems are typically corrected going forward as it is too expensive to return inventory to China. The manufacturer typically compensates Essentials through a price reduction on future orders. This means that Essentials ends up with inferior-grade inventory to sell.

Quality problems are attributable to changes in the inputs used by the manufacturer, and construction of the underwear. For example, the manufacturer made a unilateral decision to change the width and thickness of the elastic used in the underwear. This affected both the fit and feel of their most popular styles. By the time this was discovered, part of the inventory had been received in Canada and part remained on the dock in China. Lengthy negotiations occurred to determine a financial resolution to this $50K problem. In the meantime, Essentials had $28K in inferior inventory that it subsequently sold at deep discounts in clearance sales. As a result, Essentials was out of "regular quality" stock in a number of its most popular styles and sizes until replacement stock was produced and shipped six to eight weeks later.

A quality control process has recently been defined and is being implemented. The process addresses communications between the manufacturer and Essentials on planned changes to raw inputs or production processes; approval by Essentials of pre-production samples; and physical quality checks of 5-10% of all garments that arrive in Canada. As a result, this function is expected to improve to at least an adequate rating over the next few months.

In addition, there are concerns regarding the durability of the garments. Light weight knit silk is a delicate fabric which can run if snagged or if overly stretched at the seams. In addition, silk thread is weaker than other types of thread and therefore breaks more easily when excessively stretched. This can result in what appears to the customer as the garment "falling apart". There is also some anecdotal customer feedback indicating that certain styles (sleep shirts) are too transparent for their intended use.

These latter quality issues are associated with the design and production specifications provided to the manufacturer by Essentials. This is a weak point for Essentials. No one at Essentials has formal garment design training. Specifications normally involve sending a competitor's sample overseas with written instructions on how to modify it. It is then left up to the manufacturer to create the patterns, specifications and prototype for approval. As a result, Essentials does not have in its possession detailed technical design and construction specifications for its garments.

3.4.2 Human Resource Management

3.4.2.1 Organization Structure (Non-existent)

Until recently there was no defined organization structure, roles and responsibilities or job descriptions in place. Employees tended to be "jack of all trades but masters of none", often tripping over each other as they attempted to multi-task. Roles and responsibilities and job descriptions are in the process of being completed.

3.4.2.2 Recruitment (Poor)

Recruitment has been a weakness of the organization. Until recently, there were no selection criteria, job descriptions, recruitment, interview or hiring processes in place. Since human resource management has not been managed proactively, rush hires have been the rule with selection criteria including immediate availability, whether the owner "likes" the individual, a "perky" personality in person and over the phone, and a customer service background. As a result, most Essentials employees come from the restaurant (waitress) industry.

In order to be more skills-focused in hiring, a standard interviewing and evaluation process has been implemented and successfully used in filling two part time sales positions.

3.4.2.3 Compensation/Reward (Adequate)

In order to attract and retain employees, Essentials offers above market hourly wages in the $10-12 per hour range for inventory and retail sales positions. The office manager position is currently being paid at $17 per hour which is considered to be at the low end of market.

Benefits are minimal including paid lunch breaks and wholesale prices on store merchandise. No health or dental benefits are provided. CPP / EI (8% of wages) and vacation pay are paid according to regulations (4% of wages).

3.4.2.4 Management, Coaching, Development and Motivation (Poor)

There is no official performance management, coaching or development of employees. There are no practices in place to help motivate employees. Performance management practices and coaching are in the process of being implemented. Gaps in employee development and motivation have not yet been addressed.

3.4.2.5 Retention (Adequate)

Due to above-market hourly wages and the likable nature of the owner, staff turnover has not been a problem for Essentials over the last year. Changes in how new team members have been recruited, trained and coached over the last few months appears to have resulted in a small but dedicated employee base.

3.4.3 Technology and Development

3.4.3.1 Product Development (Fair)

Style, design and fit are at the heart of Essentials' value chain. However, due to outsourcing and firm size, the firm has very little control over the inputs and physical construction of its garments.

Currently, styles are copied from competitors and modified to meet the owner's personal tastes for no-frills, pure silk, great feeling, practical underwear and sleepwear. Technical design skills are low. The owner's "personal design touches" provides a consistent look and feel across all styles and provides some element of distinctiveness. However, this distinctiveness is difficult to sustain, particularly since designs are easy to copy and the same manufacturing inputs (knitted silk, colours etc.) are available to all retailers.

Ordinarily, a differentiation strategy is associated with high R&D costs. Essentials does not have the resources (financial or human) to design garments from scratch, or to distinguish itself through distinctiveness in inputs (i.e. to research advanced silk knitting and dying techniques, optimal sewing techniques etc.)

3.4.3.2 Point of Sale (Poor)

Essentials has been getting by using its accounting program, QuickBooks, as the engine to generate customer receipts and invoices. This practice is not only risky, but has proven to be inefficient and ineffective. Access by multiple, largely untrained employees, resulted in errors in the financial data file that had to be discovered and corrected by the bookkeeper or office manager. As a result of these problems, all retail sales are now being processed using manual receipts and are subsequently entered into QuickBooks by the office manager. This practice is inefficient and error prone. An automated POS system is required.

3.4.3.3 Other Internal and External Systems (Adequate)

There are several other systems used by Essentials that are performing adequately individually. However, they are not well integrated with one another. The QuickBooks accounting program is in place and is accessible remotely via a virtual private network.

Essentials online store front is outsourced to StoreSense which hosts the website, collects customer orders, routes orders to Essentials by email for manual entry into QuickBooks and subsequent shipment of the customer's order. Essentials then confirms in StoreSense that the order has been shipped. Customer payment by credit card is then processed by a third company called Paymentech. At the end of each day, Essentials receives daily direct deposits (minus authorization, commission, electronic funds transfer fees and credit card fraud charge backs) from Paymentech. An opportunity exists to automate the downloading of customer orders from StoreSense into QuickBooks. This would improve accuracy and free up the Office Manager to focus on higher value activities. A technical resource has been hired to assess and test what needs to be done to automate this process.

Wholesale orders are received by phone or fax and then manually entered into QuickBooks. Once the link between QuickBooks and StoreSense has been automated for online customers, consideration should be given to extending this capability to allow wholesalers to order online through StoreSense. This would improve accuracy and free up additional time for the Office Manager to focus on higher value activities.

Essentials has a rudimentary CRM capability. Transaction records are kept for each customer and sale. For retail customers, records include only the customer name and purchase history. For online customers, records include name, address and purchase history. Basic customer reports can be extracted from QuickBooks. However, no analysis or marketing driven activity is occurring. There is a small group of 5000 customers who have consented to be emailed to.

A major gap in their technology infrastructure is the lack of any integrated communication with their supplier. Ordering and reconciliation of shipments and payments is done manually through the exchange of excel spreadsheets using email. This is very time consuming and prone to errors/discrepancies between the records of Essentials and the supplier. Even if a more elegant solution (such as EDI) is unavailable or too expensive to implement it should be possible to standardize on the format of the excel spreadsheets and to write a simple program that would automatically update the appropriate fields in QuickBooks. This would improve accuracy of inventory records and would save significant man hours currently spent manually keying in the data.

3.4.3.4 Documented Processes (Non-existent)

With the exception of store opening and store closing procedures, documented business processes do not exist. Thus Essentials is extremely vulnerable to knowledge loss associated with staff turnover and the business is not as efficient or effective as it could be. For example, there was no standard "pick/pack/ship" procedure that was followed. This led to costly shipping errors and customer dissatisfaction. A procedure was developed and staff members were trained. Frequency of errors has dropped from "virtually daily" as reported by the owner to once every 4-6 weeks since January 2005.

The development of a detailed operations manual is necessary, especially to protect against knowledge loss due to employee turnover. However, this would be a time consuming and expensive project. Time devoted to this project would take away time spent on other revenue generating activities.

3.4.3.5 Planning, Integration and Continuous Process Improvement (Poor)

The interfaces between the various systems and processes are highly manual. External resources were hired to install the individual components such as QuickBooks, StoreSense, VPN. However, the automation, integration and data flows between systems has never been addressed.

3.4.4 Procurement

3.4.4.1 Supplier Management (Adequate)

Procurement is a minimal activity involving basic business supplies like paper, store cleaning supplies etc. Canada Post Express post envelopes are the most critical business input as they are the mechanism of distribution for the online and wholesale distribution channels. An inventory of envelopes is carried for each of three regions and three sizes Envelopes are ordered weekly in anticipation of the coming week's promotions. Prices are lower if they are ordered on line. If Essentials runs out of envelopes either because of delays in delivery, or heavier than expected demand, envelopes can be purchased at a premium from a local postage outlet (e.g. 7-11).

3.4.4.2 Forecasting and Ordering (Poor)

Forecasting and ordering processes are rudimentary and manual. There does not appear to be a formal forecasting process of demand. Instead orders to the manufacturer are a combination of minimal order volumes, recent sales activity by style, size and colour, and stocking up on the next season's styles. Individual orders are often large enough to support 4-6 months of sales for each style. Since physical inventory counts have not been done for some time, accuracy of inventory records is questionable. As a result of these practices, Essentials often has either too much, or too little, stock of different styles on hand.

3.5 Primary Activities

3.5.1 Warehouse/Logistics (Overall Rating of Fair)

Essentials warehouse and logistics function includes three capabilities: receiving, returns, and inventory management. For a variety of reasons (cost and relationship), inventory is never returned to the supplier in China. Transportation cost is a significant deterrent, as is the need to maintain a smooth working relationship. Receiving and inventory management are performed separately for the U.S. and Canadian markets. Each will be discussed below.

Essentials contracts out the receiving and inventory management function for product destined for the United States. Product is shipped by the manufacturer directly to the U.S. third-party warehouse. The third party supplier receives and processes the inventory, stores the inventory and performs the picking, packing and shipping functions for online and wholesale orders to U.S. destinations. Orders are processed in Canada with shipping instructions sent to the U.S. warehouse for fulfilment.

For product destined for sale in Canada, Essentials performs the warehouse and logistics functions at its retail location. Shipment of new product is "received" into QuickBooks through manual entry. QuickBooks decrements the inventory at the time of sale and charges it to COGS as part of the sales transaction. Presumably, the amount of inventory that should be on hand at any time should be readily available from QuickBooks. However, for a variety of reasons (problems with 2004 financial records, human resource constraints, distracted owner) there has not been a physical inventory count and reconciliation of actual stock to QuickBooks for some time. A physical inventory count of both US and Canadian inventories is currently being planned for late June in preparation for fiscal year end.

Inventory management is a major issue. Items are stored in boxes on shelves according to style. Replenishment of the retail store front, and online orders, are sourced from inventory. A manual checklist on the box is updated as items are removed; so that store resources know how much product they have available to sell. However, the accuracy of these manual checklists is highly questionable. The overall level of inventory is excessive. This is attributable to minimum production volumes set by the manufacturer and the tendency to hold onto "stale" merchandise (discontinued styles or colours) waiting for an opportunity to sell them. Inventory turns appear to be low.

3.5.2 Production (Fair)

As discussed earlier, Essentials performs the design function for its underwear and sleepwear styles and contracts out the production to the overseas manufacturer.

3.5.2.1 Supplier Management (Fair)

Essentials has dealt with the same manufacturer for 11 years. The relationship between Essentials and its supplier is currently under strain as a result of a significant quality problem with the elastic used in a large order of its garments. Through dialog on this issue, Essentials has gained an insight into the critical path of the manufacturer. The end to end production cycle takes a minimum of 25 business days and includes 5 days for weaving, 5 days for dying and 15 days for production. Including weekends, this is a 35-day minimum cycle time. What is evident from recent communications is that the manufacturer currently waits for firm orders from Essentials before commencing the first stage of the production process. Clearly, Essentials lacks the buying power necessary to encourage the manufacturer to adopt more lean retailing practices such as weaving and perhaps even dying fabric in anticipation of orders.

What is interesting is Essentials' lack of understanding of the supply chain despite an eleven year business relationship. For example, Essentials does not know the identity of the factory which manufactures its apparel. It is also apparent that Essentials has not actively managed this relationship, or explored other potential suppliers, in order to reduce pricing, improve product quality, shorten lead times or to lower minimum production volumes and increase frequency of production runs.

