STRATEGIC MANAGEMENT

FINDING HIDDEN PROFITS

Profit hunts aren't just for companies in the economic doldrums. Even for industry leaders, they can be sources of growth.

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RECESSIONS ARE DEFINED AS PERIODS OF NEGATIVE economic growth, usually accompanied by slowing sales. But in the recent downturn, profits were hit much harder than revenues. While the U.S. gross domestic product—the total value of all goods and services sold—finished up 0.3% for 2001, profits for the S&P 500 companies fell a staggering 31%, the biggest drop since the Korean War.

The economy continues to be indecisive: Productivity is gaining, but earnings continue to disappoint. Where can companies, and their shareholders, find sustainable relief from the profit squeeze? We examined the strategies of 30 companies that managed to substantially improve margins. And we found at least one answer: short, targeted "profit-hunt" programs that rely on a systematic approach to identifying revenue enhancement and cost reduction for long-lasting profit improvement. Such efforts rally the entire firm around profits, rather than around function, product, or sales geographies. Many are achieving remarkable results.


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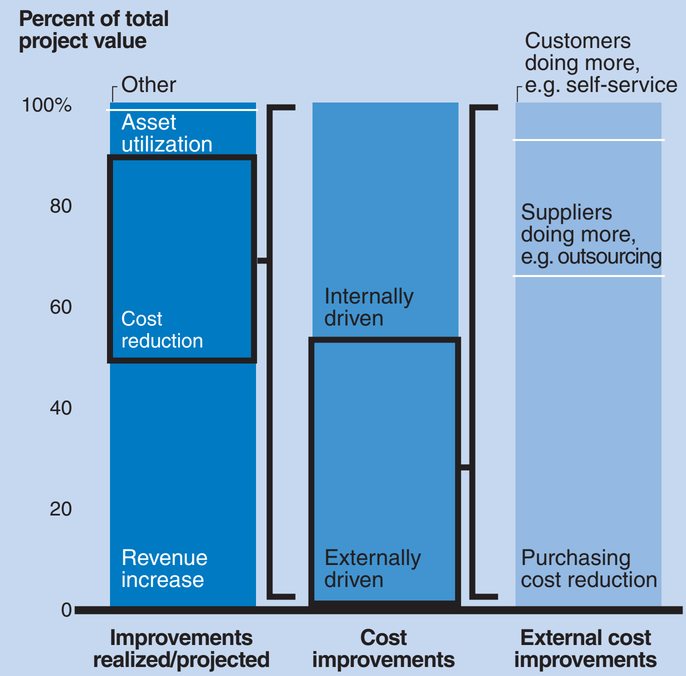
While the notion of a 6- to 12-month program to track down margin improvement opportunities isn't new, these companies found much of their quarry by new means and in unexpected places. Head count and general expense reduction, practices widely stressed in the past, accounted for only a fifth of total profit improvements at companies studied. Fully 80% came from either revenue-based initiatives, or working with suppliers or customers to reduce costs, or improving asset utilization. (See Figure 1.)

Figure 1: Redefining Profit Hunts

Redefining profit hunts: Today, more than half of the value lies in revenue and external cost reduction



Source: Bain analysis of 30 profit hunt programs, 1995-2001

Beyond Internal Cost Cutting

The following three companies in our study looked beyond internal cost cuts and found dramatic profit improvements.

Starbucks: Shifting the Sales Mix. In our 30 case studies, revenue enhancements (such as shifting the mix of sales toward more profitable products) accounted for more than 50% of new profits created. Similarly, in a Bain survey of 48 senior executives who recently conducted profit hunts, 59% said they focused primarily on revenues. Coffee retailer Starbucks is a case in point: In a recent profit hunt, it found more than $100 million in margin improvements per year, of which approximately half came from revenue enhancements.

How are companies finding so much in the top line? Many, like Starbucks, analyze the profitability of each of their products at the store level, then map that against customer demand for those products. Acting on such analysis, Starbucks pared back its product line and repriced items to generate new growth.

In its product analysis, Starbucks found that most non-beverage items—food, CDs, games, mugs, and the like—were far less profitable than hot beverages. In fact, a significant portion of merchandise was priced below variable cost. The more of those items Starbucks sold, the more money it lost. Starbuck's first set of profit hunt initiatives eliminated money-losing merchandise and food products and refocused its product line on more profitable items. This released cash that Starbucks could invest to further streamline its store and supply chain processes. It also returned customers' attention (and spending) to more profitable products.

