



After a Few Unprofitable Binges, NutriSystem Is Refocused and Ready to Expand

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NutriSystem -- the Horsham, Pa.-based online weight-loss company -- has bulked up.

nutrisystem

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Its first-quarter 2006 revenues grew 292%, to \$146.8 million, and net income rose 592%, with analysts predicting continued sharp increases in 2006. Memories of its bankruptcy filing and litigation woes under previous owners have all but been erased, even as the company plans to target new customer segments and expand internationally.

And yet, according to its two top executives, there has been as much luck and grit as glamour and glitz in the company's rise from the ashes. "Sometimes you learn more from your mistakes than from your successes," said president and COO George Jankovic, 38, who came to this country in 1991 from Serbia to study electrical engineering at the University of Colorado. "It's not like everything we found was gold. Lots of times we found dirt and worked around it until we found gold -- or silver."

Or, as chairman and CEO Michael Hagan, 43, who comes from Yardley, Pa., and earned an accounting degree at Saint Joseph's University, put it: "At the end of the day, it's about portion and calorie control.... We're not selling fads. We're Wal-Mart, not Wall Street." Hagan and Jankovic spoke at Wharton last month as part of the School's leadership lecture series.

Dressed informally in sports coats with no ties, both men were anything but casual. "In our DNA, we're both entrepreneurs," Hagan said. "We understand what it's like to make payroll, to hire people and sometimes fire people." The two men first worked together at Verticalnet, a business-to-business Internet company that Hagan co-founded in 1995. Jankovic joined in 1998 as vice president of product development after the Internet firm that had hired him as CEO was acquired by Verticalnet.

As they realized how well their styles, personalities and skills meshed, Hagan and Jankovic started searching for a new venture. Hagan learned from a contact at KPMG that NutriSystem was on the block and started researching it. "We were lucky," he said. "We had looked at five, six, seven companies before. George and I low-balled [the sellers] with a 60 cents-a-share offering. They were galactically naïve about running a sale process. It was a company that was in many ways mismanaged" with "a very limited concept of national marketing. The company hadn't innovated for 10 years."

But he liked the brand recognition he was buying and he liked the fact that NutriSystem had gotten rid of almost all its franchises. "We were not about to do the deal unless we got total control," he said. In December 2002, the management agreed to a price of 62 cents a share. Hagan and Jankovic took on no debt and raised just \$9.5 million in capital from other sources to get 60% of the company.

What they got was a corporate ruin with a history of success beneath the wreckage.

Founded in 1972, NutriSystem was the first structured weight-loss program of its kind, operating from company-owned and franchised weight-loss centers throughout the U.S. It was the country's largest weight-loss program in the early 1990s, but filed for bankruptcy in 1993 following a series of lawsuits by

consumers about its diets. There was additional litigation over a program that used a controversial fen-phen regimen of diet and prescription drugs.

In 1997, the company began a pilot program to see if consumers were interested in having meals shipped directly to their door. Two years later, it reorganized itself, closing its weight management centers and specializing in diet meal plans sold online. But the company was also cannibalizing itself, Hagan and Jankovic noted, trying to save the bottom line by unrealistic cuts in marketing expenses. "We know they were milking the company," Jankovic said. "It was almost a start-up." The two men "began to revamp the culture," Hagan added. "It was a classic kind of turnaround fixer-upper."

It didn't help that two years after they bought the company, they faced what Hagan described as "the tsunami" of the Atkins diet and similar quick remedies for obesity, all of which cut into the profits of established weight-loss companies. But Hagan said he was unfazed: A lot of trends "come and go, but the desire to lose weight is undiminished." In fact, he said, the company gets many "self-directed dieters" who first were attracted to "hucksters" but came to realize that there is no magic road to weight loss. "This isn't rocket science; it's not a fad."

In addition to brand recognition, NutriSystem had another advantage. It required no membership fees and it didn't involve consumers going to classes or even to in-person consultations. "There's no face-to-face visit," Hagan pointed out. Many consumers like this privacy, not to mention the relative low cost of the program. "At \$10 a day, we fit the budget of most consumers." The company has also been successful by offering "real food. [People] prefer burgers and pizza instead of shakes We know our consumer economics better than anybody. No one is closer to their customers."

The company's formula is simplicity itself. Every day, United Parcel Service trucks back up to warehouses and load 10-day supplies of meal packages for some 450,000 dieters. Four meals a day are included -- breakfast, lunch, dinner and a snack -- chosen from some 140 different foods that are ready to be popped into the microwave. The program includes diet and exercise plans. These are backed by advice and counseling from call centers, which the company outsources, as it does food preparation. In 2004, it added a chain of women's fitness centers.

Meanwhile, Jankovic has been pouring money back into marketing -- spending \$26 million during the first quarter of this year compared to \$8.1 million in the first quarter 2005 -- and trying different media to increase the customer base. After recognizing that the company could not limit itself to the web as a sales channel, NutriSystem began testing TV and radio spots in 2004, then moved last year into the increased use of print and infomercials. The company also uses the QVC shopping channel. "I feel like a pilot in a cockpit with all these dials and gauges," Jankovic said. "It takes two or three years to get really good at marketing. As soon as you see something working, dial it up. If something's not working, learn from it. Don't shut it down immediately. It may take several quarters to make it work. Continue experimenting and continue making mistakes [or] the competition will catch up to you ... It's not about beautiful, award-winning ads," he added. "It's about a message that drives profitable sales ... At the end of the day, it's a science."

The results seem to support Jankovic's approach. After adding only 50,000 new customers for its meal plans in all of 2004, NutriSystem landed 64,000 in just the first quarter of 2005. According to Hagan, the company expects an operating margin of more than 20% this year and foresees a rise to "about 28% in a couple of years." The company predicts that 2006 revenues will climb by at least 130%, to between \$490 million and \$510 million. Last year, the company reported an increase in revenues of more than \$212 million compared with just under \$38 million in 2004.

"This was once a \$1 billion company," Hagan said. "There's no reason it can't be again. We have a little chip on our shoulder. We were underestimated." If they had come to Wharton a year ago and predicted the 2005 results, he added, "We would have been laughed out of the building ... The challenge now is to continue this growth."

He said he expects the company to pass Weight Watchers in the United States this year, basing his optimism on the amount of business still to be had in the country and the feeling that NutriSystem is particularly well positioned to get a huge share of it. "Structurally," he said, "I don't see a lot of change around the corner." But he added quickly that the company is anything but complacent: "We're a paranoid bunch, as any management team should be."

Hagan estimated that there are some 70 million dieters in the country and that about 50 million of these are women. So the biggest potential for gain is among men, who he said are particularly resistant to going to groups and far more likely to relish the privacy afforded by NutriSystem's method. And, "we will get some backsliders back," he predicted.

The company will be launching a program for seniors and plans an expansion into Canada and then into other English-speaking countries. It also may offer some premium foods.

Asked by a member of the audience how well the two of them work together, Jankovic responded: "We are friends, but one guy's in charge. Mike's the CEO. Business isn't a marriage. There are no equals."

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