EXECUTIVE INSIGHTS

VOLUME VI, ISSUE 1

Strategic Restructuring: Improving Outcomes While Reducing Risks

Every industry has cycles of expansion and contraction. For many these cycles are aligned with the overall economy, while others' ups and downs are independent of macroeconomic trends. Over the past few years, many managers have faced disappointing performances from their businesses and have attributed it to the recession. Now, as the economic environment improves, executives find themselves asking if their underperforming operations will improve with the recovery or if the lack of rebound is caused by deeper structural problems that require more dramatic action.

L.E.K. has helped many companies answer this perplexing question. Not surprisingly, our work in this area has increased during this recent economic malaise and the emerging recovery. In this edition of *Executive Insights*, we will take aim at the topic of strategic restructuring. Specifically, we will:

- Identify the warning signs that point toward the need for strategic restructuring
- Review an approach that can be applied to produce an optimal outcome
- Highlight the restructuring guidelines that help mitigate the risks inherent in any significant change process

Strategic restructuring is different from cost cutting. Strategic restructuring is the process of aligning and sizing an organization's capabilities around the needs of the marketplace. Conventional cost cutting typically deals with just the sizing part of the equation. However, without a clear understanding of the alignment question, companies risk diluting their capabilities and alienating their customers. Strategic restructuring reinforces the capabilities that customers value most and forms the basis for establishing or maintaining a competitive advantage while trimming, or in some cases jettisoning, those costs that are no longer core or complementary.

The Warning Signs

In many corporations, decision making has become decentralized and placed in the hands of specialists – finance experts run the finance function, marketing experts run the marketing function, and so on. As a result, in larger companies there are very few executives other than the CEO, President, CFO or General Manager who view business performance across all functions, operating units and geographies. However, it is precisely from this vantage point that the earliest warning signs are most evident.

Strategic Restructuring: Improving Outcomes while Reducing Risks was written by **Rob Rourke**, Vice President in L.E.K.'s Chicago office. Please contact L.E.K. at strategy@lek.com for additional information.

L.E.K. has identified several symptoms that are frequently present in organizations that, if left unattended, will require strategic restructuring. The problems can be discovered by regularly asking the questions below. These warning signs are not exhaustive and there are certainly other symptoms that may point to troubled times ahead for a business. However, if two or more of these questions reveal disturbing truths about the health of a company or business unit, it may be time to initiate a strategic restructuring program.

The Strategic Restructuring Process

We caution against overcomplicating this initiative by creating too many teams, concurrent initiatives, or multiple reporting levels. A simple approach is most effective; it limits the organizational anxiety inevitably caused by the restructuring and ensures that most of the company's activities stay focused on running the existing business. We find that it is best to manage the strategic restructuring process in three essential phases.

The Warning Signs

- **Have negative earnings "surprises" become the norm?**
- **Has the company experienced a consistent share loss over several quarters in its key markets?**
- **Have prices declined in a dramatic manner for the company's highest-volume and highest-margin products?**
- **Have manufacturing costs escalated or quality and reliability failed?**
- **Have expense ratios (SG&A/Sales, R&D/Sales) increased to a point where they are significantly greater than management targets and peer levels?**
- **Has asset utilization dropped to a point where it is materially below management targets and peer levels?**
- **Have key customers defected to the competition at an increasing rate?**
- **Has turnover dramatically increased among top-performing managers, employees and sales personnel?**

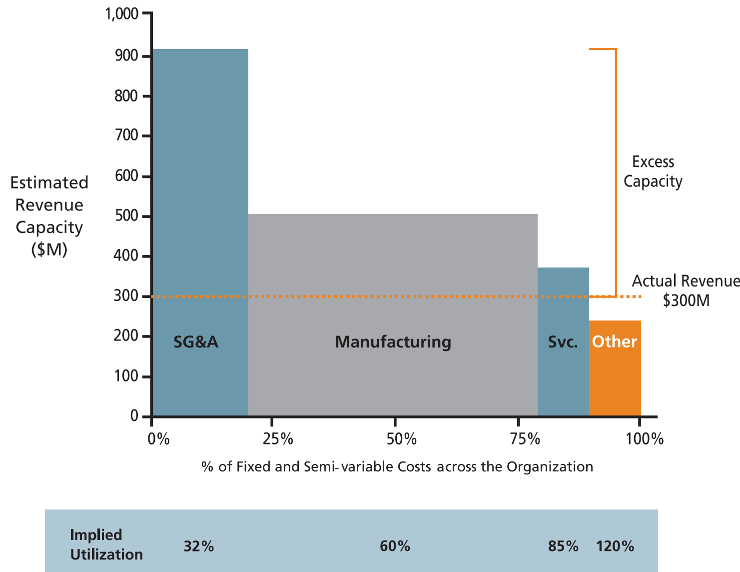
Phase One: The Diagnostic

Before improvement opportunities can be identified and prioritized, managers should understand where the needs are most acute. The diagnostic phase of strategic restructuring develops an objective assessment of the business' strengths and weaknesses and isolates these needs.

