



# road map from the aftermarket

The hard-earned lessons of the automotive aftermarket are clear: Stay focused, stay anchored, and stay with the basics.

IMAGINE A BUSINESS WHERE SUPPLY CHAIN EXCELLENCE REALLY matters.

Imagine a business where your direct competitors sell the same products you do. You're small box retail, but some of what you sell can also be bought at Wal-Mart, so in certain items you face the most formidable competitor on the planet. You don't control the designs of the products that you sell, so engineering and technology matter little.

You turn your inventories over a couple of times a year, so if you make a mistake, you sit on it for a long time. You manage 25,000 or so SKUs at the retail level, and hundreds of thousands in your wholesale network. You have hundreds of suppliers to manage, located around the world. And with every passing day, more and more of the production is going offshore.

Plus, your suppliers are merging and consolidating, so your power over them is eroding.

If you're the best in the business, you may make 10 percent of sales in net profits. If you're not, you may be just above break even, or worse. And if you struggle, one of your competitors will swallow you right up.

And now—the 2008 economy. Your products are chock full of oil, metals, and plastics. Most of them are heavy, and you need to move them a long way to get them to market in the United States, often from Mexico, or India, or China. Your transportation costs are exploding; your cost of goods, and by implication your prices, are being driven up by the commodity markets.

Welcome to the world of the automotive aftermarket retail supply chain. You can try to build intimacy and customer loyalty, but a spark plug is a spark plug. You can try to innovate with product design for private-label initiatives, but the OEMs (original equipment manufacturers) control specifications. So success comes down to a focus on supply chain fundamentals.

Ten major retailers account for about 40 percent of the do-it-yourself auto parts aftermarket. The strategic, fact-driven approaches of the top three can offer lessons that apply to all supply chains, no matter the industry.

Their most important lesson: Don't let your imagination run wild. Stay

focused, stay anchored, and stay with the basics.

### “Yes, no, or a number”

AutoZone is the largest of the after-market parts retailers in the United States, with about 85 percent of its sales coming from U.S. retail outlets. Sales in 2007 were over \$6 billion,

with after-tax earnings of almost 10 percent of sales. Quarterly releases this year indicate a modest sales growth of around 3 to 4 percent. Same-store sales, however, are flat. But in the face of the competitive squeeze, AutoZone is thriving. Earnings per share are up around 15 percent this year.

How is it improving its margins in such a challenging environment? Central to AutoZone's strategy is a renewed emphasis on category management and financial engineering.

One senior manager for AutoZone provided insight into how management runs the business: “There are only three answers to a question: yes, no, or a number.”

AutoZone's category management initiative might be described as inventory optimization on steroids. Basically, retailers using category management break down the entire range of products they sell into discrete groups, or categories, of related products, focusing on how customers purchase and use the products. Each category is then run like a profit center, with its own set of targets and strategies. The core principle of category management is having the right set of complementary items that customers want in stock at the right location, instead of just driving shelf availability at the item level. It is customer-driven portfolio management of inventory, organized around the application, rather than item management organized around commodities.

For example, a category manager will think about the customer planning an oil change and manage the store inventory to ensure that a complementary set of products is available to support that activity. So, in addition to motor oil, there have to be filters, drain pans, funnels, strap wrenches, drain plugs, shop rags, and oil absorbents to take care of spills. And the category manager will tune the pricing and profitability of the portfolio, from the low-cost to the premium offerings. It's not about managing the motor oil; it's about responding to the oil change event.

In fiscal 2007, AutoZone added over \$70 million of parts to its product assortment. At the same time, it rebalanced inventory levels within categories and conducted a top-to-bottom merchandise line review on every single category. Refinements have continued in 2008.

To support its category management initiative, the company rolled out a new planning software package that helps select the right part for the right retail location. AutoZone also uses databases

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populated with information from vehicle registrations in each store's trade area to tailor inventory to the makes and models of the cars driven by all potential customers in that area.

AutoZone's focus on inventory management is not restricted to the operating side of the business: Some healthy financial engineering is under way. Although AutoZone has over \$2 billion worth of inventory on the shelf, the company hasn't paid for most of it. At the end of 2007, AutoZone's on-hand inventory less inventory payables amounted to about \$135 million. Technically the company owns the inventory on the shelf and owes the supplier for it, but AutoZone doesn't have to pay for it until it sells—an approach the company calls "pay on scan." The net effect is that little of AutoZone's cash is tied up in inventory because the suppliers are financing it.

