EXECUTIVE INSIGHTS

Cost-Cutting Strategies To Mitigate the Impact of Inflation

Rising inflation is heavily impacting the bottom line of many companies as they struggle to pass on the full impact via price increases. L.E.K. Consulting's late 2022 study on this issue showed one-third of companies managing to improve their EBITDA throughout this period, while 20% expected to lose more than 10% of EBITDA (as a percentage of sales). The rising cost of debt is putting cash flow under further pressure, with a c.4% rise in the Euribor one of several factors in play. The increasing investment demands of energy and digital transition are stretching budgets even further as companies struggle.

As ever, there are winners and losers in all industries, but a vast majority of companies lack the headroom for the levels of price increase that could meaningfully alleviate the pressure of rising costs. The situation is even more acute wherever prices are regulated.

With costs increasing faster than revenue, management teams are looking to improve direct costs through commonplace productivity tools such as smarter sourcing, increased capacity utilisation, better turnaround time, and new ways of working such as digitisation impacts on sales and operations planning, production and quality, on-time and in-full delivery, cash management, etc. But many have experienced an acceleration of indirect costs well beyond their own control. Rapidly rising talent costs have seen increases of up to 1.2x revenue growth for support functions and even 2x for head office costs in regulated environments.

The price of technology is climbing too, with the cost of services such as new cloud computing opex adding to companies' woes.

Reducing indirect costs can appear challenging because they are dispersed and intertwined with organisational complexity, not just tied to consumption levels, leaving them potentially difficult to reduce, maintain and even monitor. However, there are strategies companies can adopt to mitigate the worst effects of inflation.

Throughout this *Executive Insights*, we discuss key success factors to reduce indirect costs, highlighting the trade-offs between immediate savings and longer-term transformational approaches. Less difficult than sometimes perceived, there are several approaches with a short-term impact, including simple spending cuts that can potentially yield 5% to 10% savings, a zero-based budget resulting in 10% to 20% savings, or even turnaround strategies that eliminate support costs or adjust service levels to prioritise core activities and preserve cash. Organisational and/or digital transformation can also trigger significant savings, but can take longer to deliver and demand stronger upfront investment.

Our recent experience demonstrates the multiple factors that combine to successfully reduce indirect costs, achieve meaningful targets and deliver sustainable results:

- Success is driven by tone at the top. By nature, indirect cost-reduction projects question current practices at each level, reducing everyone's headroom to 'throw money at problems'. CEO and executive committee (Exco) members need to make it explicit to intermediate management that reducing all indirect costs is a corporate goal.
- Transparency is key. Usually, baselining concentrates on both general ledgers for costs and org charts for headcounts. Questioning the way management accounting is done (separating head office from field, for example) and revealing the full costs and headcount by 'extended function' throughout the organisation will help show what is at stake in order to seize the prize.
- Peer scrutiny is needed to create change momentum. Avoiding the conflicts of interest caused by a head of function who is ambitious in reducing costs but reluctant to reduce his/her own resources is vital. Strategies to overcome the risk of inertia can include nominating a peer Exco member as a critical sounding board of the head of a workstream to field any recommendations.
- There is real value in starting with the cost-cutting exercise during the baselining phase as a first sprint to uncover what can be stopped within the next few months. In that phase, there should be clarity about what is a real saving (spending that won't be done anymore) versus what is just postponed until later. Our experience shows that these first quick wins help demonstrate the return on investment of the project and contribute to engagement and momentum.
- Never stop at just cost-cutting — seek to investigate process improvement with a zero-based budget mindset. This is the opportunity to look at renunciation, productivity and resourcing levers that have a real impact, that question the status quo and streamline

processes, and that open the door to more automation. Working on these process improvements creates better conditions to assess business cases relating to often costly digitisation, and helps answer two key questions: What can be done without it? What more does it bring in savings?

