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A Bullish Turn for Toro

By Susan Feyder, Star Tribune

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At a time when some manufacturers have struggled to maintain, much less boost, profitability, Toro Co. has seen its profit margins grow as rapidly as the crabgrass that meets its doom under the blades of its red-and-black mowers.

Last fall, Toro surpassed a three-year goal to double its after-tax profit margin, with a 5.5 percent margin for its fiscal year ended Oct. 31. That's a benchmark some outsiders and insiders doubted the company could ever achieve, according to Chairman and CEO Kendrick Melrose.

"People were kind of awed by the magnitude of that goal. They were saying, 'You're kidding me -- in three years?' Even our board was somewhat skeptical,' " Melrose said.

Perhaps most astounding, Toro hit its profitability target while failing to meet its sales goals in any of the past three years. The recession, a slowdown in golf course development, a drought in the West and heavy rains in the East all hurt sales of Toro's consumer and professional lawn, landscaping and irrigation equipment.

Testing at Toro
Glen Stubbe
Star Tribune

Toro defied those obstacles and met its profitability goal because of a top-to-bottom program that dissected how it designed, sourced, produced and sold its products and found ways to do all those things more efficiently. The company didn't change what it does; it changed how it does it.

Toro's momentum on profits is continuing this year. The Bloomington-based company recently reported a 34 percent gain in net earnings to $9.3 million for its first quarter ended Jan. 30. The results topped analysts' estimates and fueled a gain of about 30 percent in Toro stock, which closed last week at $60.98 a share. The climb in Toro's stock price actually can be traced to the start of its three-year margin improvement initiative, when shares were languishing at around $20.

Wall Street appears to think there are more gains to come, maintaining buy recommendations on the stock and boosting the 12-month target price to $69 a share. The outlook appears to be based on the view that Toro will achieve the goals of its latest three-year-plan -- an after-tax margin of 6 percent and 8 percent average annual revenue growth.

Seaver Wang, an analyst at the New York investment research firm of Sidoti & Co., said he believes Toro can post double-digit revenue growth in the next few years. New products and a continuing shift into higher-margin professional turf, landscaping and irrigation equipment should fuel much of the growth, he said.

An ambitious program to examine and reduce Toro's cost structure has been the key to its success so far. While it has included some plant closings and shifting some production to lower-cost facilities in Juarez, Mexico, it's not focused on shutting factories and slashing payrolls. Toro's workforce has remained the same at about 5,300 employees during the past three years with about 15 percent of its regular full-time workforce in Juarez.

A close look inside

Instead, the bulk of the cost savings have come from an examination of all the company's operations, reconciling the sometimes conflicting goals of different departments to trim the overall cost structure.

"It's been a total rethinking of how they do business," said Bill Frels, a portfolio manager at the St. Paul investment firm of Mairs & Powers, a longtime shareholder. "They have done a superb job."

The early doubts about whether Toro could meet its profit-margin target were well-founded. For years the company had been an unremarkable profit performer, with an after-tax margin that went as low as 0.4 percent in 1998.

Melrose said the catalyst for change was an analysis by Toro's investment bankers that showed the company's margins were near the bottom of its peer group, which includes Caterpillar Inc., Deere & Co., Polaris Industries Inc. and Ingersoll-Rand. Toro's advisers said its paltry margins were the main reason its stock price was stuck in neutral, even though the company had successfully shifted the bulk of its business from the consumer to the professional turf and irrigation equipment market.

"That was strategically important, to get the volatility out of our business," Melrose said. "It was what Wall Street had wanted us to do to make our stock more attractive, but it hadn't really had a noticeable effect."

With the help of Minneapolis-based Pragmatek Consulting, Toro developed new ways of managing the supply chains for all its products, with an eye toward improving inventory management, lowering the cost of goods sold and strengthening cash flow. Pragmatek Vice President Chris Anderson said his firm trained about 50 Toro managers to identify more than 100 "disconnects" -- areas in which different departments could improve the links between their operations and boost the company's overall level of efficiency and reduce costs. The managers chose 11 areas of improvement on which to focus.

