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Cost Cutting That Makes You Stronger

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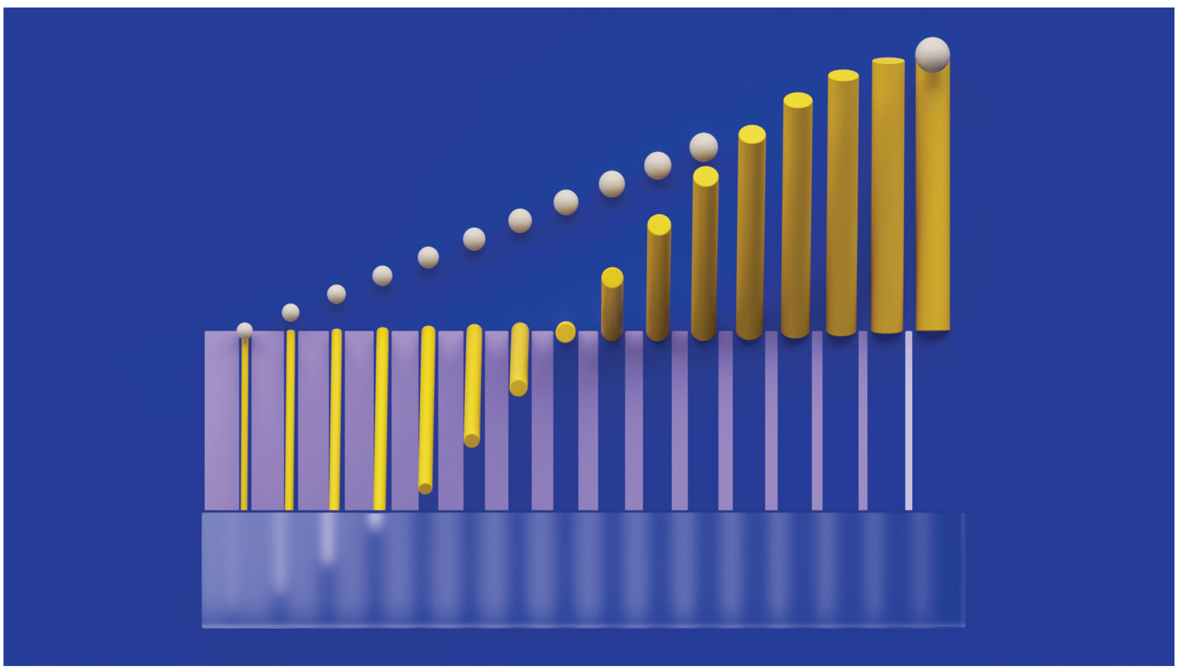

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Summary. When so much in the world feels beyond our control, costs are to a large extent controllable. But cutting them to drive short-term savings is a mistake. When companies take a one-off approach to cost cutting, they often sacrifice some of their most important... **more**

In times of economic uncertainty, many leaders turn to an old standby: cost cutting. When so much in the world feels beyond our control, costs are, to a large extent, controllable. But cutting costs with the singular goal of realizing short-term savings is myopic. Whether they're faced with an urgent need or not, leaders should view each expense line as a precious investment in the business—and recognize how the decision to increase, decrease, or maintain it will shape the company's future.

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Danaher, a global diversified conglomerate based in Washington, DC, is a successful firm that sees costs as investments. Some are good, and some are bad. Danaher doesn't work to reduce costs; instead it tries to weed out poor investments while keeping the good ones—day in and day out, during both booms and busts.

A key element of its approach involves applying something it calls the Danaher Business System to the steady stream of companies it buys. The system draws on lessons from Danaher's broad portfolio of businesses—repeatedly—to make operations ever more efficient. "Most managers have a mindset that if you apply a tool once, you're done," recalls George Koenigsaecker, who implemented the first version of the system in the 1980s as the president of Danaher's tool group. Koenigsaecker, now an investor and an expert on lean manufacturing, says a single application of a process improvement might yield a 40% gain in productivity. "But to get the 400% gain, you have to use it at least 10 different times," he notes. "You must study the process over and over." At Danaher the drive toward efficiency is relentless, and cultural reminders of it are everywhere. In meetings, for example, executives often ask if the meeting really needs to run as long as it has been scheduled for. The mantra is "Waste nothing."

Many companies, in contrast, take a one-off approach to cost cutting and do it reactively when it's the only obvious option for reaching profit targets. Unfortunately, in their hurry to eliminate things that seem discretionary, they often sacrifice some of their most important investments.