Broadly evaluating the key financial and operating ratios initiates the performance assessment by starting from the top and working down to the details. This approach helps avoid unnecessary analyses of businesses with strong performance and focuses resources on the areas that need it most. As a starting point, income statements, cash flow statements and balance sheets effectively serve as first-pass sources of information. Are there geographies or business units that are outperforming management expectations or peer levels? If so, de-emphasize the analyses on these business units to more deeply understand the issues in underperforming units.

One of the first questions to be addressed relates to capacity. Does the company have the proper capacity to profitably serve its customers or is there significant excess? This question is certainly common to manufacturing organizations; however, it is equally relevant for service companies. Determining the revenue capacity by cost function typically points to the most likely sources of future efficiencies

Determining Revenue Capacity by Cost Function
Figure 1



Implied Utilization	32%	60%	85%	120%

Figure 1 above illustrates one of several ways to convey the capacity situation by cost function across the entire organization. In this example, a large plumbing supply company found itself with significant excess capacity in Manufacturing and Sales General & Administrative (SG&A). However, cost-cutting priorities are not as simple as trimming manufacturing expenses or lowering SG&A costs by some targeted percentage.

In the case of product manufacturing, several factors should be considered, including:

- The product priorities (which products are most profitable, are growing the fastest, and have the greatest amount of customer loyalty?)
- The production capabilities (which types of products) by facility
- The marginal cost of production by facility for comparable products
- The excess capacity by facility
- The fixed costs associated with a given facility
- The location of the facility – particularly important for businesses where transportation costs represent a relatively large amount of the costs of goods sold (COGS) or final price to the customer
- Complicating factors such as union issues, contracts, and write-off amounts

Understanding these factors helps to mitigate the risk of cutting capabilities and costs in areas that should be bolstered. Conversely, detailing the relative profitability of similar products across manufacturing locations may justify deeper cuts at some facilities that produce a disproportionate amount of low-margin products.

Establishing a minimum contribution threshold for each product highlights rationalization opportunities. The contribution threshold identifies the minimum gross margin that must be earned by a product to cover its fixed costs and its capital charge. Products that fail to meet the minimum should be thoroughly investigated before they are rationalized – but such an approach provides a clear starting point for the subsequent research.

Analysis of Contribution Margin by Product
Figure 2

Contribution Margin Threshold

	Contribution Required
R&D/Sales	2%
SG&A/Sales	18%
Required Return on Capital (pretax WACC)/ (Sales/Capital Employed)	10%
Total Minimum Gross Margin Required to Be Value Creating	30%

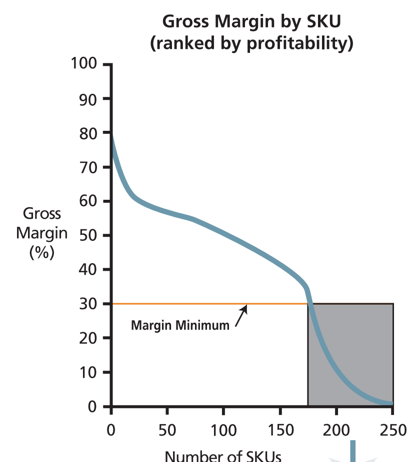
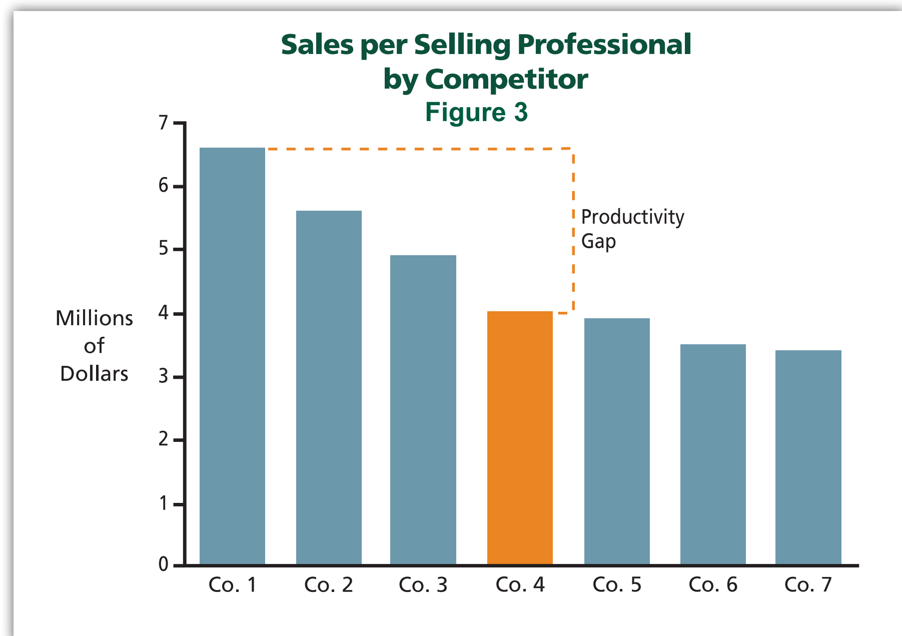