Recently, their prime contact, Mr. Li left the organization and created his own import/export business. As a result of the recent quality problems with its original supplier, Essentials is now building relationships with both the initial import/export company and Mr. Li. Since Mr. Li is familiar with Essentials' styles and business, has established relationships with a variety of factories, and is anxious to grow, this permitted Essentials what was thought to be a relatively low-risk way of experimenting with an alternative factory.

During the protracted negotiations with its current supplier, Essentials made a small test purchase from Mr. Li. Everything went smoothly. Unfortunately a follow-up colour order was produced using a different weave of silk which again affected the dimensions of the underwear and thus the fit. As a result, Essentials most popular styles differ in weave and fit depending on colour. At the moment, customers can not buy the same style in different colours and experience the same fit.

Tremendous opportunities exist to improve the quality, cost effectiveness and efficiency of the supply chain.

3.5.3 Merchandising (Range of Nonexistent to Adequate Depending on Channel)

Essentials merchandises through several channels including its retail outlet, its online stores and through third party boutiques.

Merchandising in its retail outlet is considered adequate and is performed by retail store staff. Sample styles, sizes and colours are displayed on hangers for customers to select from and try on if desired. Purchased items come individually wrapped from the supplier and can be selected from shelves or bins. Staff maintain the appearance of the store front on a daily basis, replenish stock when required and frequently change the layout of the store front to keep it fresh and appealing to customers.

Essentials does not have as much flexibility to change and update the merchandising in its online store. Only one employee is authorized to make changes to the site, and this often requires contracting out to a web designer. Thus, online merchandising is constrained by cost and lack of attention as the Marketing resource multi-tasks across channels and functions.

Essentials has little or no ability to influence how, or where, its product is merchandised in third party boutiques.

3.5.4 Advertising and Promotion (Poor)

There is no proactive marketing plan in place. Advertising and promotional opportunities tend to be impromptu and inconsistent, triggered either by inventory surpluses or slow sales periods. Essentials is constrained from under taking major marketing campaigns due a lack of human and financial resources. However, the owner has been quite creative in her ability to generate free press over the years. For example, she set up a "silk trading station" on a main street in Toronto where she traded silk underwear for anything ranging from stock suggestions to water bottles. She received very favourable attention in the press. Recently she gained free press by conducting an underwear "fashion show" at an art gallery in North Vancouver where, believe it or not, artists were exhibiting their work on the theme of "underwear".

Where print media is used, the owner or sales and marketing manager writes the copy and buys its own advertising space. The firm contracts out photography.

Word of mouth plays a key role in driving sales, particularly in its retail outlet.

Support of boutiques is minimal. There are no standard programs such as product training or co-op advertising.

3.5.5 Sales & Service (Range of Excellent to Fair Depending on Channel)

3.5.5.1 Sales & Service Essentials owned stores (Excellent for retail, Fair for online)

The owner believes in doing "almost anything" to get a customer into their first garment (right style, size and colour). After that, she believes that customers simply "keep coming back".

Since Essentials staff were hired due to their service backgrounds, service levels are high. Retail team members have been trained on the unique benefits of silk. Team members are expected to consult with customers to determine their needs, share with them the unique characteristics of silk and the construction of the garments, and to assist with styles, sizes and colour. Establishing ongoing relationships with customers, and generating positive word of mouth referrals, is a priority for all staff members.

However, the lack of an automated POS system causes the sales transaction to take too long, detracting from the customer's overall experience. There is also a heightened risk of error due to the manual entering of style and promotion codes.

The owner is a very charismatic, creative and engaging individual. I am not sure to what extent her "presence" attracts customers to shop at Essentials. The owner is currently involved in other projects which keeps her out of the store. For example, she is currently travelling in Italy for a month as part of a school program. She is also trying to develop a dynamic bar coding technology and process in conjunction with an external research company (MITACS). Due to recent quality problems and cash flow concerns, the owner was more active in the store during April and early May.

It is not as easy to control the customer's shopping and buying experience in the online store. For example, there have been recent technical problems where customers have contacted Essentials directly by email to place their orders, explaining that their shopping baskets mysteriously emptied by the time they clicked through to purchase. There is also no opportunity to provide the personal touch of consulting with the customer on the benefits of silk, styles, sizes or colour. More attention needs to be paid to the layout of the website, self-help information and calls to action.

3.5.5.2 Sales and Service Third-Party Boutiques (Fair)

For the first nine years, Essentials relied heavily on online and third party boutique channels. It is unclear how the boutiques were identified and recruited.

This emphasis changed significantly with the opening of a company owned retail store in 2003. The level of attention that Essentials has been able to provide boutiques has waned over the last year or two as its resources were distracted and stretched by illness, launch of the new retail store and support of its online business. This created an opening for the owner's ex-assistant to target the wholesale market.

Based on information from the website, Essentials has boutiques carrying its products in eight provinces. Most of the boutiques are located in Ontario, B. C. and Alberta with a smattering in Manitoba, Quebec, Saskatchewan, New Brunswick and Nova Scotia. There are also a handful of boutiques identified in the U.S. and one identified in the United Kingdom. Based on the names of the boutiques, they are targeting primarily a female market. It is important to recognize that the information on the website is somewhat out of date, listing some boutiques who are no longer active purchasers of Essentials products and failing to list other newly recruited boutiques.

There seems to be minimal, if any channel conflict between Essentials and its third party boutiques. This is probably because Essentials has a single outlet, just off a major shopping street.

Boutiques are contacted periodically by the Marketing Manager to discuss new orders. Orders are submitted by fax and are manually entered into QuickBooks. An invoice is generated to accompany the shipment. Payment is due in 30 days. Orders are shipped over night. Up until recently, Essentials has permitted boutiques to charge the purchases to their credit cards at the end of the 30-day period resulting in increased credit card fees to Essentials. Receivables have not been actively managed, with many extending 60-90 days without payment and with no interest charges applied.

Support of the boutiques has been minimal, with the exception of handling warranty returns. While there have been one or two successful co-op advertising initiatives with individual boutiques, a formal program has never been defined due to lack of human and financial resources.

The dollar value of individual boutique orders appears to have dropped quite substantially, often comparable to that of a regular retail customer, but at a deeper discount. Boutiques do not seem to be willing to carry as much stock, preferring instead to order for overnight delivery as customer demand dictates. Reasons for this are unclear but potentially include:

- Emergence of lean inventory practices,
- Loss of market share to its competitor (KAS),
- Concerns regarding quality of the product (runs in silk and stitching),
- Anecdotal stories that boutiques are suffering from a decline in customer demand,
- Lack of attention to boutiques by Essentials,
- Potentially an unwillingness to compete with Essentials retail presence.

Minimal effort has been made over the last year to identify and recruit, or to rationalize, the portfolio of third-party boutiques. Recall that 28 of the 71 active boutiques in 2004 generated only 5.7% of boutique revenues.

Even so, boutique revenues for the period January to May 2005 have increased 13.4% over the same period in 2004. (Refer to 4..9.1.1 for more detail.) While reasons for this growth have not been identified, the Marketing Manager has identified a number of new boutiques who decided to carry Essentials products after locating them as a supplier on the internet.

The ability and motivation of third-party boutiques to properly merchandise Essentials product line, to communicate the benefits and delicacy of silk, the design and construction of Essentials underwear and sleepwear is unknown.

Clearly a new wholesale third-party distribution program needs to be defined and resourced if this line of business is to continue to grow and be successful.

3.5.6 Fulfilment (Excellent)

Fulfilment is excellent. Garments come individually wrapped from the manufacturer. An Essentials sales person assists retail customers with their purchases, processes payments and places their individually wrapped garments and washing instructions in plain translucent bags. An Essentials inventory person picks and packs online and wholesale orders placing them in a bin for daily pick-up by Canada Post with overnight delivery on weekdays anywhere in North America. Orders placed on the weekend are shipped on Monday and are received by customers on Tuesday. Customers frequently comment on how happy they are with this service. There are numerous customer testimonials to this effect on the website.

3.5.7 After Sales Service (Excellent)

Essentials does everything possible to ensure a customer's perception of quality. Exchanges are done without question, even if the item can not be put back into inventory. Solutions to customer complaints are customized by sales staff, as opposed to the application of a broad brush policy. Solutions may include straight replacement, change in style, change in size or company-paid repairs. Customers are frequently compensated in some way for their inconvenience.

Bookkeeping processes are being refined to ensure that exchanges and returns (where the item is returned to inventory) and defective returns (where item must be written off) are properly recorded to ensure accurate inventory records, COGS and defective valuations.

4 FINANCIAL ANALYSIS

4.1 Financial Analysis Overview

A detailed financial analysis was undertaken in order to understand the financial performance of the company in 2004, and to estimate the relative financial performance of each channel. This information was used to prepare a Performa Income Statement for 2005 using revenue trends for the period January – May.

Financial Statements for 2004 are distorted by a large inventory adjustment and thus the associated gross margin and net operating income are not considered representative of the true financial performance of Essentials. The financial statements dated June 24, 2005 are presented and explained in Section 4.2 and are labelled “Books A”.

In order to get a more realistic picture of actual performance, and to serve as a basis for forecasting future performance, a second set of financial statements were created excluding the inventory adjustment and including the $35K U.S. debt that is missing from the company’s books. The restated financial statements are presented and explained in section 4.3 and are labelled as “Books R”. The remainder of the detailed financial analysis in Chapter 4 is based on Books R.

4.2 Books A (Official Company Financial Statements)

Table 23: Books A: 2004 Detailed Income Statement ($) January – December

		% OF SALES	$
SALES REVENUE			379,642
COST OF GOODS SOLD (COGS)			
	Garment costs	30.5%	115,961
	Duty & Brokerage Fees		34,084
	Freight – in		12,847
	Inventory Adjustment		(28,454)
TOTAL COGS			134,437
GROSS PROFIT		35.4%	245,204
Gross Margin		64.6%	
	EXPENSE		
	Accounting		5,082
	Advertising and Promotion		19,208
	Auto		1,657
	Total Bank Charges and Interest		11,420
	Communications		6,537
	Consulting		14,572
	Credit Card Commissions		11,276
	Exchange Gain/Loss		(4,019)
	Insurance		1,976
	Legal		2,620
	Meals and Entertainment		7,605
	Miscellaneous		3,987
	Office Expense (cleaning, supplies, repair & maintenance, coffee etc.)		10,960
	Payroll		61,538
	Postage		11,041
	Store rental		19,026
	Research and Development		3,330
	Sales Commissions		2,633
	Storage and Handling		2,011
	Supplies (Marketing, Store hardware, other)		1,670
	Travel		3,010
	Utilities		1,185
	Total Website		12,268
TOTAL EXPENSE			210,593
NET ORDINARY INCOME			34,611
NET OTHER INCOME			(401)
NET OPERATING INCOME			34,210

Source: Adapted from QuickBooks 2004 Income Statement Report revised June 24, 2005.

On the surface, Essentials appears to have generated a large positive net operating income of $34.2K. However, this is primarily due to a $42.7K inventory adjustment. The original income statements for 2004 included a $14,258 write off of inventory. In June 2005, it was discovered that the inventory listed on the balance sheet was significantly under valued. Two problems were discovered: inventory in the U.S. had not been included, and the exchange rate had not been applied in order to convert the inventory from U.S. to Canadian dollars. (Overseas suppliers were paid in U.S.D.)

In order to correct for the under valuation, a $-28,454 ($14,258-$42,712) was made on the Income Statement and a new set of books were issued dated June 24, 2005. As a result of this adjustment, COGS were reduced causing significant increases in both gross margin and net operating profit.

A corresponding $47.7K adjustment was made to the inventory asset line on the balance sheet bringing total inventory as of December 31, 2004 to $126.7K. Another item worth noting is the $103K long term liability. At the time of incorporation in January 2003, the owner rolled over $150K of assets into the company, and a shareholder loan was created. Since that time, the company has paid down the shareholder loan to $103K. The value of the loan will continue to erode as Essentials continues to pay the owners living expenses.

