EXECUTIVE INSIGHTS

VOLUME X, ISSUE 1

Rooting Out Costs in All the Right Places

Executives today must manage costs in both good times and bad. Boards and stockholders expect management to regularly eliminate unnecessary costs and reallocate resources to activities that will generate the greatest returns. This is not unrealistic. Our experience shows that even highly profitable companies typically have significant opportunities to reduce costs. However, doing it properly within complex businesses and changing market landscapes is a major challenge.

When reducing costs, not all costs are created equal. Shrinking every expense that appears excessive can potentially damage a company's competitive advantage and lead to revenue declines that far overshadow the cost savings. Instead, managers need to take a strategic approach that leads to cost cuts that do not impair the key value drivers of the business.

In this article, we describe the common traps that managers can fall into when initiating a cost-cutting program. We then describe a process that L.E.K. has implemented at a number of companies to make cost reductions substantial, sustainable, and value-creating. While we do not detail in this article how to execute an effective internal communication program within a cost-reduction effort, this is clearly critical to the success of any such initiative.

Cost-Cutting Traps

Many senior executives believe they can quickly identify the "fat" in their organizations. However, acting on intuition can turn into a high-risk guessing game for even the most experienced of cost-cutters – a game that can lead managers to make cost reductions in the wrong places and create bigger competitive problems than when they started.

L.E.K. has observed four traps that can prevent cost-cutting from having a positive long-term impact. The first trap is when executives try to meet short-term financial targets such as quarterly or year-end results. To avoid disappointing investors, CEOs and CFOs order business unit and functional managers to make cost cuts to close the profit gap. While these actions often work in the short term, the cost savings rarely "stick" and typically re-emerge the following year.

Why? It is usually easy to give up an expense for a few months with little consequence. That makes marketing, repairs and maintenance, and training easy targets. However, without a sufficient alternative to compensate for the lost resource, longer-term results suffer. To regain the lost capability, companies return to their former spending levels. If managers are lucky, this happens before the real damage is done. If not, the cuts can quickly destroy a brand's luster, tarnish the customer experience, or create any number of other unacceptable consequences – all of which eventually destroy value.

Rooting Out Costs in All the Right Places was written by **Jon Weber**, a Vice President in L.E.K.'s Boston office. Please contact L.E.K. at finance@lek.com for additional information.

Four Cost-Cutting Traps

1. Making short-term profit "fixes" that don't stick
2. Resistance to change
3. Blind benchmarking
4. Tunnel vision

The second trap is the natural resistance to change. Nobody wants to make changes, particularly ones that are large and risky, take time to implement, or require major investment before any benefits accrue. We have seen many companies' employees become addicted to proven processes regardless of their inefficiency – so much so that they convince themselves (and everyone else) that there is simply no other way to execute the process. They come to believe that re-engineering the process in any way will bring disastrous consequences. With heels firmly dug in, their scare tactics persuade management to look elsewhere for opportunities.

For example, at the beginning of an assignment, the chief operating officer of a retail chain defended his monthly store audits, claiming they prevented inventory "shrinkage" (i.e., theft) from raging out of control. After studying the chain's operations, L.E.K. suggested a cost improvement with millions of dollars in potential savings: moving the auditing cycle from every 30 days to 90 days but auditing the highest-risk stores more frequently. The COO rejected it out of hand. This reflects how, by nature, many managers opt for no or minimal changes – the proverbial "low-hanging fruit."

The third trap is making hasty decisions based on benchmarking against other companies. To be sure, comparing procurement, manufacturing, distribution or other business activities with those of other companies can shed insight on how to operate more efficiently and effectively. The catch is that just having higher costs in a given function does not automatically mean a company should cut costs or change activities in that function. In many cases, cutting costs can diminish the customer experience and reduce shareholder value.

Take the example of a fast-food chain. A benchmarking study revealed it had higher in-store labor costs relative to its peers, driven in part by committing greater resources to servicing drive-through customers. Accordingly, the company's initial plans to improve the economics of each restaurant included reducing the number of employee hours servicing the drive-thru. However, further research revealed that speed and accuracy of drive-thru order fulfillment – which represented about 60% of store revenue – were among customers' most important criteria in choosing a fast-food restaurant. It was on these criteria that the company outperformed its peers. Reducing drive-thru labor without sustaining order speed and accuracy would thereby destroy the restaurant's value proposition. Managers rightly backed off cutting costs there. Therefore, understanding where your costs may be excessive is important, but understanding how they impact the value of the business is just as important.

