



The Profitability Report: How to Protect Your Margins in a Downturn

Profits aren't as low as you might think. Here's how companies in 12 industries are faring, plus tips for defending your own bottom line

By Darren Dahl | Oct 1, 2009

Given the barrage of bad economic news over the past 18 months, you would think that the profit margins of U.S. companies would have withered away to nearly nothing. But though it's true that bottom lines have been hammered over the course of the recession, something promising has begun to happen: Profit margins are ticking back up.

The net margins of privately held U.S. companies grew more than a full percentage point in the second quarter of 2009. In some industries, the growth appears especially robust. Information and professional services firms saw net profit margins increase more than 3 percentage points; the finance and insurance sector saw a gain of 6 percentage points.

That's the result of an analysis of private company profits by *Inc.* and Sageworks, a maker of financial software and a leading provider of data about closely held businesses. In an effort to determine just how the tough economic climate has affected entrepreneurs, we looked at three key indicators -- gross profit margins, net profit margins, and change in revenue -- for companies in 12 economic sectors over the past eight quarters. In all but three of those sectors -- health care, wholesale trade, and real estate -- net margins strengthened in the second quarter of 2009 (the most recent period for which data are available). The data can be found on the pages that follow. We also asked top executives in each sector to describe how their industries are faring and to share some insights into how they strive to maintain their profits.

It's tempting to view the good news about margins as evidence that a recovery has begun. But it's not that simple. Stronger margins are undeniably a good thing. But they do not exist in a vacuum. Indeed, the generally encouraging news about the bottom line is offset by the fact that the top line -- that is, sales -- continues to be anemic in almost every industry sector. Retailers saw revenue fall 3.5 percent in the second quarter. Sales in the information industry dropped some 1.5 percent. "Since sales remain down and consumer spending fell in the second quarter, these increases in profits result mostly from cost cutting," says William Dunkelberg, chief economist of the National Federation of Independent Business. Unfortunately, at this point in the downturn, there's not much left to trim. Dunkelberg also cautions that many may have cut too deeply. "The reduction in costs, especially in labor, has been dramatic -- and perhaps overdone," he says.

It's also instructive to look at the difference between gross and net profit. Gross profit reveals how much a company earns after accounting for the cost of producing the product or service it sells; when gross profit margins fall, it generally means that a company has little to invest in non-income-generating activities, like marketing or tapping new

markets. Net profit, or the bottom line, shows how much a company actually keeps after subtracting all expenses, such as taxes, interest paid on debt, and other nonproduction costs.

The problem is that although net profit margins are strengthening, gross margins are falling or flat in six of the 12 industries we examined. That means that even though businesses have been able to cut costs, they don't have much pricing power. "Wherever you see reductions in gross profit margin, that suggests firms are still reducing prices," says Doug Tatum, co-founder of Tatum, an Atlanta-based consulting and executive search firm.

Still, the surprisingly robust net profit margins are cause for at least some optimism. Brian Hamilton, CEO of Sageworks, is encouraged by recent activity in the retail sector, which ramped up net profit margins in the second quarter despite an ongoing drop in revenue. "When retail trends up, that's typically good news for everyone," Hamilton says. "It means that people are starting to spend again." And if companies have been cut to the bone, it also means they are lean and mean and could be ready to pounce once demand in general does pick up -- something Dunkelberg expects to happen in the fall. "When sales finally do go up," he says, "we could look forward to a rapid increase in profits."