Table 24: Books A: 2004 Balance Sheet ($) January - December

		December 31, 2004[1] ($)
ASSETS		
Current Assets	Cash	34,680
	Accounts Receivable	25,823
	Inventory	126,735
	Prepaid	794
	Total	188,032
Total Fixed Assets	Computers, furniture, software	13,124
TOTAL ASSETS		201,156
LIABILITIES		
Current Liabilities	Accounts Payable (Cdn & US, Visa)	37,264
	Other (GST, PST, payroll)	5,686
	Investor Loan	30,000
Total Current Liabilities		72,951
Total Long Term Liabilities	Shareholders Loan	103,446
Total Liabilities		176,397
Equity	Retained Earnings[2]	(26,441)
	Net Income[2]	51,200
Total Equity		24,759
TOTAL LIABILITIES AND EQUITY		201,156

1 This balance sheet summarizes information in the new QuickBooks accounting system from January 1 to December 31 2004 as provided by the bookkeeper on June 24, 2005. The statements were revised to reflect an increase in inventory valuations of $42,711.

2 There appear to be discrepancies in data. Presumably, the total equity number should equal the total of net incomes for the years since incorporation, namely 2003 and 2004. However, based on the historical numbers presented in Table 1, retained earnings for 2003 should be $ -52,370. What is confusing is that the Income Statement for 2004 shows a net income of $34.2K. Thus, total equity should be approximately $-18,378. Yet the balance sheet shows $24,759.40. Clearly the retained earnings and net income numbers do not match other documents. This discrepancy is considered to be outside the scope of this project and will be brought to the attention of the bookkeeper and owner for resolution.

4.3 Books R (Restated 2004)

An adjusted set of books were created in order to remove the distortion caused by the one time inventory adjustment, and to correct for the fact that a $35K U.S. liability does not appear on the company's books. In addition, since the long term liability is to the owner, it was determined appropriate to roll the value of the shareholder account into shareholder's equity.

Table 25: Books R: 2004 Restated Income Statement ($) January – December

		% OF SALES	$
SALES REVENUE			379,642
	COST OF GOODS SOLD (COGS)		
	Garment costs		115,961
	Duty & Brokerage Fees		34,084
	Freight – in		12,847
	Inventory Adjustment		0
TOTAL COGS		42.9%	162,892
GROSS PROFIT		57.1%	216,750
Gross Margin			
	EXPENSE		
	Accounting		5,082
	Advertising and Promotion	5.1%	19,208
	Auto		1,657
	Total Bank Charges and Interest		11,420
	Communications		6,537
	Consulting		14,572
	Credit Card Commissions	3.0%	11,276
	Exchange Gain/Loss		(4,019)
	Insurance		1,976
	Legal		2,620
	Meals and Entertainment		7,605
	Miscellaneous		3,987
	Office Expense (cleaning, supplies, repair & maintenance, coffee etc.)		10,960
	Payroll	16.2%	61,538
	Postage		11,041
	Store rental		19,026
	Research and Development		3,330
	Sales Commissions		2,633
	Storage and Handling		2,011
	Supplies (Marketing, Store hardware, other)		1,670
	Travel		3,010
	Utilities		1,185
	Total Website		12,268
TOTAL EXPENSE			210,593
NET ORDINARY INCOME			6,156
TOTAL NET OTHER INCOME			(401)
NET INCOME			5,756

Source: Data extracted from Company's income statement dated June 24, 2005.

1 In order to get a more accurate view of financial performance, inventory adjustments were assumed to be zero.

The inventory adjustment has been removed from COGS. COGS therefore increased and net operating income decreased from $34K to $5.7K.

Table 26: Books R: Restated 2004 Balance Sheet ($) January - December

		December 31, 2004[1] ($)
ASSETS		
Current Assets	Cash	34,680
	Accounts Receivable	25,823
	Inventory	126,735
	Prepaid	794
	Total	188,032
Total Fixed Assets	Computers, furniture, software	13,124
TOTAL ASSETS		201,156
LIABILITIES		
Current Liabilities	Accounts Payable (Cdn & US, Visa)	37,264
	Other (GST, PST, payroll)	5,686
	Investor Loan	30,000
	$35KUS loan from 2003	43,750
Total Current Liabilities		116,701
Total Long Term Liabilities	Shareholders Loan	0
Total Liabilities		116,701
Shareholder Equity[1]		84,455
TOTAL LIABILITIES AND EQUITY		201,156

Source: Data extracted from Company's financial statements dated June 24, 2005.

1 The $35K U.S. loan has been added as a liability and the $103.4K shareholder loan has been rolled into shareholder equity.

Restating the company's balance sheet to include the $35K U.S. loan and collapsing the shareholder loan into equity results in a balance sheet with assets of $201,156 and $84,455 in shareholder equity.

4.4 Analysis of Essentials 2004 Income Statement (Books R)

Based on the restated income statement, the company would have generated a $5.7K net operating income. This represents a significant improvement over prior years (Refer to Table 1). However, this appears to have occurred more by accident than by design. In order to get a better understanding of the financial performance and to identify potential areas for improvement, the most significant revenue and cost items are investigated below.

4.4.1 Revenue, COGS, Gross Margin

Revenues fell 7.4% in 2004. Garment costs were 30.5% of sales. (Table 25) Associated duty, brokerage and freight costs totaled $46.9K. COGS was 42.9% and gross margin was 57.1%. These ratios are considered to be the best estimates of both actual performance in 2004 and future performance in 2005 and will thus be used throughout the rest of the financial analysis.

4.4.2 Accounting

Bookkeeping expenses were minimal at $5K. (Table 25) Based on a billing rate of $35 per hour, this equates to 143 professional hours or an average of 2.7 hours/week in 2004. Clearly this was inadequate to clean up the financial records on a timely basis. 2005 billings are unknown, but anecdotally it is evident that the bookkeeper's availability to Essentials is minimal. Essentials requires more bookkeeping attention to improve and maintain the integrity of its books.

4.4.3 Advertising

Advertising and promotion expenses were 5.1% of sales. (Table 25) Most of this appears to have been charged to an "other" category and not spent on traditional advertising mediums such as print advertising. The effectiveness of advertising and promotional activities could be improved with a proactive marketing plan for each channel with ROI measured for each advertising initiative.

4.4.4 Bank Charges

Bank charges and interest is treated as a catch all category and is used to reconcile records in QuickBooks to monthly bank balances. It appears that the bookkeeper simply calculates the difference between sales revenue in QuickBooks and monthly bank deposits from its credit card payment processing partners and charges the difference to bank charges and interest. As such this line item includes legitimate bank charges and interest, but also includes charge backs due to credit card fraud.

It became evident in Q1 2005 that there was a significant problem with credit card fraud in both its U.S. and Canadian online stores. Efforts have recently been made to tighten up credit card approval processes and as a result credit card fraud has dropped off considerably. In addition, the bookkeeper and office manager are being trained on how to use reports from the credit card processor, Paymentech. This will allow them to separate out credit card commission fees, other fees and charge backs so that they can be entered separately into QuickBooks.

4.4.5 Consulting Fees

Over the last few years the owner has hired consultants to assist with specific projects including the writing of business plans, the research, selection and installation of an e-commerce capability (StoreSense, Verisign, Paymentech) and installation of VPN.

4.4.6 Communications and Credit Card Commissions

Communication costs of $6,500 were incurred to cover costs of local service, features, toll free number, cell phone and yellow page listings. (Table 25) Upon review, the only major opportunity to cut cost would be to reduce or eliminate cell phone charges.

4.4.7 Office Expenses

Essentials incurred $11K in office related expenses. (Table 25) A review of the costs indicate a wide array of items. Attention should be given to this cost category to ensure that only the minimum in office expenses are incurred.

4.4.8 Payroll

Payroll related expenses were by far the most significant expense item totaling $61.5K (16.2% of sales). (Table 25) This includes wages, vacation pay and contributions to Canada Pension Plan and Employment Insurance for the full time staff person and a minimal amount of casual labour.

4.4.9 Postage

Postage for delivery of online and wholesale orders totaled $11K. (Table 25) This is somewhat misleading in that boutiques pay for the cost of shipment. These funds are included in the revenue line. While free shipping has been a cornerstone of the online business, changes are being made to charge shipping for orders under $50. This will result in a significant portion of online orders being charged for shipping.

4.4.10 Store Rental

Rent costs of $19K were incurred in 2004, equal to approximately 5% of sales. (Table 25) Rental costs have increased marginally in 2005 to a forecasted $21.5K to reflect improvements made in air conditioning. Essentials has a multi-year lease with an option to renew.

Rent charges for its current location are probably low relative to other possible locations such as on a major shopping street or in a mall location.

4.4.11 Website

The final significant cost category is that of website related expenses. These totaled $12.2K in 2004. (Table 25) This line item includes costs of credit card handling fees (flat fee portion only), website design and programming, security and server costs.

4.5 Analysis of Essentials 2004 Balance Sheet (Books R)

Essentials has assets totaling $201.2K and total liabilities of $116.7K resulting in total owner's equity of $84.5. (Table 26)

4.5.1 Assets

Most of the current assets are tied up in inventory. (Table 26) The second largest current asset is accounts receivable of $25.8K. Cash reserves were $34.7K at the end of the year. However, cash reserves have been significantly drawn down in 2005 to pay $23K US towards an outstanding loan.

4.5.2 Liabilities and Owners Equity

At the end of 2004, Essentials had $116.7K in current liabilities on the company's books. This includes the $35K U.S. loan. (Table 26)

The original set of company books shows a shareholder loan balance of $103K. Since the owner is the sole shareholder, this line item was rolled into shareholder equity. Thus, by the end of 2004, shareholder equity was $84.5K.

4.6 Debt Load as of June 2005

Total debt has climbed to approximately $300,000; $200,000 of which is personal debt and 100,000 is associated with the business.

Table 27: Composition of Debt

Business Debt		Personal Debt	
Amount	**Details**	**Amount**	**Details**
$25K CDN	Heavily utilized overdraft on operating bank account	$200,000	Line of credit secured by the owner's father
$15K US	Outstanding balance on a $35KUS loan dating back to 2003		
$60K	Participatory Debenture – Investor receives 8% per annum paid monthly and 2% of sales paid quarterly		
~$100K		$200,000	

4.6.1 Personal

The owner has a $200,000 line of credit secured by her father. This loan funded the $150K of assets that were rolled into the business when it was incorporated in January 2003.

4.6.2 Essentials

Essentials has a $25K overdraft on its bank account and routinely operates using the overdraft. This appears as a negative asset on the balance sheet rather than as a liability.

Essentials also has a $35K loan from an individual in the U.S. Between January and June 2005, $23K had been repaid, leaving an outstanding balance of $12K US.

There is also a $60K participatory debenture with an investor who is to receive 8% per annum, paid monthly and 2% of sales to be paid quarterly. The first $30K was invested in October 2004 and the latter $30K in April of 2005. The former can be found on the 2004 balance sheet, and the latter will appear on the 2005 balance sheet.

4.7 Profitability by Channel

In order to better understand the drivers of revenue and cost affecting the Income Statement and profitability ratios, it is helpful to consider the profitability of the individual channels (or lines of business), namely, Retail, Online and Wholesale. Unfortunately, Income statements by channel are not available from QuickBooks. However, by combining and massaging information from a QuickBooks 2004 class report and the 2004 Income Statement `(Books R), it was possible to estimate the gross margins, to allocate direct and indirect expenses, and to determine approximate contribution to overhead generated by each channel, namely, Retail (including phone/fax/email); Online (Canada and US) and Wholesale (Canada and US). In total, it was possible to allocate 72% of total expenses.

4.7.1 Revenues and Gross Margins

Revenue, COGS and gross margin estimates by channel can be found in Table 28. Estimates of gross margin for each channel were calculated using information from a QuickBooks 2004 class report. The report provides separation of revenue, COGS and gross profit between several "classes" including retail, wholesale, and an "unallocated" class. There were several issues that had to be overcome in order to determine the relative profitability of each channel.

1. Both online and retail revenues were attributed to the retail class and thus had to be separated.
2. Only a portion of COGS were allocated to individual classes (i.e. garment costs). All other costs (duty and brokerage, freight and inventory adjustments) were charged to an "unallocated class" and had to be allocated.
3. The report did not have a separate class associated with phone, fax and email orders as did the manual sales tracking report used to derive information in Chapter 1. The $48,410 of revenue was assigned to other classes probably based on mailing address. It appears that most of that revenue was allocated to the retail class. As a result of this practice, the adjusted Retail BC number is not purely "walk-in" business, but also includes phone, fax and email sales.
4. The report did have separate classes for production and affiliate customer groups. However, since the revenues are relatively minor in nature (3% of sales) and are supported by shared resources, for simplicity purposes these revenues were also rolled into the "Adjusted Retail BC" numbers.
5. Manual keying errors during 2004 resulted in $4088.88 of revenue being entered into QuickBooks without being attributed to a specific "class". This class is included in Table 28 for completeness, but is ignored for purposes of the analysis.