The fourth trap is tunnel vision. Managers can become so engrossed in their businesses that they fail to explore how to work with other business units or brands to eliminate redundancies. Some business functions also represent the "unknown," which scares managers from even considering opening, what they perceive to be, a can of worms. IT is a classic example. We've seen various operators look the other way rather than explore the prospects of making material changes to IT systems – whether implementing a new ERP platform or upgrading point-of-sale systems.

Strategic Cost-Cutting: The Process

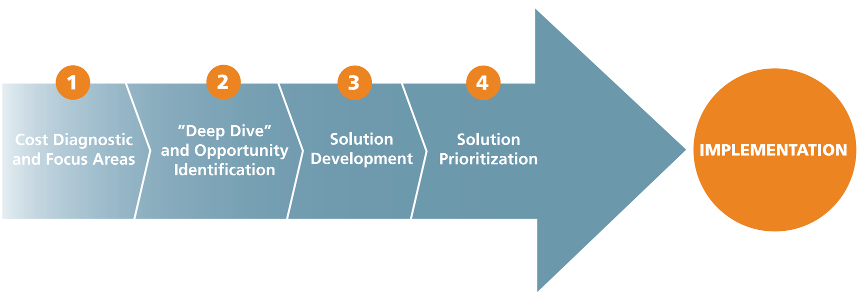
Uncovering and reducing millions of dollars in costs without eroding competitive standing requires a strategic and rigorous process of cost reduction – one that lets fact, not emotion and intuition, drive decisions. L.E.K. has used such a process successfully with dozens of companies. We find it reduces the tendency to consider only the "low-hanging fruit." Most importantly, it has forced managers to scrutinize the impact of their cost-cutting ideas on their company's strategy and has kept intact, and even improved, the key drivers of value.

Our process (*see Figure 1*) has four steps:
(1) Cost diagnostic and focus areas
(2) "Deep dive" and opportunity identification
(3) Solution development
(4) Solution prioritization

Cost Diagnostic and Focus Areas.
The first step is to gather facts about costs to create informed hypotheses on where to focus subsequent evaluation efforts. To do this, managers need a clear and accurate picture of the cost structure of their organization. While internal financial reports are a starting point, they can give an inaccurate account of the true cost position of the company's businesses. Additional work to disaggregate and reallocate costs is often required to clarify the picture. This is especially true when shared costs are not allocated to business units, are allocated based on arbitrary or outdated rules, or on excessive intercompany charge-backs. For example, a retailer with multiple chains may allocate real estate development costs based on revenues or on store counts for each chain. That allocation might fail to reflect that one chain, although comparable in size to others, is incurring much greater development costs given its aggressive store growth, relocation, and renovation programs. Getting costs correctly allocated in areas such as warehouse and distribution can be even trickier.

Figure 1

Strategic Cost-Cutting Process



Phase 1: Cost Diagnostic and Focus Areas
- Reallocate costs to the proper functions/business units
- Analyze cost trends over time, both in total and in per unit metrics
- Determine where operating leverage is and is not being created
- Develop and prioritize hypotheses for in-depth analysis

Phase 2: "Deep Dive" and Opportunity Identification
- Determine cost driver-to-value relationships
- Create fact base through benchmarking
- Develop list of cost-cutting opportunities

Phase 3: Solution Development
- Identify potential solutions for each cost-reduction opportunity
- Clearly define the key initiatives within each solution

Phase 4: Solution Prioritization
- Establish and weigh prioritization criteria
- Evaluate solutions against criteria
- Prioritize solutions

Other times,corporate costs are not allocated to the businesses at all. IT, HR, Finance, and other costs can balloon when they are not assigned to the business units or initiatives that consume them. Attributing costs properly requires reallocating them based on proxies that more accurately reflect their usage. For instance, FTEs may be the right metric for allocating certain HR costs, while internal work orders may be best for IT. In others, measures like dollar or unit sales, square footage, operating profit or store counts may be the best proxies.

Managers must get a sense not only of the current cost picture throughout the organization, but also cost trends over time. With a size and trend cost picture, managers can draw more informed views about the biggest and fastest-growing cost areas. They then must analyze data across multiple fronts – by business, by function, and even by physical location (e.g., corporate, field, and store).

Further, they must assess and normalize overall trends against common metrics (e.g., per-store or per-customer, or as a percentage of sales or profit). Some costs may be growing only modestly on an aggregate basis. For a chain with a declining store count, this view can mask the fact that the cost burden of supporting each store has risen dramatically. From these analyses, L.E.K. has found that many clients are surprised to learn that their best units are not performing as well as they had thought, and costs may be bigger and growing faster in places they did not expect.

