Brief

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Cost cutting for growth: take advantage of the lessons of recession

Reducing costs without a growth strategy is like driving into a carwash with the convertible top down

Is cost cutting just what you do to respond to a recession or a crisis? Or can you cut your way to growth? A lot has been published since the bank-led recession which analyses what can be done to keep reducing costs while taking advantage of the end of the downturn.

Among the material we looked at was work by Accenture, Bain, Booz and McKinsey as well as articles on the Harvard Business Review blogs. We have summarised the common themes.

Reducing costs without a clear growth strategy is, as Bain says, like driving into a carwash with the convertible top down, but a recent survey shows that most companies do just that. The most common approaches include across the board cuts, aggressively managing working capital, reducing management layers, freezing salaries and laying people off. All of these can be essential for short-term impact. But without some strategic focus the effect is to solve some problems and create others.

Three parts to an effective strategic focus for cost cutting

Some companies use cost cutting as a chance to rethink the organisation. It can accelerate desired change, especially where the cost cutting is driven by a strong challenge to the organisation that speeds up the alignment of leaders.

Those that are good at this cut their costs based on a clear understanding of:

1. ***What the sources of future growth will be:*** based on a fresh look at the market, customer needs and the competitive landscape
2. ***What the business model will be:*** how it will make money and what the key levers are to drive that
3. ***What the core capability is:*** the defining strengths that enable it to compete.

   One of Cadbury's key capabilities - and a strength targeted by Kraft in their takeover plans - is their ability to target, sell to, and service, corner shops, convenience stores and places where people make spontaneous purchases. A core capability (and the heart of the business model) of Google is the ability to translate consumer traffic into advertising revenue. A Booz survey looked at a wide range of companies in the consumer goods, automobile and telecoms markets and analysed how coherent their capabilities were. There was a strong statistical relationship between degree of coherence around core competencies and their profitability.

The need for speed – but take people with you

Taking and analytical and strategic approach to cost cutting can sound like a tall order when there is unpredictability or times are tough. Is this realistic? Many organisations are used to the idea that a robust strategic review takes a year and costs significant time and money. You may have to act quickly or more flexibly than that. The evidence suggests that, under pressure, most leaders can display a surprising amount of lucidity about which costs are important. Tough times are wonderful things to focus everyone's mind and can often help to ensure that a leadership team is quickly aligned and make more focused and effective decisions than in the more complacent context of a rising market. The outcome and decisions may not be 100% right, but it will not be anywhere near 100% wrong.

Speed in itself does not lead to success – especially if leaders do not take people with them. When Carol Bartz was brought in to turn Yahoo! around she quickly returned it to profit and promised growth in her first year as new CEO. She closed ineffective businesses, reduced management layers and agreed new deals with partners to drive advertising growth. She was making these decisions, and implementing them, in the first few months. However, she was outspoken and appeared to make enemies (internally and externally). She may or may not have had the right turnaround strategy, but within three years she had been fired anyway (“I am very sad to tell you I have been just been fired over the phone by Yahoo’s chairman of the board” she wrote employees from her iPad.).

Getting the focus right

If cost cutting is focused on reducing, closing or selling the activities that are not supporting the drivers of growth, the core business model or capabilities, then it will not only reduce costs, it will simplify the organisation, reduce complexity and free people up to be better focused.

Clothing retailer Zara designs and develops new clothing lines in-house, and can produce and distribute small batches very quickly. Its cost base is higher than competitors, but it sells 85% of stock at full price (industry average 65%) with margins 55% higher. It has continued opening new stores and protected its core capabilities and business model. It has significantly cut costs in IT, non-core purchasing and by delaying upgrades of existing stores. Sales and profit have grown through the recession.

In contrast, US retailer Home Depot sacked CEO Robert Nardelli after he cut costs without this understanding. Home Depot's strength used to be the experienced store staff that help DIY and small builder customers solve problems. These were laid off and replaced with fewer, younger, cheaper employees without the time or knowledge to provide advice. The core business was damaged and parts of the group had to be sold to restore finances.

Focus on supporting the right markets, service lines and customers

Understanding sources of growth also means knowing "good" customers from "bad". Losing bad ones can save money. Amex has offered cash to certain customers to close their accounts. Costs can be focused on the aspects of service and product that drive customer loyalty. For example, some mobile network providers have researched what the service breakpoints are in terms of speed of call centre response. This has identified the ideal response times, faster than which it adds no perceived benefit to customers and slower than which it affects customer loyalty. Research shows that the answers vary by brand, by function (sales, service and billing) and by industry. Moving from a target 5 second reply to 15 seconds can in some cases make no difference to customers while allowing a significant reduction in resource and cost. (For more about pinpointing the key aspects of customer service see our *Brief* on *'Moments of truth': how to move quickly from principles to action*.)

One bank, at the start of the last recession, stopped a cash-machine upgrade project and focused instead on ensuring that existing machines never ran out of cash. This was much more important to customers and allowed money to be saved.

Save costs by closing whole areas of business, whole teams or whole projects

Getting out of cherished projects that are not delivering, or much-loved older businesses with low potential is another way to save and focus - even if you sell them off at a low price or simply close them.

Research shows that the key barriers to closing or selling long-standing activities are psychological biases in leaders, including:

- ***The confirmation bias*** - leaders continue to look for data that backs up the original reason for an investment and give less weight to data that contradicts this. Instead, leaders should take care to have fresh and objective data that encourage a new perspective.
- ***The sunk-cost fallacy*** - leaders saying "this has already cost us £100m and we have to make it pay which means we need to keep spending a bit more". Instead, leaders should accept that the cost so far is past, and what matters is the value of, and return on, any net new costs.

One very effective way to overcome these biases is to put some new people in charge of key areas or investments. The alternative is to ensure that existing leaders are able to look at everything anew. That is why Avon CEO Andrea Jung took Ram Charan's advice to mentally "fire yourself and hire yourself" to help her quickly look at everything with fresh and objective eyes. By looking through the lens of a newcomer, she reversed investments she had instigated, focused marketing spend and significantly reduced the number of managers in some areas (including some she had hand-picked). She took the decisions a smart newcomer would make.

Respond fast but respond strategically

What all the published material confirms is that cost cutting can be strategic, improve focus and prepare for growth. Of course, the conventional wisdom is correct - reacting fast to a crisis or downturn and cutting costs and conserving cash is essential. But this can also be an opportunity to ensure focus and to simplify for long-term benefit, instead of making the cost cutting just an end in itself. Indeed, it is an opportunity to take a long-term lesson and make cost cutting a permanent core competency.

Sources

Sources used for this article include: Altman, Kaplan and Corbett: *The Right Way to Cut Costs* by (Bain); Banerji, Leinward and Mainardi: *Cut Costs, Grow Stronger* (Booz); Braff, DeVine: *Maintaining the Customer Experience* by (McKinsey); Coggins: *Prune Business Activities for Optimal Growth* (suite101 blog); Horn, Lovallo, Viguerie: *Learning to Let Go: Making Better Exit Decisions* by (McKinsey); McGrath: *Cut Costs like Avon - Not Home Depot (Harvard Business Review blogs);* McGrath: *A Better Way to Cut Costs (Harvard Business Review blogs);* Mankins, Harding and Weddigen: *How the Best Divest* (Bain); Nunes, Firstbrook and Ellis: *Managing in Extraordinary Times: New Choices for New Challenges* by (Accenture).