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Next, Starbucks realigned prices. It repriced a variety of items in response to recent competitor moves, real variable costs, and patterns of consumer spending. The coffee retailer raised prices on some popular beverages that had price elasticity, and spared some money-losing items from extinction by raising prices to cover costs. For instance, lollipops are a customer favorite at Starbucks, but the company was losing money on every one it sold. Today, lollipops at Starbucks cost $0.75, instead of the old $0.50. At that price, Starbucks can afford to sell them, and consumers can still get their midday sweets.

Overall, Starbucks' profit hunt netted dramatic results. For several years preceding the profit hunt, earnings growth had at best equaled and at times trailed revenue growth. But Starbucks' annual earnings growth has exceeded revenue growth by four to five percentage points from June 1999 (when the profit hunt began) through October 2002 (well after the company completed its exercise). The market took note. Since mid-1999, Starbucks' stock price has consistently outperformed the retail index.

Kroger: Working with Customers, Harnessing Technology. While Starbucks boosted profits by paring back its product line, many companies in our study had remarkable success in cutting process costs, often by engaging their customers and suppliers to help. On the supplier side, for instance, companies were able to set up win-win relationships that rewarded both parties for cost reduction. And several companies worked with customers to streamline processes and reduce costs. In fact, slightly more profits in our study—20% versus 18%—came from cost reductions that involved customers or suppliers than from internally focused cost cutting such as layoffs or plant closings. Consider Kroger, the U.S. grocery retailer, which improved profits by harnessing technology to make its checkout lines more convenient.

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With 300,000 employees, $9 billion in operating expenses (most of it wages and benefits), and the thin margins typical of the grocery industry, Kroger is extremely sensitive to changes in the labor market. By the mid-1990s, with the economy in full boom, Kroger faced rising labor costs and, in some parts of the country, severe labor shortages. As part of a broader profit hunt, Kroger decided to experiment with customer self-checkout.

In 1995, Kroger began replacing express aisles with self-checkout aisles in a handful of pilot stores. The economics behind self-checkout are clear: One employee can monitor four self-checkout aisles. Self-service aisles also have a smaller physical footprint than regular service aisles, but similar throughput. Based on labor savings alone, each self-service aisle can generate $40,000 in annual savings. But Kroger had tried to implement self-checkout once before, in the 1980s, and customers had rejected it. The question in 1995 was: Had customers' attitudes shifted?

Within a few years, the answer was clear. After a decade of using ATMs and self-service pumps, customers, now comfortable with self-service methods, embraced the technology. Customers polled said they preferred the self-service aisles for speed, privacy, and convenience. And those who didn't could still use the full-service aisles.

Follow-up customer research revealed another unexpected benefit: Thirty-three percent of customers said they were more likely to visit a Kroger store because of the self-service option. Not only was self-checkout saving money, it was bringing in more business.

By 1999, management was encouraged enough to begin a full-scale rollout. At the end of 2001, nearly 1,000 of Kroger's 2,400 stores had self-service checkout aisles; two-thirds of the stores were slated to have the aisles by the end of 2002. If Kroger rolls out self-service aisles to all of its stores, it could save $100 million per year, no small change in an industry under pressure from mega-food retailers like Wal-Mart.

Nexfor: Squeezing Existing Assets. Whereas Kroger invested in new technology, 10% of new profits in our overall study stemmed from capitalizing on existing assets. Moreover, the companies that specifically focused on asset utilization found from a third to half of their potential profits hiding there.

Nexfor Inc., an international forest-products company, based in Toronto, exemplified this approach. Unwilling to automatically commit more capital to the business when overall return on capital was low, Nexfor trained management and mill workers in cost reduction and asset utilization. Through a combination of big-picture thinking and down-and-dirty elbow grease, mills succeeded in boosting productivity and profits, to dramatic effect.

Starting in 1997, Nexfor (at the time called Noranda Forest), with $1.3 billion (Can$2 billion) in annual revenue, undertook an ambitious effort to boost results, with a stretch goal of $64 million per year. Nexfor's profit hunt (called Margin Improvement Program) was unusually broad. The company pursued more than 100 initiatives, across every division, and involved hundreds of employees in the effort.

