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How to know when better profit margins aren’t better for your company

At some point, cost cutting and higher prices can hinder growth and destroy value.

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Ask CEOs if the ability to increase profit margins year after year would help their companies compete more successfully against peers, and you’re likely to hear a resounding yes. After all, if making a profit is a company’s raison d’être, cutting costs or increasing prices to improve profit margins are good things, right?

Not necessarily. At some point, cost cutting can be counterproductive, starving a company of new sources of growth and undermining performance over the long term. Managers at one consumer-packaged-goods company, for example, increased its profits at double-digit rates for seven years by emphasizing margin growth—even though revenues grew at only 2 percent a year over that period. Eventually, the company ran out of healthy opportunities to cut costs and began slicing into activities that benefitted its customers and brands. Performance slumped so badly that managers were compelled to acknowledge, in the annual report, that they had underinvested in product development and marketing—and then had to spend considerably more on those functions to reset the business.

Indiscriminate margin-boosting price increases can also be counterproductive. Savvy readers will recognize the scenario at one large North American company where executives asked few questions of a business unit that regularly hit its earnings targets—until its performance faltered. Later on, they learned that the unit's managers had produced years of strong profit growth largely by increasing prices. That allowed competitors to step in with similar but less expensive products, cutting into the unit's market share.

It turns out there are limits to how much—or how long—companies can improve their profit margins. We recently studied the margin performance of 615 of the largest nonfinancial companies from 2001 to 2013. We found that around two-thirds were able to sustain their margin improvements over three consecutive years at least once during the 13-year period. About half were able to sustain a margin increase for four or more years. Since there are thousands of potential four-year sequences across 615 companies and 13 years, the fact that half the companies could sustain such a margin increase just once suggests a low success rate for the total number of potential four-year or longer time periods.

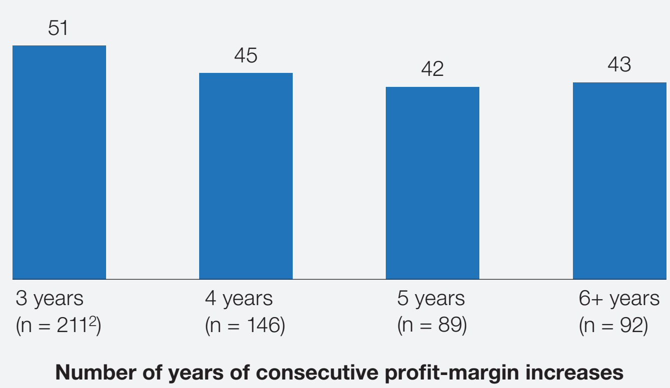
More importantly, the longer companies increased their profit margins, the more likely they were to fall behind their peers in terms of TRS once their margin growth stalled. Only about half of the companies that sustained margin improvements for three years were able beat their peers' TRS in the years that followed—about the same odds as flipping a coin. Improving margins for four years made subsequent performance even worse, not better (exhibit).

These results are averages and don't apply to all companies. How long a company can increase its margins without undermining its performance

Exhibit

Companies that improve their profit margins for more than three years running are less likely to outperform peers.

% of companies with 2-year total-shareholder-return growth[1] higher than their industry medians



[1] Cumulative total-shareholder-return growth for the 2 years after the final year of profit-margin increase among 615 nonfinancial companies in the S&P 500 from 2001 to 2013.
[2] Total number of companies that delivered 3 consecutive years of profit-margin increases from 2001 to 2013.

depends on the starting point. Underperforming companies with low initial margins or companies in certain phases of the industry cycle, for example, probably have more leeway for increases. But the longer companies increase their profit margins, the more vigilant managers must be to avoid cutting corners.

Fortunately, a few straightforward rules of thumb can help managers avoid taking margin improvements too far. Among them:

Customer focus. Managers seeking to increase margins should cut costs only when it doesn't affect customers negatively. Expediting the closing of the books at the end of each month, streamlining production processes, or introducing sophisticated fulfillment tools can cut administrative, manufacturing, and distribution costs without hurting the quality of your product or the experience of its customer down the road.

Competitor focus. Cost cuts or price increases might boost earnings in the short term. But those that affect a company's ability to market and sell its products or to meet changing customer needs will generally hurt performance in the medium to long term—which can be just a few years. The same can be said of cuts that affect a company's ability to get its marketing and sales message out to customers.

Industry focus. Before raising prices, managers should conduct a thorough review of their industry-, product-, and transaction-level strategies. Finding ways to capture more of the price you already charge, by examining discounts, allowances, rebates, and other deductions, is probably less risky than outright increases in list prices. Cutting overhead too far can also be detrimental if it leaves managers without the information and analytics they need to understand a company's performance in light of industry and competitive dynamics.

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When a narrow focus on next year's profits limits the growth potential of a business, its managers must consider whether they're exercising discipline or inadvertently starving shareholders of the potential for long-term returns. ■

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