Table 28: Estimated 2004 Gross Margin by Channel

2004 Income statement by channel	% of sales	Online				Wholesale			
		Adjusted Retail BC (note 1)	Adjusted Canada (note 1)	US (note 4)	Euro (note 5)	Canada	US (note 4)	Unal-located (note 3)	Total (note 6)
SALES REVENUE		199,802	60,743	24,317		88,692	1,985	4,089	379,627
Percent of total revenue		52.6%	16.0%	6.4%		23.4%	0.5%	1.1%	100.0%
COST OF GOODS SOLD (COGS)									
Garment costs (note 2)		51,401	22,386	5,414		37,143	1,074	(1,117)	116,301
% of revenue average and by channel	30.6%	25.7%	36.9%	22.3%		41.9%	54.1%		
Duty & Brokerage Fees (note 2)	9.0%	17,938	5,453	2,183		7,963	178	367	34,083
Freight – in (note 2)	3.4%	6,761	2,056	823		3,001	67	138	12,847
Total COGS		76,101	29,895	8,420		48,108	1,319	(611)	163,230
GROSS PROFIT		123,702	30,847	15,897		40,584	666	4,700	216,397
Gross Margin		61.9%	50.8%	65.4%		45.8%	33.5%	115.0%	57.0%

Source: Derived from QuickBooks 2004 class report.

1 Separate "classes" do not exist for Retail and Online channels. There is however, a geographical breakdown of the "retail" class which permits easy separation of the class into three: BC retail, "online Canada (except for BC)" and online U.S. The resulting 'retail BC" number was comprised of walk-in, online and phone/fax/email sales in B.C. Adjustments were made to estimate what total Canadian online revenues and COGS were. See Appendix A for details.

2 Garment costs by channel were available from QuickBooks. Garment costs as a % of sales varies by channel, with garment costs averaging 30.6% of sales across all channels. Duty and brokerage, and freight were not broken down by channel, but were instead charged to an "unallocated" class. In order to generate meaningful gross margin numbers, these latter cost categories were allocated to channels based on the percentage of total sales each channel represented. In order to provide what are considered realistic numbers inventory adjustments have been excluded from this analysis.

3 The unallocated column includes revenues that were not properly assigned to classes in the accounting system. A small negative COGS number resulted from a discrepancy between COGS charged to the "unallocated class" and figures on the income statement.

4 It is assumed that duty, brokerage, and freight costs for importing into the U.S. have been assigned to the same "account" as for importing to Canada. Thus any differences in duties or brokerage charges are not apparent between the Canadian and U.S. operations.

5 The Euro site did not generate any revenue in 2004 but did generate costs. Thus, in order to be complete the Euro channel is included here.

6 Two minor discrepancies were identified between the revenue and COGS reported in the 2004 restated Income Statement and QuickBooks 2004 Class Report. These amounted to a $353 discrepancy in gross profit. This variance was considered immaterial and for consistency purposes the QuickBooks Class Report numbers were used to determine relative profitability of the various channels.

Assuming that the above assumptions and allocations are correct, it appears that BC Retail (walk-in, phone/fax/email, affiliates and production) outperformed all other channels in terms of revenue ($199.8K), gross profit ($123.7K) and all but one channel in terms of gross margin (61.9%). (Table 28) The Canadian Wholesale operation was second in terms of revenue ($88.7K) and gross profit ($40.6K) but second lowest in terms of gross margin (45.8%). This is not surprising given that boutiques receive a standard discount rate of 50% off retail. The online Canadian channel was third in terms of revenue ($60.7K) and Gross Profit ($30.8K) and is middle of the pack with a 50.8% gross margin. The U.S. online business was fourth in terms of revenue ($24.3K) and gross profit ($15.9K), but had the highest gross margin (65.4%). This would suggest that sales in the U.S. were not as deeply discounted as in the Canadian online store. Wholesale U.S. came in at the bottom in terms of revenue ($1,985) gross profit ($666.12) and gross margin (33.6%).

4.7.2 2004 Cost of Goods Sold (COGS)

4.7.2.1 COGS

COGS include three cost categories: garment costs, duty and brokerage fees, and freight. Inventory adjustments are ignored. Garment costs as a percentage of sales varied from a low of 25.7% for retail to a high of 54.1% for U.S. Wholesale.

Duty, brokerage and freight were allocated according to the relative percentage of sales for each channel. (Table 28)

4.7.3 Allocation of Expenses

Each line item on the 2004 detailed income statement (Books R) was reviewed and categorized as being either a direct, indirect or overhead cost. Direct costs were traceable back to a single channel, whereas indirect costs were shared across two or more channels. Certain costs were deemed to be overhead (or business sustaining) costs.

Table 29 outlines the direct and indirect costs allocated to each channel, and estimates the contribution each channel makes to overhead costs. The table also includes a total column which shows total contribution to overhead costs, total overhead costs to be covered, and the resulting net income number from operations.

Table 29: 2004 Direct and Indirect Expenses ($) by Channel (Ignoring impact of inventory adjustment)

		Adjusted Retail BC (note 1)	Online			Wholesale		Unallo-cated	Total (note 4)
			Adjusted Canada	US	Euro	Canada	US		
Sales Revenue		199,802	60,743	24,317		88,692	1,985	4,089	379,627
GROSS PROFIT		123,702	30,847	15,897		40,584	666	4,700	216,397
Gross Margin		61.9%	50.8%	65.4%		45.8%	33.5%	115.0%	57.0%
EXPENSE (note 3)									
Advertising and Promotion	direct	19,208							19,208
Credit Card Commissions	indirect	5,934	1,804	722		2,634	59	121	11,275
Insurance	indirect	988	494			494			1,976
Office Expense (cleaning, supplies, repair & maintenance, coffee etc.)	indirect	5,480	2,740			2,740			10,960
Payroll	indirect	46,167	5,192	2,079		7,581	170	349	61,538
Postage (note 2)	indirect		4,489			6,554			11,043
Store rental	indirect	9,513	3,867			5,646			19,026
Storage and Handling (note 2)	direct			1,859			152		2,011
Supplies (Marketing, Store hardware, other)	direct	1,670							1,670
Utilities	indirect	592	241			352			1,185
Total Website	indirect		4,089	4,089	4,089				12,268
TOTAL DIRECT & INDIRECT	Total	89,553	22,916	8,749	4,089	26,002	380	471	152,160
Contribution to Overhead		34,149	7,931	7,148	(4,089)	14,582	285	4,229	64,236
% of sales contributing to overhead		17.1%	13.1%	29.4%	0.0%	16.4%	14.4%		
Other Expense									
ICBC claim, unclaimable GST	Total								58,435
NET ORDINARY INCOME									5,802

Source: Data derived from QuickBooks 2004 class report and 2004 Income Statement.

1. Adjusted Retail B.C. includes Production and Affiliates and phone/fax/email.
2. Assumes postage is attributable to Canadian operations only. Postage associated with U.S. online and U.S. Wholesale channels is assumed to be included under storage and handling fees.
3. Methodology for allocation of indirect costs can be found in Appendix B.
4. Small variances exist in revenue, COGS and gross profit between the two source documents. (Refer to Note 6, Table 28) QuickBooks 2004 class report numbers are used for purposes of this analysis.

Table 30: Expenses categorized as Overhead

Overhead Expense	$
Accounting	5,082
Auto	1,657
Total Bank Charges and Interest	11,420
Communications	6,537
Consulting	14,572
Legal	2,620
Meals and Entertainment	7,605
Miscellaneous	3,987
Research and Development	3,330
Sales Commissions	2,633
Travel	3,010
Exchange Gain/Loss	(4,019)
Total	58,435

Source: 2004 Restated Income Statement (Books R)

[1] Sales Commissions are treated as overhead since it was a one time occurrence.

4.7.4 Assessment of Channel Profitability

All channels, with the exception of Euro Online, cover their share of direct and indirect costs and also contribute to overhead, although to different degrees. (Table 29) Thus, all else being equal, all channels (except for the Euro online and possibly the US Wholesale channel) should be maintained. However, the financial and human resources may not be available to do so.

Despite having the highest direct and indirect cost allocations, the retail operation is the dominant channel, contributing the most to overhead in real terms ($34.1K) and having the second highest contribution percentage to overhead (17.1% of sales). All other channels fall far below retail.

Wholesale is second in terms of absolute contribution ($14.6K) and third in terms of percentage contribution (16.4%). The Canadian online and U.S. online channels rank third and fourth in terms of absolute contribution ($7.9K and $7.1K respectively). However, there are wide variances in their relative percentage contribution with US online dominating all other channels at 29.4% of sales.

Canadian online has the lowest contribution to overhead at 13.1%. This is attributable to its relatively low gross margin of 50.8% and to its share of the indirect costs of the Canadian operations.

4.8 Financial Ratios

Financial Ratios were based on the restated financial statements, Books R.

Table 31: Restated Financial Ratios

Measure	Ratio
Liquidity Measures	
Current Ratio	1.6
Quick Ratio	0.5
Activity Measures	
Inventory Turnover	Very Low
Days' Receivables	104
Leverage Measures	
Debt Ratio	0.6
Debt To Equity Ratio	0
Times Interest Earned	Not Available (2)
Profitability Measures	
Gross Profit Margin	57.1%
Net Profit Margin	1.5%
Return On Assets	2.9%
Return On Equity	6.8%

Source: Based on restated 2004 Income Statement and Balance Sheets from Section 4.2.

[1]Inventory records throughout 2004 are inaccurate. Therefore it would not be meaningful to calculate inventory turns using this information. From the inventory assessment performed in section 1.6, it is evident that excessive inventory is on hand and that inventory turnover is low.

[2]Since interest payments can not be isolated from the income statement, the times interest earned ration can not be calculated.

4.8.1 Liquidity Measures

Liquidity measures determine the ability of a firm to meet short-term obligations.

4.8.1.1 Current Ratio

On the surface, the current ratio appears acceptable at 1.6. Since the $35K U.S. loan was not properly entered in the company's books, it will also be paid for out of the shareholder account using current assets of the company.

Furthermore, excessive inventory exists for most styles in both Canada and the U.S. 25% of the inventory units are for the 11 least popular styles which cumulatively represent only 19% of unit sales in 2004. Thus, the current ratio appears to be overly optimistic.

4.8.1.2 Quick Ratio

A more precise calculation is to focus on the ratio between monetary current assets and current liabilities. The quick ratio excludes the value of inventory from current assets. Essentials quick ratio is .5 and is calculated by dividing current assets-inventory / current liabilities.

It is clear that Essentials does not have enough cash on hand to meet its current liabilities (including the $35KUS loan).

4.8.2 Activity Measures

Activity measures provide an indication as to how efficient a firm is in generating sales with its assets.

4.8.2.1 Days' Receivables

The average collection period for the wholesale business (the only one that sells on credit) appears to be excessively high at 104. Accounting theory suggests that the average collection period should not exceed 1 1/3 times the regular payment period. Since sales to boutiques are "net 30", the average collection period should be 45 days. Essentials collection period is more than twice that. This should not be surprising since interest is not currently being applied on outstanding invoices beyond 30 days, and there is no proactive collection process in place. Consequently, boutiques do not have a compelling incentive to pay on time.

4.8.3 Leverage Measures

Leverage measures determine the degree of indebtedness of a firm and its ability to meet long term obligations.

4.8.3.1 Debt ratio

Essentials has a debt ratio of .6. This means that the company's assets appear to be much greater than its liabilities. This is largely due to the fact that the $103K shareholder loan has been rolled into shareholders equity. While this treatment does provide a better picture of the true value of owner's equity, it is somewhat misleading. After all, the $103K is in fact a loan that needs to be repaid if the owner is going to be able to pay down her personal debt.

4.8.3.2 Debt to equity ratio

Since there is no long-term debt, the company has a non-existent debt to equity ratio.

4.8.4 Profitability Measures

Profitability measures indicate the returns on assets and equity generated by the business.