There were many successes, but probably the biggest came in Nexfor's oriented strand board (OSB) business. OSB is a composite wood material, an alternative to plywood, that has become a standard in new home construction. A highly profitable product for Nexfor, at the height of the housing boom in the mid- to late 1990s, prices and demand surged for OSB. Nexfor's strategy for increasing output had been to build new mills and to buy existing ones. However, overall Nexfor was barely breaking even and failing to meet its cost of capital; it simply couldn't invest sufficiently in OSB. Indeed, the only recourse appeared to be gleaning more from existing OSB assets. Mill throughput became a hot topic.

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How could mills eke out more? No observer passing through would suspect slack. The OSB mills appeared well managed and running near to design capacity.

Yet profit potential existed in spades. Nexfor examined its OSB mills and asked the question, "What is full potential?" It found enormous room for improvement. Indeed, a mill that management considered its best—among the most productive of its kind worldwide—used significantly more set-up time than other mills within the Nexfor system. In fact, there were best practices at each of the OSB mills that were not being followed at the other mills.

Nexfor implemented a host of new practices across the OSB system, including new press loading and unloading procedures. And it began using more efficient resins. These efforts improved output in its four mills by an astounding 25%. In other words, they got an entire new mill's worth of production without having to build one. With demand for OSB products remaining red-hot, the increased throughput quickly translated into $12.8 million in additional annual profit.

Nexfor's success in its OSB profit hunt demonstrates that even well-run businesses can camouflage profit potential. It also demonstrates the power of bundling small initiatives. Nexfor pursued initiatives in a variety of areas: production, asset utilization, product-mix, maintenance, general and administrative expense, purchasing, and raw materials, to name a few. Most of these programs were small, not more than $1.3 million in value. But they added up: Nexfor eventually found $160 million in margin improvements on $1.3 billion in revenue, wildly surpassing its stretch target of $64 million.

Nexfor thought big, imagining the full potential of the business. But it also recognized the value of each step toward its goal, digging into corners of the business to unearth pockets of profit.

In the end, the success of Nexfor's profit hunt program transformed the company's entire management culture. Now, Nexfor executives plan and operate their businesses to maximize margin improvement, essentially conducting a profit hunt every year. Since 1997, every division of the company—paper and pulp, OSB, wood products, and European panelboard—has contributed initiatives annually. And Nexfor has quantified the overall progress versus prior-year results in its annual reports.

Approaching Your Profit Hunt

While no one-size-fits-all set of tactics exists for snaring profits, some common attitudes do. These attitudes include: insisting on quick results, thinking offensively, and using profit hunts to pressure-test corporate strategy.

- *Insist on quick results.* Much of the savings should be realized (meaning actual cash on the books) within 12 months of program kickoff. In the cases we examined, 43% of total annual profit improvement hit the books in the first year, and 80% was realized within two years. Long-term profit initiatives, on the order of, say, three to five years, are sometimes proposed as a way to minimize organizational disruption. Don't believe the promises. Big savings that are planned for "down the road" usually fail to materialize, either due to obsolescent ideas or organizational burnout.
- *Think offensively, not defensively.* Prevailing myths cast profit hunts as defensive moves. One myth says they are most appropriate for industry "followers." Another says they are useful only in tough times—say, to tighten corporate belts in a recession. Both myths need debunking. Consider Starbucks, which began its profit hunt in 1999, at the height of the economic boom and when it was already the industry leader. Did Starbucks need to conduct a profit hunt to thrive? Probably not. Did the extra $100 million per year in profits help it grow even faster and pull further ahead of competitors? Certainly.
- *Use profit hunts to pressure-test corporate strategy.* Profit hunts involve peering into the dusty corners of your organization, and can illuminate strategic issues beyond immediate margin improvement. Capitalize on the profit hunt to update your understanding of asset utilization, the cost structure of products and plants, what competitors are doing, who is and isn't pulling his weight, and so on. One company, after analyzing the profitability of all its products, realized that it had drifted away from the high-margin, core products upon which the company was built. The profit hunt clarified its strategy, precipitating a complete rethinking of the company's product line and mission.

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Profit hunts involve peering into the dusty corners of your organization.

After two years of economic doldrums, disappointing profits and pressure from management and investors, many companies will have seized the obvious opportunities to boost margins. But for many of these same companies, substantial, hidden profits wait in the wings. Flushing them out may require broadening the scope of your search or harnessing technology. It may require looking to the top line, or engaging customers and suppliers to cut costs. And it may mean squeezing your existing assets or investing in new ones. Yet, if the cases of Starbucks, Kroger, and Nexfor are any guide, digging for the hidden treasure today can improve the way you do business for the long-term. ◆

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