Figure 2 illustrates an example of the analysis.

In this case, we found that the plumbing supply company needed to revise almost 25% of its product line. Based on an item-by-item review, price increases were instituted for some products, while others received reduced service levels. In many cases, products were simply eliminated.

Similar to manufacturing, the size and capabilities of the SG&A infrastructure must be assessed before they can be aligned with marketplace needs. Measuring productivity becomes the building block of understanding SG&A costs. Ascribing these costs to specific lines of business, geographies or products provide a clearer perspective on the relative profitability of the business units. Additionally, much can be learned about target resource levels by performing similar benchmarks across competitors or peers. Make certain to consider the impact of scale when setting targets, as many costs are semi-variable if not fixed.

Sales force effectiveness is another aspect of strategic restructuring that not only produces cost improvements but also increases the business' ability to profitably grow the top line and increase revenue capacity. Again, benchmarks serve as a good starting point. The figure above depicts a benchmark of sales force productivity – sales per selling professional – for the plumbing supply company. In this case, the client's sales force exhibited median levels of productivity relative to its main competitors. However, a large disparity existed between the industry's top performer and the client. The difference between Company 1 and the client (Company 4) represents the opportunity to improve productivity by 60%. Closing this gap would significantly improve the top line or dramatically reduce selling expenses.



Capitalizing on this opportunity depends on the cause of the disparity. Sales-force-related causes include the compensation structure of the sales force (fixed versus margin/value added); the driver(s) of the variable compensation element (revenue growth versus margin); or the tools, training, and autonomy of the sales force. For the plumbing supply company, the disparity resulted from a combination of two factors. First, its existing sales compensation scheme lacked proper incentives to drive new revenue generation. Second,a deeper understanding of key client needs was required by the field sales force. Through changes in compensation structure and a sales force restructuring that encouraged representatives to spend more time with customers, the disparity was significantly reduced.*

At this point in the strategic restructuring process, management should have a clear understanding of the opportunities for business performance improvement. Before implementation commences, it is critical to pressure-test the probable reaction of the market to key decisions.

Phase Two: The Market Perspective

When identified businesses, products, or geographies are not producing sufficient cash flow to cover their capital absorption costs, management must ask several questions:

- What is the market outlook for this product/line of business (e.g.,will the business grow into its cost structure)?
- If the business is unlikely to grow into its cost structure in the short term, what would be the market's reaction to a price increase to produce a positive contribution to capital?

* *Pricing is another important component of sales-force effectiveness.*

- If the market is unlikely to absorb a price increase, what amount of infrastructure must be reduced to return the unit to profitability?
- Will the market accept the required reductions in infrastructure (e.g., service levels, technical support) for this unit?
- Finally, if all of the answers to the prior questions point to shedding the unit, what is the best way to exit, how will the exit impact other units, and what amount of infrastructure can be reduced for the business in total?

Gauging the market's reaction and the competitive implications of potential decisions concerning the strategic restructuring is critical. For example, will the closure of a manufacturing facility impact customer relationships? Will competitors see such actions as a sign of weakness and more aggressively compete for share? How will underlying demand evolve and what are the implications for future product mix and capacity? What will happen with key vendor relationships?