4.8.4.1 Gross Profit Margin

Based on the recently revised financial statements, Essentials generated a 57.1% gross margin.

Gross margins by channel (Table 29) range from a low of 33.6% (U.S. Wholesale) to a high of 65.4% (U.S. Online). In dollar terms, the Adjusted BC Retail channel ($123.7K) outperforms Canadian wholesale ($40.6K), Adjusted Canadian Online ($30.9K) and US online ($15.9K). The remaining channels are insignificant contributors.

4.8.4.2 Net Profit Margin, Return on Assets and Return on Equity

Ignoring the large inventory adjustment, Essentials achieved a 1.5% net profit margin, a 2.9% ROA and a 6.8% ROE.

4.8.4.3 Conclusions based on Ratio Analysis

Liquidity, activity and leverage measures are poor. Current assets are comprised primarily of inventory assets. Liquid assets will be used to pay off part of the shareholder account and to cover the $35K US loan. Inventory turnover is low and collection periods for the wholesale business are inordinately long. Leverage ratios do not appear to be of concern. However, in reality the $103K shareholder loan, while equity, still needs to be repaid.

From a profitability perspective, Essentials appears to have been marginally profitable in 2004, which is a huge improvement over 2002 and 2003.

2005 will be a critical year for Essentials. It will be critical for the business to generate a positive net income. Current debt sources are tapped out. An additional $30K loan was established in April 2005 to keep the company afloat. However, the cost of this debt is relatively high at 8% interest + 2% of sales. These terms also apply to the $30K loan secured in Q4 2004. In the first half of 2005, the owner paid back $23K US of the $35K US loan. The remaining $12K US must also be paid back, ideally in 2005.

4.9 Performa 2005 Income Statements (Status Quo Scenario)

A detailed 2005 Performa budget has been prepared reflecting actual sales trends January through May, forecasted sales for the remainder of the year, increases in staffing and associated labour costs, and increased storage and handling fees for the U.S. operation.

Upon inspection it appears that Essentials operating expenses have grown considerably, particularly in terms of staffing related costs. While revenues are growing, they are not growing at a rate sufficient to compensate for the forecasted level of expenses.

4.9.1 Current View 2005 Income Statement

Table 32: Current View 2005 Income Statement

Current View "Status Quo" July 2005		Q1	Q2	Q3	Q4	Total
Ordinary Income/Expense		$	$	$	$	$
Income		81,396	94,572	109,080	157,318	442,367
COGS (garment, duty & brokerage, freight-in, inventory adjustment)	43.0%	35,000	40,666	46,905	67,647	190,218
Gross Profit	57.0%	46,396	53,906	62,176	89,671	252,149
Expense						
Accounting		1,800	1,800	1,800	1,800	7,200
Adv & Promo		4,151	4,823	5,563	8,023	22,561
Bank chgs&interest		3,000	3,000	3,000	3,000	12,000
Investor						
% sales- qtrly			1,891	2,182	3,146	7,219
interest pd monthly			1,200	1,200	1,200	3,600
Total FT labor		16,768	20,936	20,936	20,936	79,575
Total PT labour		6,129	7,340	7,260	7,260	27,989
Total Labour		22,897	28,276	28,196	28,196	107,564
Total communication		2,025	2,025	2,025	2,025	8,100
Consulting		7,800	7,200	2,400	0	17,400
Courier & Post		30	30	30	30	120
Credit Card Commissions		2,360	2,743	3,163	4,562	12,829
Dues, Licences and Subscription		332	332	332	332	1,326
Insurance		428	428	428	428	1,710
Internet Access, Late fees and Finance Charges		120	120	120	120	480
Meals & Entertainment		1,050	1,050	1,050	1,050	4,200
Office Expenses		3,000	3,000	3,000	3,000	12,000
Payroll Expenses		2,748	3,393	3,384	3,384	12,908
Postage and Delivery		2,767	3,215	3,709	5,349	15,040
Product Sewing Repairs		60	60	60	60	240
Total Rent		5,376	5,376	5,376	5,376	21,504
R&D		150	150	150	150	600
Sales Commissions		0	0	700	0	700
Storage and Handling		1,260	1,260	1,260	1,260	5,040
Total Travel		150	150	150	150	600
Utilities (Hydro)		375	375	375	375	1,500
Total Website		3,156	3,156	3,156	3,156	12,624
Total Expenses		65,034	75,053	72,807	76,171	289,065
Net Ordinary Income		(18,639)	(21,147)	(10,631)	13,500	(36,916)

Revenue as of June 10, 2005 is up approximately 15% over the same period in 2004 (Table 31). By extrapolating this trend, it is forecasted that 2005 revenues will reach $442.4K. (Table 32) Based on data available from the channel profitability analysis in chapter 4, average COGS is estimated to be 43% of revenue, resulting in a 57% gross profit. At current staffing levels and updated storage and handling costs, total expenses will reach $289,065. Net ordinary income for the calendar year would be $-36916. Clearly this is not a tenable position for Essentials. To aid us in the analysis, COGS, labour, payroll and website costs are decomposed below.

4.9.1.1 Revenue Trends by Channel January to May 2005

A break down of revenues by channel shows significant percentage growth in online channels, more moderate growth in wholesale and virtually no growth in the adjusted BC Retail channel. The latter figure is somewhat misleading as it includes moderate growth in walk in and email/phone/fax sales which are offset by declines in demand from film companies and affiliates.

Table 33: Channel Revenue Performance January - May 2005

	$ Revenue January – May		Growth	
Channel	**2004**	**2005**	**$**	**%**
Online Canadian	17,959.91	27,243.20	9,283.29	51.7%
Online US	6,450.87	10,836.25	4,385.38	68.0%
Wholesale	26,842.31	30,948.35	4,106.04	15.3%
BC Adjusted Retail				
Walk-in	55,282.31	61,472.38	6,190.07	11.2%
Email/phone/fax	18,134.40	19,780.18	1,645.78	9.1%
Production	6,606.87	5,128.00	(1,478.87)	-22.4%
Affiliates	5,761.36	-	(5,761.36)	-100%
Total BC Adj Retail	85,784.94	86,380.56	595.62	.7%
Total All Channels	137,038.10	155,408.36	$18,370.26	13.4%

Source: Manual Daily Sales Tracking Reports 2005.

4.9.1.2 Investor Related Expenses

The investor cost category is a new line item. (Table 32) It reflects the terms of the participatory debenture that was negotiated in April of 2005 and discussed in section 4.6.2 The $60K investor loan is forecasted to cost Essentials $10.8K for the period April through December 2005. Clearly this is a fairly expensive form of financing.

4.9.1.3 Labour and Labour-Related Expense Breakdown

Table 34: Labour and Labour-Related Expense Breakdown

	Q1 ($)	Q2 ($)	Q3 ($)	Q4 ($)	Total ($)
Full-time labor					
Marketing Manager	11,250	11,250	11,250	11,250	45,000
Office Manager	5,218	8,870	8,870	8,870	31,827
Office Manager	300	816	816	816	2,748
Total Full-Time labour	16,768	20,936	20,936	20,936	79,575
Part-time labour					
Inventory	1,560	1,280	1,200	1,200	5,240
Sales	4,464	5,760	5,760	5,760	21,744
Extra Casual hours	105	300	300	300	1,005
Total Part-Time labour	6,129	7,340	7,260	7,260	27,989
Total Labour	22,897	28,276	28,196	28,196	107,564
CPP / EI / Vacation Pay					
CPP / EI					
Full Time	1,341	1,675	1,675	1,675	6,366
Casual	490	587	581	581	2,239
Vacation pay					
Full Time	671	837	837	837	3,183
Casual	245	294	290	290	1,120
Payroll Expenses	2,748	3,393	3,384	3,384	12,908
Total Labour and Payroll	25,644	31,669	31,579	31,579	120,472

With optimistic expectations, Essentials significantly increased its labour-related expenses from 16.2% of revenue in 2004 to a forecasted 27.2% of revenue in 2005. A staff member was promoted to Marketing Manager with a doubling in salary to $45,000 per year. An office manager was hired at an estimated hourly wage cost of $34,800 per year including over time. Two part-time sales positions at $12.00 per hour have been created to cover store hours Monday to Saturday. A part-time inventory management position at $10.00 per hour has been created to manage inventory and to pick, pack and ship online and wholesale orders. Total wages add up to $107,564. CPP, EI and vacation premiums total $12,908, bringing total labour-related costs at current staffing levels to $120,472. Clearly Essentials can not afford this level of staffing.

4.9.1.4 Forecasted 2005 Website Related Expenses

Table 35: Forecasted Website Expenses

	Q1 ($)	Q2 ($)	Q3 ($)	Q4 ($)	Total ($)
Credit Card handling	675	675	675	675	2,700
Design	900	900	900	900	3,600
Programming	540	540	540	540	2,160
Security	60	60	60	60	240
Server	981	981	981	981	3,924
Total Website	3,156	3,156	3,156	3,156	12,624

Even though Essentials would benefit from improvements to the look and feel of the website, website related expenses have been held constant at $12.6K. Essentials pays e-Commerce suppliers fees for each of the websites (Canada, US and Euro): $75/month for credit card handling (other fees such as credit card commissions are included in other line items), and $107.50 per month for the server. Essentials uses the services of a web designer and a web programmer to update the websites. The budget includes one hour of design time per week and three hours of programming time per month. This level of support will basically keep the site running, but will not allow for any improvements.

4.9.2 Sensitivity Analysis

Revenues would have to reach $507,132 in order to break even at the current forecasted expense level of $289,065. Forecasted revenues are forecasted to reach $442,367 which falls short of this break even point by $64,765. To reach this number, revenues would have to grow by 33.6% over 2004 levels. Given the current revenue growth trajectory of 15%, and with half the year gone, this does not appear to be feasible.

Alternatively, costs must be reduced by almost $40,000 or 13.8% in order to break even. However, since the calendar year is almost half over, very deep cuts in the order of 25+% would be required in order to reach break even. Most costs are fixed in the short term. However, major pruning of labour-related expenses would save up to $38K, generating a small net operating profit of $1,186. These changes would involve the owner eliminating the Marketing Manager and part-time sales positions effective July 1 2005 and performing those roles herself going forward.

Table 36: ***Effects of Reduction in Staff***

	Q1 ($)	Q2 ($)	Q3 ($)	Q4 ($)	Total ($)
Full-time labor					
Sales/Mktg	11,250	11,250	0	0	22,500
Ofc Mgr	5,218	8,870	8,870	8,870	31,827
Ofc Mgr	300	816	816	816	2,748
Total FT labor	16,768	20,936	9,686	9,686	57,075
Part-time labour					
Inventory	1,560	1,280	1,200	1,200	5,240
Sales	4,464	5,760	0	0	10,224
Extra Casual hours	105	300	300	300	1,005
Total PT labour	6,129	7,340	1,500	1,500	16,469
Total Labour	22,897	28,276	11,186	11,186	73,544
CPP / EI / Vac Pay					
CPP / EI					
Full Time	1,341	1675	775	775	4,566
Casual	490	587	120	120	1,318
Vac pay					
Full Time	671	837	387	387	2,283
Casual	245	294	60	60	659
Payroll Expenses	2,748	3,393	1,342	1,342	8,825
Total Labour and Payroll	25,644	31,669	12,528	12,528	82,370

Thus, even if the business manages to break even, current assets will be unable to cover the $35KU.S. loan payment. It is estimated that the owner would have to raise an additional $44K to cover these expenses or generate an additional $76K in revenue. In order to meet both operating and shareholder loan requirements at full staffing, revenues would have to reach $518K. This represents a growth rate of 36% over 2004.

It seems clear that even with the elimination of two full time positions; the current business model is unsustainable, even in the short term, without additional financing. If revenues come in at around forecast ($442.3K), the owner will have to raise approximately $44K in order to cover the $35K U.S. loan. Raising additional capital will not be easy given the financial health of the firm.

5 ISSUES

The top priority is determining how to survive the year, and buy enough time to sell or to reorganize. This means dealing with the forecasted operating shortfall of $36K and the remaining $12K outstanding U.S. loan. Unfortunately there are no panaceas or magic bullets.

The longer term objective is to determine how to reorganize to attain, sustain and grow profitability.

There are four categories of short and long-term issues to be addressed. They include: owner considerations, financial issues and constraints, external factors, and internal value chain issues. Each will be discussed at length below.