Managers can gain further insights into potential cost-reduction opportunities by diagnosing where the business is getting "operating leverage." Operating leverage results when an increase in cost produces a greater increase in revenue. Identifying where there is and is not operating leverage is critical to unveiling where unnecessary costs may be hiding. To be sure, management may be investing in certain functions, and negative operating leverage will occur in the time before the benefits of these investments begin to materialize. The key point is that managers should expect a return on their spending and take action if this does not happen. When diagnosing a company's cost structure, one should look both historically and toward the future (based on strategic plans and associated financial forecasts) to find answers regarding if and when operating leverage may be realized. Managers must make sure they are gaining significant leverage from more-mature businesses. This leverage allows for investments in growing businesses or functions necessary to create future shareholder value. Conversely, areas with negative leverage today are expected to see a reversal in the future as investments begin to pay off.

Managers can then select the areas that appear most worthy for further in-depth analysis. But one caution: The purpose of this first phase is not to exhaustively uncover and analyze all possible cost-reduction opportunities throughout a company. That would take far too long, and the risk of getting lost in the weeds is too great. Rather, managers should formulate informed hypotheses to bring focus and depth to the subsequent analysis about which cost-reduction opportunities have the greatest potential.

"Deep Dive" and Opportunity Identification.

Once managers agree on where to focus their cost-cutting exploration, the exhaustive analysis begins. It is crucial to gain an in-depth understanding of the cost driver-to-value creation relationships within each focus area. Which factors drive costs and what value do they generate? For example, a restaurant chain's cost of goods sold (COGS) is driven by the quantity, mix, vendor contract terms, and quality of food and beverage sold. In turn, these factors which also influence pricing strategy and the overall food offering, directly shape consumer brand perceptions and purchasing decisions. Clearly, ideas for cost reductions must consider the impact on consumer perceptions and buying behavior. In other cost areas, the amount of labor, complexity of activities/processes, or other factors may be the primary cost drivers. To understand which levers to pull, managers must map all of them out and model the cost driver-to-value relationships.

Managers can then conduct selective benchmarking to identify cost gaps and savings opportunities. Benchmarking can be crafted in various ways to achieve different goals. Managers can benchmark against competitors, against other departments or geographic regions within the company, or against previous years' results. What you actually benchmark can also vary tremendously: best-practice operating procedures, organizational structure, and cost burden.

As mentioned in the section on cost-cutting traps, determining whom to benchmark against is tricky. Too broad a peer set will provide widely inconsistent and likely irrelevant data due to the inclusion of companies that differ fundamentally from your own. Too narrow a set may yield a skewed fact base or one too specialized to provide directly transferable insight. With so many options, managers must carefully define the best protocol. While benchmarking can be an extraordinarily valuable exercise, if done the wrong way it can lead to misleading results and misdirected cost reductions.

Proper benchmarking is difficult and can take considerable time, which is all the more reason to be selective. At its core, benchmarking combines secondary research with sophisticated primary research that gains access to competitors and extracts relevant and accurate information from benchmark participants. Further, converting benchmarking data into useful information is both an art and a science, requiring robust capabilities in financial modeling, assumptions triangulation, and interpretation.

With an internal and external fact base on areas of focus, managers can identify where to cut costs. The output of this phase will be a long list of cost-cutting opportunities and their potential financial impact.

Solution Development

L.E.K.'s experience has been that at this stage, managers are likely to have uncovered dozens of opportunities to cut costs. In this phase, managers generate ideas to address each cost-savings opportunity. For example, to reduce the growing costs of disparate local training programs throughout the world, e-learning initiatives could be integrated into the training curriculum. Or, the IT help desk function could be outsourced to lower IT costs and improve service quality and employee efficiency. These ideas will emerge throughout the process of completing the prior two phases, as well as through other forms of ideation, which can be led internally or by outside facilitators.

For each cost-reduction opportunity, managers need to define how they will capture savings. Further, they need to articulate the changes they must make in the business to ensure they do not destroy customer or shareholder value in the process. For instance, managers must not only define the resources they can eliminate, but also the capabilities they need to retain in order to ensure performance does not slip. This does not mean that all cost-saving initiatives will be pursued. Deciding which to pursue is the focus of the final planning phase.