Such risk has been growing lately. In a PwC survey conducted in November 2022, 42% of senior executives said that cost cutting would be a priority in 2023—a prediction borne out by the waves of layoffs making headlines during the first half of the year. When cost-cutting programs are implemented in haste, as many of the current ones have been, there is little (if any) debate over the strategic intent behind spending. Typically, leaders dole out across-the-board targets, leaving functional groups and line managers to quickly figure out what (or who) must go. That winds up leaving organizations weaker, imbalanced, and in some cases desperate and without direction.

To learn more about how companies have successfully managed costs while still achieving growth, we did a study of the 1,500 largest global public companies, based on 2021 revenue. (Our colleague Harsha Kasturirangan, a director at Strategy&, helped us with this research.) Among that group we identified 201 companies (or 13% of the sample) that from 2015 to 2018 implemented what we call a *cost transformation:* achieving EBITDA above the industry median while experiencing revenue growth below the industry median. That separated companies that grew their margins through cost reduction from those that grew them through top-line improvements. Then we analyzed those 201 firms' financial results in the three-year period ending in 2021. Of those companies, 125 (62%) delivered below-market revenue growth and profitability. Their revenue remained relatively flat, dipping 0.6%, on average, and their EBITDA dropped by 8.3%. Despite their earlier margin improvements, their efforts ultimately weren't successful, because they'd undermined their future results.

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The good news is that 76 of those 201 companies (which included Danaher) experienced higher revenue growth and profit margins in the following three-year period. On average, their revenues rose by 16.8% and their EBITDA by 6.8%. These companies represented a wide range of industries—including technology, industrials, pharmaceuticals, and financial services—with no single industry accounting for more than 11 companies. They were also widely distributed geographically, headquartered in 19 countries across North and South America, Europe, Asia, and Australia.

These 76 companies clearly had set themselves up for future success. The question was: What did they get right that the others got wrong?

Creating a Growth-Oriented, Cost-Effective Organization

To succeed at cost transformation, you need to start with a blank sheet and ignore sunk costs. This is the mindset underlying zero-based budgeting as well as Peter Drucker's famous question "If you weren't already in this business, would you enter it today?" Applying this lens to every project, line item, and role allows leaders to look at the cost structure strategically, which is imperative, because there may be no topic more strategic than where you spend your money.

But simply challenging every line item isn't enough in our analysis—and on its own may feel like a disjointed and endless effort. We believe you also need to take five critical steps.

Connect costs to outcomes. Treat every dollar spent as an investment in creating the value that you give your customers and in the specific cross-functional capabilities needed to deliver that value. Costs should no longer be locked inside organizational silos that get protected and thus are disconnected from growth. Budgets must be discussed in depth with the leadership team and prioritized to focus on what truly supports your strategic goals and the capabilities that will help you achieve them.
A great example is IKEA. The company has long been guided by a succinct principle that makes this promise to customers: "We do our part. You do your part. Together we save money." After opening his first retail store, in 1958, the company's founder, Ingvar Kamprad (the I and K of IKEA), drove employees to pursue any cost-saving opportunity that didn't affect the quality of the merchandise, the customer experience, or the efficiency of operations—a practice that continues to this day. IKEA's designers, for instance, work continually on packaging to reduce its materials and size so that the company can fit more pieces into a container, save money, and offer lower prices. That congruence between strategy and execution is rare in product design. In many companies products are designed by people who aren't responsible for managing expenses. But IKEA connects its design to all the outcomes for the customer, including cost. If you visit the company, its cost consciousness is apparent. For example, executives almost always take guests—even VIPs—to eat in IKEA cafeterias rather than fancy restaurants, to avoid any expense that might be passed on to customers.

Simplify radically. Companies often take their activities for granted and make incremental adjustments rather than take a bold, holistic look at what businesses, product lines, SKUs, or operations should be part of their future. Most also underestimate the cost of complexity, measuring only direct costs rather than system costs. One way to get a better perspective is to imagine a new competitor arriving in your segment without the burden of all your past decisions. How would it compete? What products, activities, solutions, and services would it create? How would it simplify the customer offering to create the highest value? The Dutch company Philips had a storied history in, among other things, lighting and personal electronics, but in the mid-2010s it decided to concentrate on health care and divest, spin off, or sell every other kind of business. Philips knew that to succeed it needed to focus management's attention solely on health care. With this tremendous simplification came new investments in the capabilities that supported a much bolder health care strategy—which led to major innovations in health products and services.

Reimagine value chains digitally, in rapid sprints. Yes, automation offers great potential—but not when it's held hostage to big, drawn-out technology programs. Companies can realize the benefits of digitization by rethinking entire processes end to end, but they'll capture much greater near-term gains when they put automation on top of—or in the place of—existing tools. To manage such efforts, some companies build "digital factories," capability areas that are responsible for the rapid and continual rollout of automation across the entire organization. These "factories" dramatically streamline the process by following an established playbook. They also allow companies to evaluate all automation investments holistically. While you may question how you could afford one at a time of intense cost-reduction focus, we have seen that they can not only pay for themselves but also generate enough savings to fund other cost and growth initiatives.