"Ken was a firm believer in having Toro people be the ones to carry this out," Anderson said. "It was a matter of teaching them how to fish rather than us handing out food."

Toro began employing a method of strategic sourcing that takes into account all phases of products' life cycles, from development to production and delivery. Often it meant reconciling the conflicting goals of individual departments, like the purchasing department's desire to buy parts in bulk to save money and plants' desire to keep parts' inventories lean.

Toro also developed a system for its engineers to see what kinds of parts, such as bolts and screws, were already being used in existing products in order to use the same kinds in new products. The goal was to simplify and cut the costs of inventory management.

Anderson said his consultants also had Toro managers study warranty claims to determine if there were common complaints it could eliminate by reworking certain products. That helped it reduce costs associated with repairing products under warranty.

As Toro enters the next phase of its program to improve profitability and increase revenue, the company will look at areas in which it can build market share, Melrose said. For example, Toro has a dominant share in irrigation equipment for golf courses, but isn't as strong in residential and commercial markets. "The key is to find out why we're not as good in these other areas," he said. "The engineering, production, distribution and competition is basically the same."

The company faces a similar situation in landscape contracting products, with a high market share in products made for the residential market but lower shares in equipment used to groom parks, sports fields, cemeteries and the grounds of schools, hospitals and government buildings. "Some of these areas, likes sports fields, are fast-growing markets," Melrose said. They are growing at least as fast as Toro's target of 8 percent annual revenue growth.

Other opportunities lie in overseas markets, which account for less than 20 percent of total sales. The consumer lawn care market in Europe, plus the growing number of golf courses in China, Thailand, Malaysia, Latin America and part of the Middle East are "underserved markets" with growth potential, according to Melrose.

The Home Depot decision

The increasing prominence of Home Depot as a vendor for some Toro products also plays a part in the company's plans for revenue gains. For years, Toro resisted selling its products through mass merchandisers in fear of undercutting its dealers. Last year, Home Depot accounted for more than 10 percent of Toro's $1.5 billion in sales.

"Dealers sold about 60 percent of lawn mowers 25 years ago, and today it's about 15 percent," Melrose said. "I would run into [Home Depot founder] Bernie Marcus at meetings, and he would come up to me, poke me in the chest and say, 'You will sell us mowers or you will die.' We watched our share go down because we had decided to be wedded to the dealer. I finally said we've got to find a way to sell through a big merchant but do it in a way that values the dealer."

In 1999 Home Depot began selling only a moderately priced mower that Toro had designed for the mass merchant but that could be sold at the same price by dealers. "[Dealers] were psychologically unhappy, but their business grew because they had a better mower to sell at a better price," Melrose said. Their service departments also stood to benefit by referrals from Home Depot, which doesn't service equipment.

Greg Schiffler, sales manager at Doug's Power Equipment in Spring Lake Park, said he and other dealers weren't happy about having Home Depot sell Toro products but understood the pressures that led the company to make the change.

"There are pros and cons," he said. "We get customers who saw it on Home Depot's ads or in their stores and then come to us to buy it because of the relationship a dealer can offer."

Schiffler said he's grateful that Toro did not give Home Depot access to its entire product line and believes that many of these buyers of the moderately priced model will come to his dealership if they decide to trade up to a different model.

Although acquisitions could play a part in Toro's future growth, Melrose said he's not counting on them in order to meet revenue goals. For now the company will invest in itself by buying back up to 2.5 million of its shares in a Dutch auction that runs until the middle of this month. Toro will pay $56.50 to $60 a share, or a total of about $141 million to $150 million.

Wang says he sees the buyback as beneficial to stockholders, who can either sell some shares back to the company in the auction or benefit because the lower number of shares will boost Toro's earnings-per-share. Wang recently increased his estimate for fiscal 2004 to $3.84 a share, from $3.09 share, with part of the gain tied to the improved results and part to the lower number of shares.

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