The 40-40-20 Model

Sales are good but profits are down... Something must be out of whack!

By Alan Beech

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Dear Alan,
I've become stuck and I need help. To an outsider it probably looks like my business is running beautifully. I have a solid crew of guys in the back, I've got great service advisors upfront, and I'm bringing in enough to pay the bills. The problem is I'm not making the kind of profit I'd like to see. I have big dreams for this business and I've come a long way since starting out. But I just can't figure out why I'm still not making real money!
—Mike

Dear Mike,
The situation you describe is one I think a lot of us have experienced at some point or another. It can be truly frustrating, especially when so many aspects of the business are in good shape.

You've obviously done a great job finding a reliable staff. Hiring the right people can be a challenge these days. Not only have you assembled a good team, but you've developed processes that make them productive, and you have more than enough business to keep them busy.

So why aren't you getting rich?

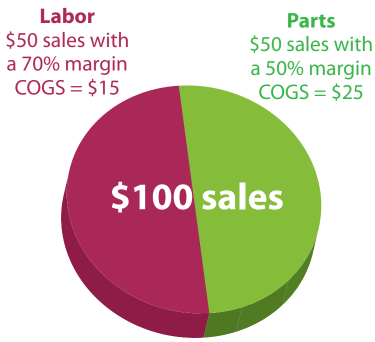
You need to tackle the profit problem. There are three things that must be addressed: sales volume, margins, and expenses. Once these items are in line and under control, I guarantee you'll begin to make the profit you're looking for.

More than just sales

Success means more than just adequate sales. Time and time again I see shop owners who get caught up in driving sales while remaining completely oblivious to everything else that's going on behind the scenes. Yes, sales are very important... and it sounds as if you've got that under control. Now you need to focus on achieving the right margins and controlling expenses.

In a perfect world, out of every dollar you earn, 40 cents should cover the cost of the goods sold, 40 cents should cover your operating expenses, and the last 20 cents should be pure profit. This scenario – let's call it the 40-40-20 model – is not always achievable but it provides a useful guideline to follow.

When I talk about margins, it's in relation to the cost of goods sold – or COGS. The cost of goods sold is comprised of both the cost of the part and your labor cost.



Total COGS = $15 + $25 = $40

The industry standard margins you should be aiming for are 50% on parts and 70% on labor. So, for example, if you sell $100 worth of parts, the cost of goods sold should be $50 (a 50% margin). On $100 worth of labor, the cost of goods sold should be $30 (a 70% margin). Putting those two elements together, the way they would be in a typical mechanical repair job, we see that the total cost of goods sold would be $80 – 40% of the $200 bill we presented to the customer. We're already on our way to achieving the 40-40-20 model.

You'll quickly learn how important it is to use a pricing matrix to help you hit your margins. It's not always possible to achieve a 50% margin on parts. It all depends on the type of work you do and the kind of parts you sell. But with a preset matrix, at least you'll know what your target is, and it will simplify the pricing process.

Controlling expenses

In addition to getting your margins set correctly, you'll need to control expenses. It's fair to say that runaway expenses are the silent killer of many small businesses. I know from personal experience how easy it can be to get distracted by increasing sales while ignoring soaring expenses. But when you're trying to troubleshoot a profit problem, you have to set sales aside and focus on reducing expenses.

I can remember sitting around the table with my own group when I was faced with this dilemma. I had the highest sales in the group but the lowest profit. As a group we dug deeper and it soon became clear that the crux of the problem was my expenses. They had gotten out of control. It was time for me to scale them back.

What came next was the very unglamorous task of going through my expenses, line by line, in an attempt to recover the lost profit. I had to make some extremely difficult decisions, ones I knew would be unpopular with both my customers and staff. But at the end of the day, I had to make a profit. That was something I could not forfeit.

It was with grim determination and a renewed vigor to put things back in line that I began to scrutinize my expenses with a fine toothcomb. I contacted suppliers and renegotiated my rates. I was pleasantly surprised at how open they were to having this discussion. Suppliers want to keep your business, so don't be wary of having this conversation. Some of the cuts came easier than others… but overall it was not an easy process. I won't sugar coat it.

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The hardest cut I made was cancelling my customer rewards program. I'd been very excited about when we launched it, and customers really took advantage of it. But when I crunched the numbers, I realized it had become a major drain on my business. It was no longer feasible. It was difficult to pull the plug on it but, again, making a profit had to be my top priority.

Wake-up call

This was the wake-up call my business needed and I'm eternally grateful that my group was there to encourage me through it all. Through the process I was able to lower my expenses by 7% and keep them down. I now keep a thorough record of my expenses with detailed spreadsheets that make it easier to stay in line. I actually have fun tracking the numbers and seeing how low I can keep my spending.

I watch all kinds of expenses, but I have come to see that large capital expenditures don't belong in the list of monthly expenses. Instead, I separate those items so they can be amortized over time.

Obviously in order to maintain a successful business, there are things that cannot be sacrificed. For me it's extremely important to have the best employees I can get, and I want to compensate them very well for the excellent work they produce. The wages I offer, however, still fall in line with the margins I'm trying to achieve.

I've posted my expense guidelines on my website at www.beechconsulting.ca. You're welcome to use it as a tool as you begin to tackle your expense problem.

Our goal in business is to earn 20% profits (before interest, taxes, depreciation, and amortization). From my experience as an automotive consultant only about 5% of shops are ever able to achieve this goal. Those that do are able to look beyond mere sales and accurately gauge their margins and expenses.

I could not have solved my profit problem alone. Without the help and support of my group, I would never have learned how to control my expenses. The other shop owners in my group were a source of encouragement when I needed to make difficult decisions. And they were a wealth of knowledge when I needed direction on how to move forward.

I strongly recommend that you join a group or find a coach if it is at all possible. The role of a shop owner can be a lonely one at times, having a support group is an invaluable investment in your business and can be the difference between success or failure.

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