When the executives at one of our clients, a global food and beverage company, embarked on an enterprise resource planning (ERP) modernization program that was scheduled to last several years, they quickly realized that the cost improvements needed were so significant that the company couldn't wait that long to realize them. They created a digital factory team that brought together people with experience in automation design, development, adoption, and maintenance and tasked them with reimagining manual, costly, and time-consuming processes (such as the procurement-to-accounts-payable cycle and HR practices from hiring through retirement). The team's solutions captured savings within the current ERP platform while reshaping processes in preparation for the improved automation and insights the new system would enable.

Rethink what work you and your ecosystem take on. Creating powerful new capabilities isn't cheap; a lot of technology, data, and people are involved. Smart companies recognize what has to be truly differentiated—and then think about who can deliver it best. Your ecosystem of partners probably has much greater scale in some areas than you have on your own. Outsourcing nondifferentiating capabilities or even elements of your most important capabilities can allow you to focus your investment where it matters.

What a company must do today is much more complex than it was just a decade ago. The traditional marketer, for instance, was a generalist who could manage a great variety of activities. But now marketing requires specialized expertise in many areas, such as social media, ethnographic research, data science, and content curation. Having all that know-how on staff is not only expensive but requires a talent model that accommodates career paths and skill development in a multitude of areas. Outside agencies can offer an easier way to access scale with such capabilities and often a more dynamic career track for specialized talent.

In the early 2000s, Apple realized that manufacturing was neither core to its strategy nor a historic strength. As a result it rapidly moved nearly all manufacturing of components and finished products to its ecosystem partners. That freed the company up to pursue even greater innovation in materials and design and to further integrate data and devices across its various offerings, strengthening its overall product differentiation.

Build a sustaining, cost-focused management system. Smart companies don't think of cost cutting as a onetime reaction to a

slowing economy; they believe it's a primary duty of managers to remain constantly vigilant about costs. But that attitude is unusual. Too many companies downsize during periods of economic stress, only to turn around and increase selling, general, and administrative expenses in subsequent years—without seeming to understand this pattern.
Budgets are a real test of how your company thinks about costs. If yours tend to get adjusted incrementally through function-by-function agendas, you're probably not actively—or strategically—managing them. But if your budgets are zero-based and allocated and evaluated across functions, focusing on the most critical and differentiated capabilities, you're creating a culture and a process for managing cost.

HP took the right approach in 2019. Although the global economy was strong at the time, the iconic provider of computer and printer products and services had begun feeling headwinds from increased competition and commoditization. In response it embarked on a cost transformation that radically simplified its product portfolio, eliminated an entire organization layer to get closer to customers, and centralized R&D. In addition, HP optimized its real estate footprint, creating more-efficient digital workspaces as it moved to a hybrid work model. It also built a new digital backbone: an ERP system that allowed it to deploy additional tools and capabilities. Those carefully considered moves cut more than $1.3 billion in annual costs. Those savings enabled HP to make important investments in both R&D and acquisitions that positioned the company to weather significant volatility in its sector.

HP is now aiming to achieve $1.4 billion more in annual savings by reducing complexity and costs in its mature businesses and simplifying its operating model. A substantial portion of that money will be reinvested in its Future Ready initiatives, which seek to drive growth through innovation. HP's chief financial officer, Marie Myers, notes that these changes often require "hard choices" but believes they will allow the company to keep delivering cutting-edge offerings to its customers.

Getting Started

Enterprise cost transformations are challenging to pull off. They require major changes in technology, operating models, ways of working, and other parts of a company's DNA. That kind of change has always been difficult to implement, but in the past decade constant firefighting and increased pressure to perform have made it even harder.

To link costs to their strategy and avoid hastily made cyclical cuts that leave them weaker, companies should do the following:

Align the top. A strategic transformation cannot be delegated. The board, the CEO, and the executive team must all be committed to taking the steps necessary to achieve the goals that have been articulated. The more revolutionary the change, the more likely those with power under the status quo are to resist it. Some members of the incumbent management team may lack the capabilities, mindset, and willpower to execute the program. For that reason one of the early actions in any transformation should be facilitating those executives' alignment—or departure—swiftly and discreetly.