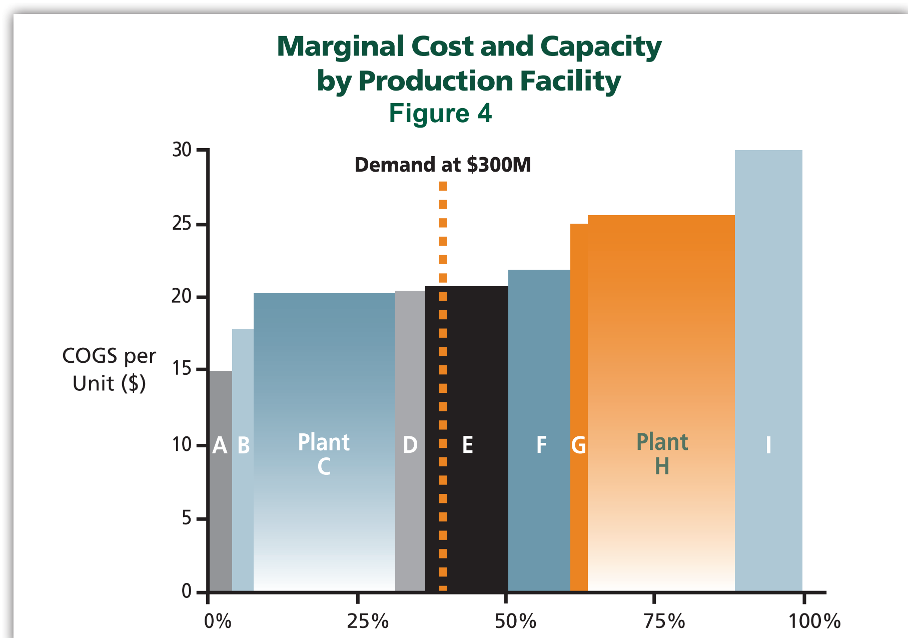
The due diligence in this phase is similar to the market and competitive intelligence required when embarking upon many other strategic decisions. As is often the case, the most robust answers will be derived directly from customers. Focusing your primary research around the uncertainties associated with the strategic restructuring issues will add clarity to your decision and aid in the implementation plan.

The customer research will also highlight the opportunities for the business to reallocate resources among its most important product and service lines. Returning to the plumbing supply example, we found that customers did not realize a material difference in quality, service, or convenience as a function of the client's manufacturing location. As a result, a supply curve was constructed to highlight the facilities that would be candidates for rationalization. The figure below illustrates the results.

The company operated nine manufacturing facilities. Given the expected demand profile identified through the customer research, facilities F, G, H, and I could possibly be shuttered. However, upon closer inspection, the difference in marginal costs between Plants C, D and E were negligible. Moving plant E forward in the stack allowed for the additional rationalization of facility D and additional cost savings for the client.

Understanding a company's own supply curve is particularly useful for these decisions. It becomes even more compelling when these curves are developed for the competition. Competitor supply curves not only enable management to determine their business' profit-maximizing footprint, but also uncover capacity that could be displaced or become obsolete due to market conditions.

Caution must be exercised when conducting the primary research. Develop interviews that allow you to gain a perspective on the issue without revealing the decision you might possibly take. For example, if the decision is to exit a geography, you would not want to ask a customer in that region how an exit would impact the relationship. Instead,we recommend asking a series of questions related to the importance of multi-region capabilities when vendor decisions are made regarding the products and markets that you serve. The need for discretion is even more acute when conducting competitor interviews. Frequently, leveraging a third party to execute the competitive research is a good approach in order to avoid issues with signaling, reduce bias in the data, and mitigate disclosure risks.



Knowing What Your Customers Value

A client recently debated outsourcing a major cost center that provided services to nearly 30% of its customers. Though a significant portion of its customers utilized these services, the function was sub-scale and not likely to grow. Outsourcing alternatives were evaluated and through a vendor screening, one company was identified as having comparable capabilities with a 20% lower transaction cost. The simple economic decision would be to outsource the function. Fortunately, before the decision to outsource was finalized, they asked L.E.K. to gauge the market's reaction.

We interviewed key customers and the customers of major competitors and revealed that outsourcing these services would create a significant capability gap in the company's portfolio – customers relied upon the integrated nature of this function. Twenty-five percent of the customers would be "highly likely" to switch vendors if the function were outsourced. Additionally, the interviews found that customers were less price sensitive to the service than what was assumed. As a result, the function was not outsourced and a price increase was phased in. The infrastructure of the function was also reduced, as interviews indicated that the customers that purchased this service would not experience the growth required to justify current levels.