5.1 Owner Considerations

The owner has recently returned from a trip overseas, and has concluded that she wants to sell the business. The owner is worn out, emotionally and financially. She is ready to pursue other personal and professional goals. As a result, she has minimal energy and interest to invest in improving the business before selling. She recognizes that this means the business may sell at a lower price than it otherwise could.

The owner acknowledges that revenue growth has been flat for several years, and that she has been unsuccessful recruiting and retaining the necessary skill sets to effectively transition from a one person operation to a growing small business with multiple employees. She believes that someone with the requisite skill sets could achieve success.

Her target price, including inventory, is $400K but hopes to sell for over $500K. The owner believes that she should at least be able to get a price equivalent to one times revenue. She believes that at this price she would be able to leave the business with a clean slate, having settled all her business and personal debts. Whether purchasers exist who are willing to pay this price is unknown. The business has not been independently appraised.

5.2 Determining Fair Market Value

5.2.1 Valuable Features of the Business

Despite its inconsistent financial performance to date, the business does have a number of potentially valuable features to a purchaser.

First, the business has generated approximately $400K in revenue for several years in a row. This has been despite staff turnover, lack of financial management, and an owner whose energy and time were divided between assisting an ailing parent and her business. Second, Essentials has built some brand equity over the years, establishing a small loyal retail customer base of 300+ customers and 48 active wholesale boutique customers. Third, Essentials inventory assets as of June 2005 total $152K which, at 2004 COGS ratio of 30.6%, could theoretically be converted into approximately $500K in revenue. Fourth, the company has an established e-commerce capability with two viable but underperforming websites and supporting fulfilment operations in U.S. and Canada. Fifth, Essentials has an affordable and potentially viable retail presence in an upper scale neighbourhood with three years remaining on a renewable lease. The store comes complete with the necessary merchandising displays, shelves, work desks and computers to continue operation. These have a book value of approximately $13K. Finally, Essentials has a well established supply chain involving two alternative importers and exporters in China and brokers in both Canada and the U.S.

In its current financial condition, the key to maximizing the sale price will be to find a purchaser who determines that the business and its assets are under-performing and that the purchaser has the right skill sets and superior intuition to take the business it to the next stage of development.

5.2.2 Valuation of the Company

The owner has set a minimum selling price of a minimum of one times annual revenue ($400K). However, this is based on personal objectives as opposed to professional estimates of the fair market value.

A standard approach to calculating a firm's value is the Gordon Growth Model, which essentially discounts the value of future earnings. (Carlson and Sargent 1997) Since a history of positive net earnings has not been achieved by Essentials, and revenues have remained flat for several years, this approach would result in a zero value for Essentials. This is believed to be an overly pessimistic representation of the firm's true value.

In contrast, the Internal Revenue Service (Murphy 1998) has published several rulings regarding business valuation. Revenue ruling 59-60 identifies numerous factors relevant to valuing Essentials including:

- The financial condition of the business,
- Value of goodwill or other intangible assets,
- The nature and history of the business since its inception,
- The economic outlook and condition of the specific industry.

From this perspective, fair market value is normally considered to be the total of the adjusted book value of tangible assets minus liabilities plus a value for intangible assets such as goodwill. For Essentials, the December 31, 2004 restated book value of tangible assets (cash, receivables, inventory, prepaid expenses and fixed assets) minus liabilities was $84,455. However, this number must be adjusted upwards to include both the fair market value (as opposed to book value) of the inventory and the value of goodwill (brand name, reputation and clientele).

As mentioned earlier, the $152K of inventory on hand in June 2005 could generate as much as $500K. The buyer and seller would have to come to an agreement on what the fair market value of the inventory would be. Some potential purchasers might value the inventory below cost, others "at cost" of $152K, while others may agree that it has a retail value in excess of its cost. The upper end would be "at full retail value" of $500K.

Optimistically, the right buyer would agree to a price somewhere between cost and full retail value. For example, if the buyer were to agree to discount the maximum fair market value of the inventory to include only the most popular 11 styles, the inventory would be worth in the neighbourhood of $380K ($254K over December 31, 2004 book value).

The value of goodwill is much more difficult to estimate. According to Murphy, goodwill is primarily based on earning capacity. Theoretically, the presence of good will, and thus its value, depends upon the excess of net earnings over and above a fair return on the net tangible assets. Evaluated in this manner, Essentials inconsistent financial performance over the years would not warrant much goodwill.

However, Murphy goes on to add that other factors such as prestige of the business, ownership of trade or brand name and a record of successful operation over a prolonged period in a particular location may furnish support for the inclusion of intangible value. When one considers Essentials intangible assets such as functioning U.S. and Canadian websites, a small loyal retail and wholesale customer base and associated brand equity, and the fact that it has been in business for 11 years with the last two years being in its current location, a case can be made to include some allowance for goodwill in the purchase price. Furthermore, the future prospects of both the intimate apparel industry and Essentials primary target market of 45+ females are both positive.

In addition, the owner has indicated a willingness to assist a new owner during a six month transition period. This would further increase the good will of the business.

Thus, while the Gordon Growth Model would value this firm at zero, it is possible that a buyer may be found. As long as a distress sale is avoided, the owner may be able to sell for more than the $84.5K book value of the firm. The actual selling price would be largely determined by the buyer's subjective evaluation of the value of the inventory and goodwill. It is considered unlikely that a buyer would be found who would be willing to pay the owner's target selling price of $400K.

5.3 Financial Issues and Constraints

5.3.1 Current Financial Situation

The company's financial performance has been inconsistent over the years due to the lack of strong financial management. The large inventory correction has masked true operating performance in 2004. These factors combine to make the company unattractive to both potential investors and purchasers.

In early 2005, two full time equivalent positions were added effectively doubling payroll related expenses. Unfortunately, a 15% revenue growth rate, combined with a 57% gross margin, is insufficient to offset the increases in forecasted expenses. On the current trajectory, Essentials will lose $36.9K this calendar year.

Heroic efforts will have to be made on both the revenue and cost fronts if Essentials is to be able to cover operating requirements and fund the draws on the shareholder account.

5.3.2 Constraints

5.3.2.1 Financial

Available sources of financing are currently fully utilized. Recent sources of financing have proven to be expensive. It is uncertain whether the owner will be able to raise additional funds from outside investors to assist her while she reorganizes.

Current assets must cover not only business-related expenses, but must also cover draws on the shareholder account. Thus, cash flow is an ongoing problem. As of June 2005, there was a back log of $48K in accounts payable with approximately $10K in cash and $11Kin accounts receivable to draw on.

One of the greatest financial constraints is the lack of accurate and timely financial and management information. Historical records prior to January 2004 are not readily available. Historical accounting data is spread across multiple systems and generations of databases. The accuracy and validity of the available data is questionable. Discrepancies exist between financial statements.

5.3.2.2 Human

The current revenue stream is insufficient to support three to four full time positions. Even with three to four full time positions, human resources are stretched to the maximum learning and performing highly manual processes in support of six channels.

The company, and employees, are pursuing too many different opportunities and achieving only moderate success in each. Reductions in staff will require Essentials to focus strategically on only a few opportunities. Decisions will have to be made to prioritize and rationalize geographic opportunities, target market opportunities, channels and product line (styles/colours).

5.3.3 Differences in Profitability Across Channels

5.3.3.1 2004

In 2004, Essentials supported six different channels, four of which were covering direct and indirect expenses and thus were contributing to overhead. While encouraging, due to lack of time and resources, none of them have achieved more than moderate success. Two channels (Online Euro and U.S. Wholesale) failed to perform adequately.

Essentials wholesale revenue base seems to have declined since it opened its own retail outlet in 2003. By 2004, the retail channel had become the dominant channel in terms of absolute contribution to the business. Despite its higher cost structure, it outperformed all other channels in real terms ($ contribution to overhead), and all channels (except for U.S. Online) in relative contribution to overhead (% sales).

The U.S. online channel is currently contributing minimally from an absolute perspective reflecting limited penetration of the U.S. market. However, it has the highest contribution to overhead per sales dollar of 29.4%. This is because the U.S. online channel has a different business model, involving contracting out the receiving, warehousing, picking and packing functions. Given the 29.4% contribution level, Essentials would benefit from growing the U.S. online business.

On the other hand, the Canadian operations (online, retail and wholesale) share resources and facilities. As a result, as long as Essentials has a retail presence, it is not considered feasible to consider adopting a U.S.-like model in Canada.

5.3.3.2 2005

2005 sales results for the period January through May are encouraging. However, Wholesale US and Online Euro continue to under perform.

5.4 External Issues

5.4.1 Competitive Advantages / Disadvantages

Essentials competitive advantages and disadvantages differ by geographic market and distribution channel.

In terms of the online U.S. market, Essentials appears to compete most directly with Wintersilks for the casual, practical silk underwear market. Essentials is at a disadvantage relative to Wintersilks in terms of the range of product categories that it carries, its premium price point and durability (hand wash versus machine wash).

In terms of the Canadian online market, KAS has copied Essentials product line and price points. Thus, Essentials differentiation is threatened. Currently, KAS appears to be focused exclusively on the Canadian online and wholesale markets. KAS may have benefited from Essentials lack of attention to maintaining and growing the wholesale market over the last two years.

While it is unknown how much online advertising the U.S. and Canadian competitors do, Essentials penetration of the U.S. and Canadian markets is limited by the lack of proactive marketing.

One of Essentials competitive advantages relative to KAS is the existence of the retail outlet which provides Essentials with key insights and feedback from its customers, and the opportunity to build loyal customer relationships. The downside of the retail operation is that it detracts Essentials limited resources from focusing on online and wholesale distribution channels. This creates an under served market for KAS to address.

The retail outlet serves a segment of the population (45+ women) that is not currently being targeted by large national intimate apparel chains like La Senza and La Vie En Rose.

Furthermore, there seems to be minimal channel conflict with its boutique customers, probably attributable to the fact that Essentials is a single store operation outside of a main shopping areas.

5.4.2 Customer – Related Issues

5.4.2.1 Customer Loyalty / Vulnerability

Contrary to the owner's beliefs, the company appears to have a relatively low repurchase rate amongst its customers. Only 19.6% of regular customers bought twice in 2004 and 12.7% bought three or more times.

While small, this latter group translates into a lucrative base of 308 regular customers. These customers represent only 12.7%of the customer base, but generate 31.2% of the revenue from regular customers (24.3% of total revenue). Thus, while Essentials benefits from this customer base, it is also highly vulnerable to the loss of loyal customers.

In order to continue to build and maintain a growing base of loyal customers, Essentials needs to be able to provide consistency in product (fit, feel, function, appearance) over time. This capability has proven to be rather elusive over the last year.

Developing a loyal customer base is made even more difficult by the relatively low consumer brand awareness of Essentials, in both online and retail channels. Furthermore, Essentials must address the low awareness and preference levels for silk relative to other fabrics.

5.4.2.2 Market Segmentation

Essentials is attempting to serve too broad a target market. While the owner initially thought her market was anyone between the ages of 18 and 92, the retail market that has emerged for her product line appears to be 45+ upper middle income women. Essentials does have a small male clientele, despite the fact that it has done little in the way of proactive marketing to target that segment. In the short to medium term, Essentials does not have the financial or human resources available to pursue all market segments.

Essentials also has gaps in its understanding of customer needs and thus in its ability to tailor programs to address those needs. Decisions are made based on the owner's intuition and personal tastes, rather than based on customer insight and understanding. For example, no demographic or psychographic information is available on its online customer base.

5.5 Internal Value Chain Issues

5.5.1 Product

There are several important issues associated with Essentials product line. First, Essentials must address inconsistencies in production, and design concerns that affect customer perception of quality (i.e. silk weight, weave and durability).

Second, Essentials lacks strong product differentiation in both the U.S. and Canadian markets.

Third, given its limited resources, its product line is too diverse in terms of gender, number of styles and colours. This results in high inventory levels of slow moving product.

5.5.2 Poor Inventory Management Processes

The firm is inventory rich, but cash poor. Inventory levels have continued to grow in 2005, growing from $126.7K to 152K by June. Assuming that the inventory can be turned into sales revenue at a COGS ratio of 30.6%, current inventory levels could theoretically be converted into sales of $500K. This represents more than one year's worth of sales.

