EDITORIAL

MUSICIAN'S FRIEND FINANCIAL MESS

Last month, following the financial collapse of one of the industry's most venerable retail institutions, we asked, "What Happened To Manny's?" This month, newly released financial information on the largest and most prominent mail-order company prompts us to ask, "What Happened To Musician's Friend?" For the year ended December 31, 1998, the Medford, Oregon-based mail-order firm lost a breathtaking \$11.0 million on sales of \$94.0 million. Struggling with a crushing \$2.2 million in interest expense and an \$11.0 million negative net worth, and faced with continued losses into 1999, Musician's Friend management confronted a painful choice in June of this year: Sell out to Guitar Center or prepare for a visit to Bankruptcy Court.

Local retailers, both large and small, have railed against mail-order competition for decades. The standard complaint goes something like this: "With a low overhead operation, catalogs use price and no sales tax to skim the market we invest to create. We do all the work selling and displaying the product; then, after visiting our store, the customer goes home, calls an 800 number, and saves sales tax."

Mail order may have certain competitive advantages; however, the massive losses at Musician's Friend suggest anything but a "low overhead" operation. Just consider that the cost of turning out millions of Musician's Friend catalogs in 1998 was \$7.54 million, or 8% of sales. Annual leasing costs for stores, warehouses, phone systems, and computers added another \$2.0 million to the expense column. In total, occupancy and promotional costs at Musician's Friend topped 10% of sales. According to NAMM's retail operational manual, an average m.i. retailer spends 5.5% on occupancy expense and 2.5% on advertising and promotion.

In 1983 Rob Eastman set up shop in his San Diego garage, mailing out flyers to sell guitar strings and other accessories. His parents, Bud and Maxine Eastman, had founded Guitar Showcase in San Jose and later went on to start *Guitar Player* magazine, so Rob came to the venture with a thorough understanding of the industry. Offering competitive prices, broad selection, and exceptional service, with policies like a genuine 30-day money-back guarantee, Musician's Friend enjoyed meteoric growth from the start. Between 1989 and 1998 sales increased by a factor of ten, to \$94.0 million, and by 1998 the company had compiled the second best five-year growth rate of any major retailer in the industry. With over one million copies mailed quarterly, the Musician's Friend catalog was also arguably the world's best read music publication. With all these outward strengths, the obvious question is: How could Musician's Friend begin hemorrhaging red ink?

FROM BIG PROFIT TO BIG LOSS AT MUSICIAN'S FRIEND

	1998	1997	1996
Sales	\$94,052,382	\$70,697,769	\$46,373,034
Cost Of Goods Sold	\$67,947,415	\$48,017,520	\$30,499,939
Gross Profit	\$26,104,967(27.7%)	\$22,680,249(32.0%)	\$15,873,095(34.1%)
General Operating Expenses	\$26,026,349	\$12,226,435	\$7,326,010
Catalog & Advertising Expense	\$7,544,686	\$5,112,342	\$2,976,581
Rental Expense	\$1,230,901	\$333,154	\$103,416
Interest Expense	\$2,335,975	\$963,815	\$387,814
Other Income	\$15,186	\$101,965	\$303,192
Net Income (loss)	(\$11,017,758)	\$4,146,468	\$5,391,047

Financial data based on statements filed with the Securities and Exchange Commission on August 16, 1999.

From an outsider's vantage point, the meltdown at Musician's Friend seemed to be the cumulative result of a series of miscalculations. First, there was an in-house "Easy Payment Plan" where customers could opt to have purchases billed to their credit card in equal installments over a three- or six-month period without any interest charges. Customers loved the plan, prompting a surge in sales and an increase in average order size; however, a subsequent computer problem resulted in disputes with credit-card companies and problems with credit limits left Musician's Friend with millions in uncollectable revenue.

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