Phase Three: The Implementation

The implementation stage is where the risk to the organization is the greatest. Several types of hazards may materialize, including:

- **Diminished expectations** – the benefits from the restructuring are not as great as anticipated.
- **Increased expenses** – the break-up costs or alternatives required to deliver the benefit are more expensive than anticipated.
- **Delayed timing** – organizational barriers, change resistance, or resource issues delay the achievement of the benefit.
- **Customer risk** – key customers are disrupted during the restructuring process and defect.
- **Employee risk** – key employees are alienated during the restructuring process, and they leave.

A performance-based restructuring plan is one tool to help minimize the risks. By ascribing responsibility to a team dedicated to delivering the anticipated restructuring results within a defined time period, senior management can monitor progress and circumvent obstacles in the road. The plan does not need to be complicated, nor should it be an exercise in analysis paralysis. However, at a minimum it should identify the resources, timing, activities, interdependencies and contingencies associated with each stage of the implementation. Most important, expected benefits should be clearly assigned to each stage to reinforce accountability.

L.E.K. has helped numerous clients successfully navigate these waters. Based on our experiences with supporting organizational change through the strategic restructuring process, we have observed ten critical rules that should be followed to help ensure the maximum benefit.

1. Dedicate a Team

From diagnostic through implementation, strategic restructuring is difficult and requires focused resources to make the proper decisions in a timely manner. Moreover, the fundamental business still needs to run. Diverting too much management attention between the underlying business and the restructuring effort will create a distraction.

2. Commit Senior Management Direction

Driving change is easier when the organization realizes it has the attention of the corporate executive team. Additionally, many decisions associated with restructuring help shape the future of the company and, as such, are best made by senior management.

3. Champion Results

Create a culture of achievement by measuring the progress of the restructuring efforts against the specific performance metrics established at the beginning of the implementation. Sing the praises of achievement and proactively address delays.

4. Overcommunicate

Organizational change is unsettling. Allay employees' fears by articulating the plan. Communicate the reasons for the changes, the benefits from the changes and its timing. Communicate often.

5. Run the Business

During the change program, you still have a business to run. Do not dedicate so much time to the restructuring initiative that the core business suffers.

6. Do It Once

Avoid the cycle of continuous restructuring as anxiety caused by the process is unhealthy over an extended period of time. Successfully emerging from the restructuring phase is the strongest and most credible sign to employees, customers and investors that the business is on the right path forward.

7. Reinforce Customer Intimacy

Proactively reach out to your most important customers at the outset of the process. They are more likely to maintain their loyalty if they see you are sensitive to their needs and concerns. They will also be more willing to forgive any bumps in the road that you may encounter.

8. Develop Retention Programs

Departure of key employees will curb your ability to realize the full potential of the restructuring. Establish retention programs early, and align the payouts with results, to reduce flight risk and to motivate optimal behavior.

9. Top Grade

Systematically assess the performance, capabilities and aspirations of your employees. Avoid trimming resources by 20% across the board. Focus on the bottom 20%. Place superior performers in new roles to improve organizational competence as you emerge from the restructuring.

10. Make the Hard Decisions

Use the strategic restructuring process as a vehicle to make unpopular decisions. Are there pet research and development projects that have gone astray? Are there managers who, while popular, have experienced diminished effectiveness? Under normal business conditions, making tough decisions creates resentment and uncertainty among employees. During the strategic restructuring process, there is an elevated tolerance for these kinds of decisions.

Better Outcomes with Reduced Risks

Strategic restructuring is a critical tool to align the capabilities of an organization with the needs of the marketplace. It is far more than a cost reduction, rightsizing or reengineering campaign. The benefits can be profound to a company because it improves both short-term profitability as well as the ability to capitalize upon future growth. However, the journey is not for the faint of heart. The process is plagued with pitfalls and the route must be carefully navigated. By following the defined phases and making informed decisions, executives can expect to have value-creating results while minimizing the risks.

L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and analytical rigor to help clients solve their most critical business problems. Founded more than 25 years ago, L.E.K. employs more than 900 professionals in 20 offices across Europe, the Americas and Asia-Pacific. L.E.K. advises and supports global companies that are leaders in their industries – including the largest private and public sector organizations, private equity firms and emerging entrepreneurial businesses. L.E.K. helps business leaders consistently make better decisions, deliver improved business performance and create greater shareholder returns. For more information, go to www.lek.com.

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