Forecasting and ordering processes are rudimentary and manual. Inventory management processes and control are poor. Thus, inventory levels are much too high, particularly in its low volume styles and in its U.S. warehouse. Inventory turns are very low.

5.5.3 Poor Supply Chain Management

Essentials currently has strained relationships with its suppliers in China due to inconsistencies in the manufacturing of its garments. Essentials is perceived as a small but squeaky wheel. Inadequate attention is paid to explicitly defining technical product specifications and to working with the suppliers to ensure that they are consistently met. The owner incorrectly believes that this is primarily the responsibility of the manufacturer.

5.5.4 Lack of Website Technical and Marketing Expertise

Essentials website is both basic and passive in nature. No proactive online advertising has been undertaken in order to drive traffic to the website. As a result, it has low brand awareness and low locatability/attractability. Furthermore, the website has fairly low contact (hits to visits), conversion (visits to purchases), and retention (repeat purchases) efficiencies.

Despite being one of the first online stores on the internet, Essentials does not have a strong internal website capability. To date, technical design and programming activities have been contracted out. Essentials lacks a clear vision for its website and the technical design, programming and marketing skills to execute on it.

5.5.5 Lack of Automation

Given limited human and financial resources, Essentials can not afford to remain as a predominantly manual operation.

5.5.6 Lack of Documented Processes

Almost none of Essentials business processes are adequately documented. This makes the business highly vulnerable to the knowledge loss associated with staff turnover. Consequently, each staff departure represents a significant set back for Essentials.

5.5.7 Missing Competencies

In summary, Essentials is missing many of the skills necessary to be successful in the long term.

- Financial management skills such as planning, budgeting and controlling are virtually nonexistent. Financial statements are not actively used to manage the business.
- Bookkeeping and accounting skills, processes and systems are poor.
- Technical garment design skills do not exist.
- System integration (internal and external with suppliers and wholesalers) is missing.
- Website technical design and programming skills are contracted out.
- Marketing skills (especially online) are weak. Essentials does not have a proactive marketing plan for its retail, wholesale and online channels. A marketing plan would address all four "Ps" of marketing including product, price, distribution and advertising/promotion.
- Hiring processes focus on acquiring required skill sets.

5.5.8 Existing Competencies

The owner has managed to survive for 11 years and achieve modest success based on her sound intuition and gut instinct for the business. In order to maximize the transferability of these skills, a purchaser should negotiate for the owner to remain on during a transition period.

Aside from these skills, Essentials greatest competencies are in the areas of selling to and servicing its walk-in retail and wholesale boutique channels.

6 RECOMMENDATIONS

The owner must take immediate steps to both reduce costs and increase revenue in order to minimize the amount of external financing required and to avoid a distress sale. She should also take specific actions designed to prepare the business for sale and to maximize its fair market value. Should she be unable to sell the business for her minimum target price, she should reorganize and run the business to achieve, sustain and grow profitability. Sound financial management over the course of a year or two could significantly improve the attractiveness of the company to potential purchasers. Recommendations for each of these three stages (Survival, Get Ready to Sell, Reorganize) are addressed below.

6.1 Stage One: Survival

Immediate steps must be taken to both reduce costs and increase revenue. Opportunities for cost reduction are identified first, followed by opportunities for revenue generation.

6.1.1 Costs

Many cost categories are either fixed in the short to medium term (such as rent) or are variable in nature and can not be controlled (such as credit card commissions, postage etc.). Cost categories that can be managed are discussed below, and recommendations are made for each.

6.1.1.1 Payroll

While the operating shortfall could be entirely addressed by eliminating both the sales and Marketing Manager positions, this is not recommended. This is considered to be too extreme. Essentials can not afford the immediate knowledge loss of the Marketing Manager, nor can the operation continue to function, reorganize and grow with only two people.

Instead, it is recommended that the part time sales positions be filled by the owner and that the Marketing Manager position be reduced to half-time. The Marketing Manager is amenable to a reduced work schedule. Her duties should be revised to include support of the website and documentation of web-related activities. The owner would also take on the marketing and advertising roles. It is estimated that these steps would save $25,500 in 2005 in the latter half of 2005.

6.1.1.2 Advertising and Promotion

Advertising and promotion is another potential candidate for cost savings. Advertising and promotion expenses for 2004 were the equivalent of 5.1% of sales. However, it is not certain that the funds were spent in the most cost effective manner. Given the key dependency of sales on advertising, cuts to this cost category must be made carefully. It may be possible to reduce the percentage somewhat and still maintain revenue growth by concentrating on the return on investment for each advertising campaign. It is estimated that a reduction from 5.1 to 4.1% of sales would save approximately $4.4K.

6.1.1.3 Website Expenses

The Euro website should be closed immediately resulting in a savings of approximately $2.1K during the latter half of 2005.

6.1.1.4 Storage and Handling

Storage and handling costs in the U.S. have increased due to the increase in inventory. Reducing the inventory levels would bring costs down from approximately $5K to $2K per year. Inventory levels can be reduced by paying duty and bringing items into Canada to sell.

6.1.1.5 Other Controllable Cost Categories

Efforts should be made to reduce the reliance on the Marketing Manager's cell phone. It is estimated that $1.2K could be saved in the latter half of 2005 by increased use of land line phone calls.

It might also be possible to reduce office expenses which are currently forecasted at $1000 per month. Employees should be encouraged to order the minimum required levels of supplies etc. A target 10% reduction should be implemented, equivalent to $1.2K.

6.1.1.6 Total Cost Reductions

By taking the above measures, the business would reduce its costs by 37.4K, which is enough to offset the forecasted operating shortfall. However, it is insufficient to cover the other cash commitments.

6.1.2 Revenue

Efforts must be made to convert inventory assets into cash at reasonable gross margins as quickly as possible. There are a number of different ways to do this. Specific suggestions include:

- Recruit boutiques that serve male clientele in Vancouver, Calgary and Toronto in order to clear slow moving men's and unisex styles;
- Bring excess inventory from the U.S. warehouse into Canada since Essentials current customer base is primarily in Canada;

- Develop promotions aimed at clearing excess and slow moving inventory (e.g. current colour sale);
- Increase units sold per sale;
    - design an offer that encourages customers to buy their average yearly allotment of five pairs of underwear in one shopping visit at Essentials. This builds on the success of the April 2005 "3 underwear pack" sale and online "buy more and save" campaigns;
- Merchandise to appeal to both the dominant shopping styles (buying separates, buying sets);
    - merchandise and sell "sets" on line and in the front of the store at a slight discount over buying them individually;
- Increase the average dollar value per sales transaction by bundling and cross-selling at every opportunity;
    - develop scripts and train employees to bridge "underwear only" sales into purchases of related higher margin garments such as camisoles, sleep shirts, and other garments for the upper body;
    - track single style versus multiple style sales and set a target for improvement;
- Encourage repeat purchases and word of mouth;
    - offer an incentive if the customer re-purchases, or refers another customer who purchases, within 30- 60 days of the original purchase;
    - generate lists of, and contact customers, who have previously purchased styles, sizes and colours for which there is a lot of inventory;
- Experiment with other sales channels;
    - try a table at the Vancouver Flea Market.

6.1.3 Mezzanine Financing

Additional external financing will probably be required in the short term. The owner may have to turn to family and friends if external financing is either unavailable or too expensive.

6.2 Stage Two: Prepare to Sell

In the short-term, Essentials should do what is necessary to keep the four channels (retail, wholesale, Canadian online, US online) in operation as each presents an option to a potential buyer & could be attractive if considered to be under performing. The U.S. website in particular could be lucrative in the right hands.

The financial history and health of the company will be of prime concern to potential purchasers. Essentials needs to have a set of financial statements that provides a reasonable reflection of its financial performance. Now that the owner intends to sell, the integrity and timeliness of financial information is of critical importance. Both the seller and buyer would be interested in determining a realistic fair market value.

Thus, it is imperative that the backlog of bookkeeping entries for 2005 be cleared in terms of deposits and bank reconciliations. A more efficient and effective manner of reconciling online sales with ultimate bank deposits must be determined. Training of the office manager needs to be completed, so that she is in a position to maintain the books in a proper manner. Any adjustments required as a result of the recent inventory counts should be entered. Financial statements for the fiscal year ending July 31, 2005 should then be prepared.

Services of a Chartered Accountant (CA) should be engaged to both ensure that the financial statements appear reasonable and to assist with running the business in a manner that would maximize profitability and thus selling price. A CA should review both year to date and fiscal year end financial statements in order to spot any potential discrepancies and to provide advice to the owner, bookkeeper and/ or office manager on any issues. The CA could also anticipate questions that potential purchasers might ask and assist the owner in preparing responses. This would help ensure that the owner's business is positioned in the best possible light.

The CA could also assist the owner in reviewing financial statements on a weekly, bi-weekly or monthly basis. The CA could interpret the trends and information contained therein, allowing the owner to take early corrective and decisive action. The objective would be to establish consistent improvements in performance month to month. Even a few months of consistent upward performance could greatly influence the selling price of this business.

6.3 Stage Three: Reorganize to achieve and sustain profitability

If the owner is unable to sell the business for her minimum target price in the short term, she should reorganize the company to focus on what the owner and company does well. By focusing on achieving and sustaining profitability over a relatively short period of time (six months to two years), the company would become much more attractive to potential purchasers.

Strategic and tactical ideas on how the business should be reorganized are included below. While tailored to the current business and its competencies, many of these recommendations could be adopted by a purchaser who wishes to take the company to the next level of development.

The goal of the reorganization is to achieve a state of strategic fit between Essentials internal capabilities and external market forces (customers, suppliers, competitors) which creates a sustainable competitive advantage. Achieving this fit should provide Essentials with the ability to achieve, sustain and grow profitability.

6.3.1 Strategy

It is recommended that Essentials pursue a clear niche differentiation strategy. Let's look at each dimension of this strategy separately.

6.3.1.1 Niche Market

Essentials should focus exclusively on the 45+ female market. Essentials has proven to be successful serving this segment from its retail outlet. The attractiveness of this target market will continue to grow as the demographic group increases and since 45+ women significantly outspend other age groups in terms of intimate apparel.

Essentials should continue to specialize in silk underwear and sleepwear since the intimate apparel sector is growing faster than other apparel sectors. The sector is also benefiting from product innovations which create higher margin value-added products such as shapewear, which are of particular interest to the older and plus-size consumer segments.

6.3.1.2 Differentiation

Essentials has two basic strategies to select from, cost based or differentiation. Essentials does not have the economies of scale to achieve a low cost position in the silk underwear market. Instead, Essentials should pursue a differentiation strategy within its niche market.

Despite its attempts to establish a private label brand, it is apparent that there is a strong commodity element to underwear and silk wear. As Essentials has experienced, it is extremely difficult to establish a brand purely based on the characteristics of its product line. The lack of intellectual property and rapid product innovation mean that intimate apparel brands must be based on a broader foundation. In the case of Essentials, its unique brand differentiation should involve elements of its product, its specialization and its superior service.

Essentials should continue its brand positioning as "simple and sensible" silk underwear and sleepwear for every day wear. Essentials should not emphasize the sensuousness of its products, as other competitors have effectively claimed that ground. Essentials should however emphasize that its products are affordable luxuries.

Essentials should position itself as a "silk underwear and sleepwear specialist", using its retail outlet to develop and emphasize its superior knowledge and understanding of both customer needs and product benefits. Essentials should also highlight its superior service levels for retail, online and wholesale customers.

In summary, Essentials value proposition must answer two key questions for customers – Why should I buy silk undergarments and sleepwear? Why should I purchase (and repurchase) from Essentials? Its advertising and its sales process (both online and retail) should both build awareness and preference for silk underwear, the Essentials brand, and the Essentials shopping experience.

6.3.1.3 Channels or Lines of Business

Due to the lack of financial and human resources, it is recommended that Essentials focus its scarce resources on those channels where it has core competencies and competitive advantages (Retail and Wholesale) and abandon its online operations.

Essentials strengths are in the personal selling, fulfilment and servicing of its retail and wholesale client base. While its wholesale performance has suffered in recent years due to the opening of its retail location, it is believed that Essentials has the core competencies to recover and to do wholesale well.