Implementation FAQs

Despite the clear success of these factors, most companies raise several concerns when thinking about implementing an indirect cost-reduction project. These include:

- **"How does it integrate specifics of our business?" —** This is a fair concern and there is no one-size-fits-all generic approach. While the basic methodology can remain the same, it needs to be adapted to suit the unique needs of the organisation, with project workstreams tailored to key steps of the value chain. For example, in healthcare services, care delivery processes (attracting patients, outpatient/inpatient booking, lab testing, patient pathway, billing, etc.) should be detailed, in addition to specific (regulatory, practitioner relations) and non-specific (IT, HR, Finance) support functions.
- **"Who should be involved?" —** Should you risk your project getting ungrounded by involving mostly Exco levels, or risk inertia and local conflicts of interest by involving mostly middle management? The key is to name change agents who understand the processes, pressure-test performance improvement levers with some middle management and ensure Exco members are involved in the decision.
- **"What does good look like?" —** External benchmarks are often seen as poorly adapted to the situation at hand. Cost-cutting benchmark databases quickly find their limits, and this is the reason why strategy consulting adds more value to such cases, by systematically leveraging external interviews and building tailored business cases based on direct competitors and reference players. Moreover, internal benchmarking remains a source of useful insights for multi-site businesses.
- **"How do I jump-start implementation?" —** Many cost-cutting and zero-based levers rely purely on management decisions and don't require any investment or any one-off costs for their implementation. The key is to create the right governance to ensure management will make these decisions and hold to them.
- **"Do I need a chief transformation officer (CTO) to pilot this?" —** No. Exco members who signed off on their workstream should integrate the execution roadmap with their day-to-day management. A CTO could provide coaching on topics such as problem-solving and help with reporting capacity, but the company should not dilute responsibilities.

We often see ungrounded performance programs where announced savings are, month by month, offset by "unexplained negative variance" in the financial reporting. Embedding the cost-reduction program in robust management reporting systems prevents this from happening. Remember that one can only change well what one measures well — management can use robust reporting triggers to clearly identify issues and help keep indirect cost as lean and healthy as possible.

Companies can always derive additional benefits beyond pure cost reduction in cost-cutting and zero-based levers, such as:

- Creating a detailed view with benchmarks of what it takes to become an indirect-cost leader in the industry, with additional inspiration from other industries
- Bringing visible change in the organisation, in areas that are more often not under the same level of scrutiny as direct costs
- Reducing complexity and creating conditions for further savings through increased automation/digitisation
- Reinvesting some of the savings to self-finance automation/digitisation
- Freeing up resources can have a meaningful impact on revenue generation and margins — such as reducing administrative work of experts, or freeing up space when it is scarce, to do more business

Additionally, in most cases, cost-cutting and zero-based projects more than pay for themselves with limited implementation costs. From our experience, depending on capex requirements, each lever will generate its target savings across three to 24 months' time. This limits financial risks in comparison to large and uncertain transformations.

Risk factors

The main risk is in execution given the number of stakeholders, their potential conflicts of interest and the very diverse nature of savings levers to be dealt with (from pure expense cuts to process improvements generating headcount savings). The impact of potential layoffs needs to be carefully addressed; however, current talent scarcity in the employment market makes it easier for people to find new opportunities. Cost-cutting and zero-based projects introduce a new culture of cost performance, reducing your risk of lacking competitiveness while ensuring that cost-cutting is adapted to your own business context.

In summary

The present inflationary context provides an opportune moment to undertake projects of this nature. They serve as a powerful means of demonstrating the ability to achieve cost competitiveness without impacting business essentials. This is key for both talent retention and alignment with shareholders — even the 20% hardest-hit companies will be able to demonstrate that they have done their best (on top of other turnaround levers) if they are forced to renegotiate their debt.

A view from an L.E.K. partner

"These are challenging times for any business and dealing with factors beyond our control can feel impossible. But our work shows that clear strategy and careful implementation can make a big difference to companies under pressure from inflation."

— Jean-Philippe Grosmaitre

For more information, please contact strategy@lek.com.

About the Authors

Jean-Philippe Grosmaitre
Jean-Philippe Grosmaitre is a Partner in L.E.K. Consulting's Paris office and a member of the global Organization & Performance practice. Jean-Philippe's experience includes M&A value creation, performance improvement and operational turnaround. He regularly assists private equity funds on sell-/buy-side value creation assessment and portfolio improvement projects.

Tom Marshall
Tom Marshall is a Principal in L.E.K. Consulting's London office and a member of the firm's European Organization & Performance practice. Tom advises clients on a range of critical issues including strategy development and implementation, organizational strategy, performance improvement, corporate transformation, due diligence (both commercial and operational), synergy assessment, post-merger integration, a broad range of digital issues and delivering change programs.

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