Build confidence through accelerators. Early wins create momentum, focus the organization, and help convince employees that change is possible. Initiatives to capture them—which often involve quickly shuttering projects that aren't showing results or are no longer strategic—should close performance gaps in a few critical areas, reduce costs, and free up money to fuel longer-term initiatives. If they show a positive impact on profit and cash flow from day one, they'll set up the transformation to be self-funding. Other immediate opportunities include cutting unnecessary roles, applying digital automation to cumbersome tasks, and reducing spending on external contractors.

Aim for a two-year journey. Investors and analysts are increasingly skeptical of transformation efforts that extend beyond 24 months, especially since those that promise to deliver most benefits on the back end often fall short. Organizations also get fatigued when they have to endure repeated and invasive changes for multiple years.

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So it's important for a cost transformation effort to deliver results in the short, medium, and long terms. Think of it as having three chapters. Chapter One: Launch initiatives to rightsize costs without relying on technology, freeing up cash to invest in what really matters. Chapter Two: Activate more-complex initiatives that involve moving work across geographical boundaries or automating large swaths of processes using ERP or advanced digital technologies. Chapter Three: Ensure that you have built a continuous cost-management process and are investing in new products, platforms, and capabilities that will give you a fundamental advantage.

Build a dedicated infrastructure for change. Revamping the business while running it is a juggling act. The company will need a chief transformation officer, who should focus on aligning strategy and costs in every economic environment—and hold executives responsible for "performing" and "transforming," recognizing that doing both is critical. This new or enhanced C-level executive should be supported by a transformation office that structures workstreams, appoints project sponsors and leads, defines accountabilities, and drives results. That office must build trust by being authoritative and independent. It should serve as a single source of truth that provides verifiable data. It also should intervene when impediments must be overcome, major course corrections made, or diverse workstreams synced.

Enlist middle managers and frontline employees early. Because they bridge the gap between the front line and senior leadership, midlevel managers are well positioned to contribute. Give them a voice in the process so that they feel invested in it. Let them offer their feedback, doubts, and ideas. Give them incentives to generate real innovation—perhaps even share the gains with them. Frontline employees, for their part, are best able to assess what expenses can be cut and what processes can be streamlined without compromising quality or client satisfaction. Our work with clients shows that frontline opinion leaders can promote broad-based support for cost-management efforts that is far stronger than what any corporate-sponsored effort can achieve.

Put your culture to work. Continual change becomes sustainable when your culture enables transformation rather than hinders it. The key is to focus on a few critical behaviors—ones that some people demonstrate regularly now and that would lead to tangible business improvements if everyone adopted them. Changing behaviors is difficult, and trying to change more than a handful at one time is impossible, but focusing all employees on a few eases them into a new way of thinking.

At one global food company all employees were asked to adopt three behaviors: speaking up when they saw evidence of waste anywhere and offering solutions to fix it; using self-service for their business needs wherever possible; and encouraging their teams to bring any backup materials to operating reviews and stick to the agenda. Those behaviors promoted cost consciousness even when nobody was watching and prompted employees to spend the company's money as if it were their own.

Build mechanisms for an ongoing focus on costs. The need to reallocate resources to your strategic capabilities and highest-growth businesses is constant. Financial systems should create more transparency around “good” costs—those associated with differentiating capabilities—and “bad” costs, which are required to keep the lights on and the business open. Give budget owners detailed information about cost drivers and help them develop a deeper understanding of the economics of decisions.

For example, one of our clients created a simple slide to show how one dollar of savings flowed through the system and resulted in stronger company performance. That let managers directly see how curbing unnecessary expenses translated into company results that benefited them personally. At IKEA an annual review of all costs—and prices—is part of an effort to live into the firm’s stated purpose of saving customers money and ensure constant attention to cost management.

Leaders should hold individual functional and business unit owners accountable for achieving a step change in certain cost pools (such as SG&A, transportation, indirect spending, and cost of goods sold) in addition to traditional P&L targets. Executives must personally model cost-conscious behavior. They need to actively demonstrate that they’re “proud to be frugal” to dispel the common skepticism that cost reduction is something that the top tells the middle to do to the bottom.

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Today’s economy is putting cost management front and center in boardrooms and on leadership teams. In addressing this issue, executives face a choice. They can cut costs the traditional way and risk making their organizations weaker, or they can do the hard work of rethinking the very basics of their business: identifying the bold outcomes that will differentiate the organization, simplifying every part of their operations, creating savings through automation, leveraging their ecosystem to take on activities they shouldn’t be owning, and building cost management into everything they do.

You'll know you've made progress when costs aren't a negative topic owned by only a few, when your budget truly reflects strategic choices, and when your entire company appreciates how precious every investment is. At that point you won't just have found a better way to manage costs—you'll have found a way to transform your company and shape your future.

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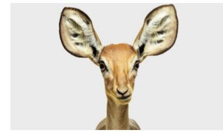

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