Automotive Center
Case Study

This case study shows how using detailed, accurate, and timely information leads to extraordinary profitability. Automotive Center was started from scratch in 1954 and over a period of about 25 years, was built into a business worth approximately $3 million (in 1980 dollars), at least ten times the value of most auto parts stores.

The genius (profit) is in the details!

Automotive Center was founded by Joe Erman in 1954 as a small automotive carburetor and electrical parts store and repair shop. Due to the company's success over its first few years, major, well-known manufacturers such as AC Delco, Borg Warner, and Gates Rubber Products came to Joe, offering distributorships. Over the next ten years, the company experienced phenomenal growth, transforming itself into a large auto parts wholesaler distributor and worldwide exporter. What is most amazing is that the company's growth was financed from earnings and bank lines of credit supported by those earnings. There were never any outside investors.

Rapid growth requires excellent management.
Maintaining profitability and solvency in any business is difficult. Doing so in one that is growing rapidly is even more challenging. When most people think of a growing business, they only think of growth in terms of sales. They forget that accounts receivable, inventory, and payroll also have to grow to support the increasing sales, using up a significant amount of precious cash.

All too often, companies profitably grow themselves into bankruptcy because they don't maintain their profit margins and let too much cash get tied-up in inventory and accounts receivable. Yes, a company can earn a profit and yet grow so fast that it can't pay its bills. Excellent management skills are crucial if the company is to succeed, because there's very little room for error or waste.

Success secret number one was maintaining full margin.
Gross margin (or gross profit) is the difference between the selling price and the cost of the item(s) being sold. During the 50's, 60's, and 70's, the normal gross margin for an auto parts distributor was 22%. Any slippage in margin had a significant, negative effect on profitability. A 1% drop in sales price required a 9.1% increase in sales volume to earn the same dollar profit. Being able to maintain a 22% margin was a major contributor to Automotive Center's success.

Success secret number two was tightly managing inventory.
Maintaining positive cash flow while growing rapidly demanded that cash not be tied-up unnecessarily. It was mandatory that the inventory turned over a minimum of four times per year and that there were no obsolete items on hand. These objectives were met year after year and were also a major contributor to the company's success.

Accurate, highly-detailed, and timely information is crucial.
No one can keep accurate track of hundreds of customers and thousands of different inventory items in their head. Guesswork and hunches can't be relied upon when making decisions. Timely, high quality information is mandatory. Joe understood this need and put processes, systems and procedures in place to gather detailed data on a transaction-by-transaction basis. The processes also ensured that tight internal control was maintained, mistakes were minimized, and that operations were performed as efficiently as possible.

Gathering detailed transaction information requires significant time and money.
Automotive Center averaged about 250 sales transactions per day and most of them included several different items on the same invoice. Data for each transaction had to be gathered and processed to produce the required information. An office staff of six people was needed to complete it all, a far larger staff than found in most other businesses of a similar size. At that time there were no computers available to help in the processing. Today, the same data can be gathered more easily and with far fewer people.

Sales transactions were closely monitored.
Customers had to be invoiced correctly for the company to maintain its gross margin. Billing errors and price-cutting were the two things that could erode margin. Because of this, every sales transaction was systematically monitored for correctness.

Billing errors come in two forms, math mistakes and charging wrong prices.
To combat billing errors, three steps were taken. First, each sales invoice was double-checked by the office staff to catch math errors. Second, the company's cost for the items sold was entered on the office copy of each sales slip. The gross margin for each sale was calculated both in absolute dollars and as a percentage and entered on the sales slip. Finally, every morning Joe reviewed each slip, often catching errors. Because of his familiarity with parts prices and expected margins, he could spot instances where wrong prices had been charged. Any time an error was found, the person responsible for the error was given the task of preparing a correcting invoice, or credit memo, and informing the customer of the error and subsequent correction.

Margins dollars are lost when prices are discounted.
Price-cutting was not an issue at Automotive Center because the company's sales force was not allowed to discount prices, period. The only times special deals were offered was when a manufacturer ran a promotion and their deal was passed along to the customers. The company virtually always earned its full margin, even on promotional sales.