Maintaining its retail presence offers Essentials with a number of competitive advantages. First, it is a channel that its primary Canadian competitor, KAS, does not use. Second, it provides physical access to a segment of the target market which prefers to shop face to face, and which is increasingly choosing to shop at specialty stores instead of traditional channels. Third, it provides an opportunity to learn about its target market and how to better meet their needs either through its own retail store or third-party boutiques. Fourth, there is no direct retail competitor, regionally or nationally, that is exclusively focused on serving the intimate apparel needs of 45+ year old women.

In terms of wholesale, Essentials should focus on increasing revenues to its top 48 boutiques and to attract other, potentially high volume boutique outlets. The wholesale program should be designed to include support provisions (perhaps co-op advertising, merchandising advice, point of purchase materials, training on silk etc.), the application of interest on balances outstanding at the end of 30 days, and an active collection process. Average collection periods should be significantly reduced to around 45 days.

Unfortunately, while Essentials was one of the first online retail stores, it does not have the internal competencies to do this well. It currently has a passive yet functional website presence. However, it is weak in terms of locatability/attractability and in the visual appeal and interest necessary to convert hits to visits and ultimately visits into purchases and repurchases. Essentials lacks a clear vision for its website and the associated technical design, programming and marketing skills. Furthermore, competition on the web is becoming increasingly intense both in terms of the number of sellers, but also in terms of their level of online marketing sophistication. In order to try and grow its online sales, Essentials would have to make a significant investment in growing its internal capabilities.

By abandoning its online operations, Essentials can concentrate its limited resources (human and financial) on improving the financial performance of its remaining two channels, namely wholesale and retail.

However, should a purchaser materialize who is interested in leveraging and developing the website capability, recommendations on how to improve the locatability/attractability and conversion effectiveness of the website have been included in section 6.3.2.8 below.

6.3.2 Tactics

6.3.2.1 Product – Related Recommendations

In order to fully meet the intimate apparel needs of the 45+ female niche market, Essentials will have to initially reduce and then later expand its product line. In the short term, Essentials should focus on clearing out styles that are either low volume sellers, and / or are targeted at other market segments (e.g. male market). In the longer term, Essentials should consider expanding its product line to better serve the 45+ segment by adding shapewear, silk-synthetic blends, larger plus-sizes and potentially even bras. However, additions to the product line should not be made until Essentials is financially stable and has significantly reduced its inventory levels.

Essentials should minimize the number of colours that it carries. Essentials should focus on its neutrals and carry only one or two other carefully selected colours to add some splash to its stores (retail, online and wholesale). The inclusion of numerous colours means higher inventory levels due to minimum order quantities. Since colours sell more slowly than neutrals, this means that neutrals are sold out and need to be replenished, while inventories of coloured items grow.

Essentials should re-position its unisex designs and sizing as women's. Anecdotal reports indicate that the proportions of several of the unisex designs (e.g. long sleeve and long pants) do not fit men properly. For example, the arm length and body length of long sleeve shirts are reported by some customers as being too short. This would also bring this product line into positioning with its target market.

Essentials needs to apply special attention to rectifying manufacturing inconsistencies and quality design issues associated with future orders. The owner needs to gather feedback from customers (loyal and one time purchasers) on each style in order to understand what changes should be made to designs, weaves, and weight of silk etc. For example, sleep shirts are considered by many customers to be too transparent for their purpose. While the owner may disagree, she should test the attractiveness of the sleep shirts at different silk weights with her customers.

Essentials should endeavour to cross-sell and upsell at every opportunity. Items should be bundled together. For example, sets of camisoles and panties. Efforts should be made to promote higher price point / high margin items. Bundling a less popular item with a more popular item may be an effective way of clearing inventory.

6.3.2.2 Customer Recommendations

Essentials needs to understand the intimate apparel (specifically underwear and sleepwear) needs and wants of 45+ year old women better than its competitors. It also needs to understand the reasons behind the relatively low repurchase rate of its customers. In order to achieve this, Essentials should implement some form of a customer feedback program for both one-time purchasers and loyal customers.

Loyal customers should be regularly contacted to assess their perceptions of Essentials and its products and service levels. Intention to continue purchasing should be measured. Changes in buying patterns should be monitored. Any changes in intention levels, buying patterns, or negative customer feedback should be promptly addressed. This could include a personal phone call from the owner. Opportunities for improvement should be identified that will help maintain and grow a loyal customer base. Word of mouth advertising should be encouraged.

A sample of one-time purchasers should be contacted in order to assess their perceptions of Essentials products and service, and to determine the primary reasons why they have not repurchased. Opportunities for improvement should be identified.

Essentials should gather and record customer information (contact, age, gender, household income etc.). This information should be used to develop tailored marketing strategies aimed at addressing the specific needs and purchase behaviour of identifiable groups (e.g. plus sizes, sleep shirt lovers, those who have indicated an interest in shapewear etc.)

6.3.2.3 Automation

Opportunities for automation have been missed as systems were implemented in isolation of one another. In order to keep labour costs down, improve accuracy, and create capacity for growth, Essentials should

- Install a point of sale terminal to reduce the manual keying required to create a receipt;

- Download ordering and receiving of supplier shipments directly into QuickBooks inventory records, effectively eliminating manual entry;
- If the decision is made to retain the online stores, Staple should;
  - download customer orders from the Online stores directly into QuickBooks, effectively eliminating manual re-keying and generation of invoices,
  - build an online store for wholesale orders, eliminating the current manual ordering taking and invoice generating process.

6.3.2.4 Documentation of Processes

In order to insulate Essentials from knowledge loss associated with staff turnover, Essentials needs to create a detailed operations manual. While some progress has been made in this area much more needs to be done. The owner needs to create the time for the existing resources to document what they know for future reference. Since this is not immediately customer service or revenue impacting, the incentive will be to procrastinate. However, doing so could result in debilitating knowledge loss.

A detailed operations manual would help ensure uninterrupted operations and prevent Essentials from losing ground due to staff transitions. A detailed operations manual would abbreviate learning curves, thus helping to ensure continued forward momentum.

6.3.2.5 Inventory Management

Essentials should implement lean retailing principles including reducing its inventory levels and increasing its inventory turns. It should not be unreasonable to target for a minimum of three to four inventory turns per year. This would reduce the amount of inventory on hand from the current $152K to approximately $50K which would significantly improve cash flow.

In order to do so, Essentials forecasting and ordering processes would have to become more sophisticated. Full inventory counts should be scheduled for year end, and rotating inventory counts should occur monthly as a barometer check.

6.3.2.6 Supply Chain Management

The owner should be actively managing her supply chain, looking for ways to reduce garment costs, reduce minimum order quantities, and improve the quality and consistency of her product. Presumably, globalization, free trade, and excess manufacturing capacity should combine to reduce prices of products manufactured in China. Essentials should be diligent in negotiations to ensure that they are receiving the best possible prices. Furthermore, Essentials should endeavour to identify plants in China that are prepared to manufacture in smaller order quantities. This would give Essentials more flexibility and reduce its overall inventory level. A reduced product line (styles and colour) as discussed in section 6.3.2.1 would also aid in this regard. Furthermore, Essentials needs to invest much more effort in documenting its designs and technical specifications, and working with its suppliers to improve the quality and consistency of manufacturing.

Efforts should be made to automate the ordering and receiving of shipments. Standard excel formats could be designed to allow for automatic population of QuickBooks inventory fields.

Essentials should strive to be a better customer, by owning and defining the exact specifications of its garment designs.

6.3.2.7 Financial Management and Other Competencies

The owner needs to become familiar and comfortable with financial statements, budgeting and general management. Tight control over costs while achieving aggressive revenue growth will be required. Consideration should be given to hiring a Chartered Accountant to ensure that the books are maintained in a quality and timely manner according to GAAP. The importance of this recommendation can not be over emphasized.

Financial Statements should be available within five business days of month end. Income Statements and Balance Sheets should be reviewed monthly and corrective action taken as necessary.

When hiring in the future, the owner needs to hire for specific skills. These would include bookkeeping, garment design skills, technical web skills, marketing (as opposed to just advertising) skills and experience in the intimate apparel sector.

6.3.2.8 Website

In order to become an effective online retailer, a purchaser would have to invest to develop a vision for the online business (U.S. and Canadian), and to recruit the necessary design, programming and marketing skills. While it would be possible to contract out some of these skills, it is recommended that these skills become internal core competencies.

In terms of its online stores, the purchaser should experiment with online advertising such as banner/display ads and pay per click in order to see if they can drive traffic to their website, and if that traffic in fact translates into increased sales. At the same time, the company should invest in improvements to the visual look and feel of its web pages and should implement pop-ups and text aimed at cross-selling, promoting product attributes and its unique value proposition (product, specialization and superior service).

Specific suggestions for improvement include:

- Migrate from the current horizontal format with floating, unanchored images to more of a vertical catalogue orientation to give the illusion of catalogue shopping;
- Migrate from a philosophy of simplicity where all images are presented on a single page with minimum text, to a more engaging structure which generates interest and curiousness, leading the visitor progressively deeper into the site;
- Improve the visual representation of the products through better quality images (better photography and use of attractive 45+ models);
- Highlight on the home page answers to "Why silk?" and "Why Essentials?";
- Recognize that the website takes the place of consultative face to face selling, and that well positioned and thought out call to actions play a vital role in leading the

visitor through the sales process (awareness of personal needs, liking the products and company, and ultimately purchasing);

  - for example, Victoria's Secret recently revamped website has several call to action boxes on its home page such as "Think Sale" and "Think New". These stimulate the customer to think "I should check out what's for sale and I should think about buying new items for the Fall". This would be the type of thought pattern one would induce through personal selling;

- The home page and supporting web pages should be updated and revised periodically in order to maintain the interest of new and returning customers.

In terms of the U.S. online store, Essentials should ascertain whether customers are price sensitive, and if so, whether the prices of its products should be brought closer in line with Wintersilks.

The Canadian online store is a lower priority as it has the lowest contribution to overhead. However, an analysis should be undertaken immediately in order to understand why the Canadian online channel has a gross margin (50.8%) that is significantly lower than either retail (61.9%) or U.S. online (65.4%) channels. For example, is the level of discounting in the Canadian online store much higher than other channels?

APPENDICES

APPENDIX A:

Methodology for separating the "Retail Class" into retail, online Canadian and online U.S. revenue, COGS and gross profit streams:

Step 1: Subclasses existed by province and for the U.S. Therefore, it was easy to extract data for Online US and for Online Canada (with exception of BC).

Step 2: Split "Retail BC" class into retail and online streams. (Retail streams include a portion of phone, fax, and email orders separately identified in manual sales tracking report used in chapter 1 and are therefore not strictly "walk in" business.)

1. In Chapter 1, it was identified that 16% of total revenue originated from the Canadian online store. Using this number, I estimated what the total Canadian online revenues should be using the QuickBooks class report total revenue number.
   a. Total QB class revenues: $379,641.50
   b. Est. Canadian online sales @ 16%: $60742.64
   c. Subtracted "Online Canada (except for BC)": $55252.75
   d. Estimated BC online revenue: $5489.89
   e. Transferred $549.89 of revenue from BC Retail revenue total to Canadian Online total.
2. An adjustment to COGS was made assuming that the BC online revenues would have the same % COGS as "online Canada (except for BC)".
   a. Online Canada (except for BC) COGS: 36.85%
   b. Estimated COGS associated with $5489.89 of BC revenue: $2023.25
   c. "Online Canada (except for BC)" COGS adjusted upwards by that amount.
   d. BC Retail COGS was adjusted downwards by that amount.
3. The BC Retail numbers were then modified to include minor revenue and COGS originating from VIP and staff classes.
4. Gross profit and gross margins were then calculated for each adjusted category.

APPENDIX B:

Indirect costs were allocated to channels according to the following methodology:

Expense Item	2004 Expense ($)	Allocation Basis
Credit Card Commissions	11,276	2.97% of sales
Insurance	1,976	50% retail, 50% other, none to U.S.
Office Expense (cleaning, supplies, repair & maintenance, coffee etc.)	10,960	50% retail, 50% other, none to U.S.
Payroll	61,538	sales to retail/ other % of sales
Postage	11,041	as 7.39% Cdn online and wholesale note 5
Store rental	19,026	50% retail sq footage & 50% Cdn warehouse-%sales
Utilities	1,185	50% retail sq footage & 50% Cdn warehouse-%sales

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