### Back to basics

Advance Auto Parts, another large player in the market, faces the same pressures as AutoZone. Sales in 2007 were just a shade under \$5 billion, yielding a net after-tax income of 4.9 percent of sales. Like AutoZone, it is finding a way to become more profitable in a difficult economy by recalibrating around the basics.

To stay competitive in today's tough market, Advance Auto Parts is focusing on strategies to improve inventory effectiveness. Those strategies include providing better late-model and import parts coverage in key markets, making incremental inventory investments to speed up responses to store requests for parts, customizing parts assortments for specific stores, limiting order capability at the store level, and rationalizing sales-floor SKUs to remove less productive inventory.

The result: improved inventory turnover rates chain-wide and a merchandise mix that more accurately meets customers' needs on a store-by-store basis. This, in turn, drives sales. Inventory effectiveness drives top-line revenue growth.

It sounds a lot like category management.

At the same time, Advance has targeted expenses to improve the bottom line. The company has pruned initiatives that do

not demonstrably support profitable growth, cutting information technology, logistics, and other investment projects that did not deliver an acceptable rate of return. According to financial information posted on its Web site, Advance has identified more than \$70 million in expense reduction initiatives for

2007 and 2008.

The combined initiatives have led to improved results this year, yielding net after-tax income of 6.1 percent of sales in the quarter ending in July 2008, a quarter of a percentage point improvement over the same period in 2007. Overall sales are up almost 6 percent.



### Be the consolidator

O'Reilly Automotive, another top tier supplier in the automotive aftermarket, has taken a different approach. Sales in 2007 were \$2.5 billion, with a net after-tax profit of 7.7 percent of sales. In the quarter ending June 30, 2008, net income is up 7.5 percent compared to the same period in 2007. However, rather than continuing an internal focus to drive performance improvement, it has decided to look for opportunity in somebody else's sandbox. O'Reilly is growing through acquisition, hoping to achieve economies of scale in inventory and distribution, and improve overall profitability of the combined operations.

In April of this year, O'Reilly agreed to merge with CSK Auto Corp. CSK operates Checker Auto Parts, Schuck's Auto Supply, Kragen Auto Parts, and Murray's Auto Stores. Year-over-year sales for CSK have been declining, and net after-tax income for the latest period is less than 1 percent of sales. But CSK's annual sales of \$1.9 billion will raise the combined O'Reilly/CSK organization to nearly the size and scale of Advance Auto Parts.

There is always risk in mergers, but CSK's markets, which are west of the Mississippi, nicely complement O'Reilly's base, predominantly east of the Mississippi. And scale matters in the auto parts business. Clearly, there is opportunity to improve the profitability of CSK's operations, and O'Reilly has demonstrated its skill as an operator.

Like AutoZone, O'Reilly has sophisticated inventory management systems that customize the assortment of products stocked at each store based upon market demand and vehicle registration data. O'Reilly intends to apply its sophistication in operations and inventory management to CSK's operations, while at the same time taking advantage of its increased size across what will effectively be a national distribution network. Instead of two independent distribution networks, one for the east and one for the west, the combined operation will have the opportunity to manage coast to coast.

### Beyond automotive

Each of these companies demonstrates

that, in order to be effective, a supply chain strategist has to evaluate performance in the overall economy and the specific industry the supply chain serves. In today's economy, businesses of all types and sizes are confronting cost issues outside their control. But what the corner office cares about is profits, not costs, and each of these three companies provides valuable lessons in making supply chain excellence relevant to driving growth and profits.

What makes the automotive aftermarket sector particularly challenging is the large number of parts stores must stock in order to service the customer. Cars are being driven longer, which compounds the problem, while new technologies continue to broaden the product line because new technologies require new parts.

Automotive aftermarket retail supply chain strategists have found a way to use supply chain competencies to differentiate themselves from the competition and drive profits: making sure the right part is on the right shelf at the right time.

Wes Randall of Auburn University elaborates. "In a retail supply chain, when you're the intermediary between the manufacturer and the customer, you really have to be very deliberate in your response when commodity prices are creating profit pressure. Before you just pass along the price increases to the customer, you really need to see if you can find a way to be more productive with your internal financial structure and performance. It might be economies of scale. It might be category management. It might be rethinking how often you ship, or how much inventory you push to retail.

"Fighting against the macro-economic environment is like shoveling against the tide. It is what it is. Adapt, adjust to the current market, but be ready to respond when the market begins to turn back around."

That's a lesson the successful players in the automotive aftermarket have taken to heart: They are looking inside their four walls, focusing on their own supply chain strengths. And they're letting the facts and customer-focused opportunities—not their imaginations—drive them. □