Very close attention was paid to the inventory.
By far, the largest asset of the company was its inventory, worth hundreds of thousands of dollars. Managing it was a challenging task because competing and conflicting objectives had to be met. On one side, the amount invested in inventory had to be kept to a minimum so that the proper number of turns could be achieved and so that cash wasn't tied-up unnecessarily. On the other side, an adequate supply of parts had to be on hand or sales, and ultimately customers, would be lost. Detailed item-by-item information had to

be available when purchase decisions were made. Without it, the company would be unable to achieve the proper balance and could literally end up out of business.

A perpetual inventory system is vital.
A perpetual inventory system is one that keeps track of the on-hand quantity for each item in a store's inventory. When an order is received from a supplier, the quantity of each item received is entered on to that item's inventory card and a new on-hand total is calculated. Every time an item is sold, the quantity sold is deducted and a new on-hand balance is calculated. At any time, the on-hand quantity of every item is known. Having this tool reduces lost sales due to mis-placed items, saves time when answering customer inquiries, and reduces losses from shrinkage (theft, both internal and external).

A perpetual inventory system lets you make informed purchasing decisions.
At the end of each month, the quantity sold for each item during the previous month was totaled and entered directly on its inventory card in a separate "sales history" area. When ordering, the buyer could look at the monthly movement activity for the past three years and see both seasonal and general usage trends, making it far easier to decide what to buy. This information was crucial to maintaining proper stock levels and ensuring appropriate turnover rates. The inventory was so well managed that cash was rarely tied-up in excess goods.

Managing by the numbers leads to insight and better decision making.
Joe managed by the numbers, using the real-time, factual data that the company's processes produced. He knew he could rely on those numbers when making decisions. Because of the information he had, Joe always knew which customers were buying, what items and product lines were moving, which customers returned an abnormally high percentage of their purchases, product lines that had high defect rates, and how often sales were lost due to out-of-stock conditions. The insights Joe gained made him an excellent manager and an astute forecaster of industry trends.

When Joe died, he left behind a business that had out-performed every other automotive parts wholesale distributor in Northern California during his tenure. During that time, at least six competitors went bankrupt and closed their doors. All of them started out with far more capital than Automotive Center. Joe proved that managing by the numbers and paying attention to nitty-gritty details really does pay-off.

Why do most business owners refuse to manage at this level of detail?
They typically say that it's too difficult or too expensive. They're wrong. Joe's success in building Automotive Center was the direct result of having real-time information he could rely on. Without it, he would have failed because he would have run out of cash. To prove that the company's success was the result of its processes, systems, and procedures and not simply luck or coincidence, here are a few more pieces of evidence for you.

The same systems worked for many other auto parts stores, both large and small.
Chanslor & Lyon was $50 million automotive warehouse distributor that was a subsidiary

of a New York Stock Exchange company. This company was having significant internal control problems that were costing them over $1 million a year. Their problems included massive numbers of billing errors, unauthorized price-cutting, and employee theft. Using processes, systems, and procedures borrowed from Automotive Center, a project team closed the loopholes and the company regained the $1 million per year it had been losing.

Chanslor & Lyon also used to finance retail auto parts store owners (jobbers) in areas where they wanted distribution. As part of C&L's marketing program, consulting services were offered to their jobber customers, especially those they had financed who were falling behind on their payments. When the Automotive Center systems were implemented by the jobber, their business returned to profitability. When they were passed off as too labor intensive or complicated the jobber failed and C& L was forced to repossess their inventory, putting the jobber out of business.

Today's computing technology makes all the difference in the world.
Until recently, gathering the information needed to manage as Joe did was difficult, time-consuming, and expensive. Conventional wisdom held that the cost of acquiring it was too high. Today, with the computing power now available, there's no reason not to gather detailed transaction data.

To be highly profitable and enjoy positive cash flow, a company must earn healthy gross margins, keep their accounts receivable current, their inventory fresh and turning, and have strong internal control systems in place. The best way to meet these objectives is to have systems in place that capture detailed transaction data every day and then have the data used when making decisions. As Joe Erman demonstrated, knowing where you stand at all times is vital.

Today, more and more companies are realizing that having detailed and timely information to manage with pays-off in increased profits and cash flow. They are installing the systems needed to get it and are being handsomely rewarded for doing so. Managing details really is the secret to success.

Seriously consider implementing a data collection and reporting system in your business so that you too, can begin making better, more informed decisions and begin enjoying the benefits that extraordinary profitability brings.