Solution Prioritization

Not all opportunities are created equal, and some cost problems may not be as important to address as others. In this phase, managers prioritize the potential cost-reduction solutions they have identified.

Cost-reduction initiatives can be complex. Consider again the opportunity to reduce COGS at the restaurant chain. While consolidating vendors to leverage scale and improve contract terms for food and beverage may be straightforward, the risks and benefits of moving to lower-quality ingredients are much less clear. In fact, managers may need further input to make this decision, such as direct feedback from consumers or results from pilot studies. Prioritizing initiatives requires a sophisticated process that assesses each opportunity across a number of criteria (*see Table 1*).

Table 1

Solution Prioritization Criteria

Likely cost savings	Base case estimate of annual cost savings, given execution risks and variability of outcomes
Costs and investments to achieve savings	Incremental costs (e.g., severance, lease termination fees, operating expenses for new management structures and processes) and investments (e.g., new technology platforms) to implement and sustain savings over the long term
Revenue impact	Net revenue growth or decline from any changes in resources, activities, processes, products and services offered
Earnings impact	Net effect on reported earnings
Timing	Time required to both implement initiatives and begin realizing financial benefits
Risks	Execution risks and the degree of variability they create across the other criteria
Value creation	Net present value (NPV), which represents the expected value to be derived from the initiative

This framework goes beyond merely the quantification of potential cost savings. It forces management to think about other important qualitative and quantitative factors, especially the impact of potential cost cuts on value creation. Further, managers cannot evaluate the options without specifying the alternative resources, activities, and processes that are required to operate the business after they reduce or reallocate costs. This is critical to ensure the savings endure over the long term and that costs do not creep back (*see Table 2*).

After evaluating opportunities by these criteria, management teams can collectively prioritize the initiatives they should pursue. Naturally, managers often have different perspectives on the importance of each factor. As a result, there is not one pure metric or formula for prioritization, and the prioritization process should be an iterative one with healthy debate.

Some initiatives will have a large payoff and can be realized quickly, representing wins that should be pursued immediately. Doing so creates momentum and funds investments that may be required to realize savings in other areas.

Table 2

Example of Solution Evaluation

Cost-Savings Opportunity	Solution	Likely Cost Savings	Costs and Investments	Revenue Impact	Earnings Impact	Timing	Risks	Value Creation
Maximum synergies are not being realized across brands (e.g., duplicative activities, lack of coordination, untapped scale economies)	• Create shared services platform for ad production, purchasing, and various G&A functions • Consolidate and renegotiate vendor contracts based on aggregate scale	●	●	○	●	◑	◑	●
"Do-it-ourselves" mentality adds costs in IT, resulting in process inefficiencies and lack of customer data	• Increase levels of outsourcing in IT support and software development and maintenance • Consolidate systems platforms and streamline processes that have become overly complex and inefficient	◕	◔	◑	◕	◑	◑	◑
Operational field management is too large	• Increase spans of control for field management • Cross-train personnel to be multi-functional and further reduce headcount	◑	●	○	◑	◕	◑	◑
Duplication of activities by the company and its suppliers is resulting in a higher cost structure	• Redefine internal/external product design and production processes • Eliminate redundant internal activities and renegotiate contracts	◑	●	○	◑	◕	◕	◑
Distribution infrastructure and logistics are not optimized, resulting in higher cost and stock-outs	• Optimize forecasting and outbound logistics to reduce freight costs and improve inventory management	●	◑	◔	●	◑	◑	◕
Underperforming stores are hurting profitability and driving excess overhead costs	• Close and relocate stores to improve overall profitability and also enable reductions in corporate and field support costs	◕	◑	◔	◕	◑	◑	◕

Key: Attractive: ● Unattractive: ○

Conclusion

Every company today must make cost-cutting a regular – not episodic – event, because it is instrumental to creating shareholder value. Managers can easily put competitive standing at risk through cost reductions that seem right but harm the brand. Therefore, cost-cutting must be done carefully. To make substantial cost reductions both lasting and value enhancing, managers must first be careful to avoid a number of common traps that can foil the effort. By pursuing a process that doesn't treat all costs the same, but rather respects the inherent differences in their value-generating power, managers can cut costs confidently and with limited risks. Further, utilizing proven criteria to evaluate potential cost-reduction opportunities builds the consensus necessary to move into implementation.

Whether the goal is to create value by improving operating margins or funding strategic growth initiatives, cost-cutting as an enabling tool should not be cast aside. With the approach we described, it should be considered a real and acceptable strategic option.

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