

## Seven Secrets to Downturn Survival

Existing cost management programs may not be sufficient to survive and thrive in a downturn

### Introduction

A recent Deloitte\* survey showed that most Fortune 500 companies already have cost-cutting programs in place, a clear indication that businesses are taking the economic downturn seriously and are prepared to withstand a recession. Or is it?

In the survey of 70 Fortune 500 executives, 68% said their company maintained an ongoing focus on cost improvement – even during the recent economic boom. This is good news, particularly because conventional wisdom suggests that companies only pay attention to cost reduction when times are tough.

The bad news is that many companies may be setting their sights too low. In the survey, two-thirds of executives reported they expect their current cost reduction initiatives to deliver only single-digit cost savings. These small improvements might have been sufficient when times were good and healthy top-line growth helped to cure a variety of ills; however, many companies are likely to find that this incremental approach to cost-cutting may not be sufficient to carry them through the uncertain times ahead. What we believe they need is a more comprehensive or transformational approach that can deliver significant and sustainable improvements to their underlying cost structure.

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### Continuous improvement is not enough

For many companies, programs such as lean and six sigma have become a way of life. In fact, 86% of our survey respondents said their cost reduction efforts include a focus on "process excellence," making it the top-rated cost lever. These types of programs can help a company drive continuous, incremental improvement; however, the resulting savings are often relatively modest.

To survive and thrive in a downturn, we believe companies should do more than continuously improve their operations. Also, they should look beyond incremental improvements such as hiring freezes, deferred expenses, reduced travel and training, and across-the-board budget cuts. We have found that these belt-tightening efforts are generally not sustainable beyond the short term. And, in many cases, the savings they produce simply may not be enough to weather the storm. In fact, such initiatives can often be a barrier to achieving the necessary improvements because they can lead a company to believe it is already addressing the problem. Also, they may divert attention and resources away from more important structural cost improvements.




## A better approach

In a downturn, companies should capitalize on the cost levers at their disposal. See Figure 1 for an example of various cost improvement levers. For many, that means focusing a higher level of attention on strategic, structural improvements such as streamlining their infrastructure, adjusting their service delivery model, and redesigning their business model. These types of improvements can generally deliver cost savings that are both larger and more sustainable than an incremental approach to cost-cutting.

Strategic, structural cost improvements can position a company to prosper during a downturn by helping it protect its margins, capitalize on opportunities, and capture market share. A nimble cost structure can help companies scale back on costs in response to slowing demand, and can enable them to take advantage of unexpected opportunities such as bargain-priced acquisitions. It can also help them respond more quickly when the economy rebounds by freeing up resources to invest in new products and services, marketing, and advertising, which can help a company get a jump on the competition.



**Figure 1. Cost improvement levers**

	Cost Improvement Levers	Description	% Savings*
<b>Tactical Improvements</b> 	<b>Spend Reduction and Demand Management</b>	Focuses on strategic sourcing, demand management, and tax management to aggressively reduce external spend	10 – 20%
	<b>Business Process Redesign</b>	Focus on streamlining business processes via simplification, elimination, or outsourcing	5 – 10%
	<b>Infrastructure Rationalization</b>	Focus on IT and Real Estate portfolios, projects, platforms, and support rationalization	15 – 25%
	<b>Service Delivery Model and Organization Alignment</b>	Focuses on re-aligning staff based on method of adding value and relationship to business	10 – 30%
	<b>Business Model Redesign</b>	Shift to a more cost-efficient business model	20 – 30%
<b>Strategic, Structural Improvements</b>			

\*Relative savings estimates based on Deloitte experience.

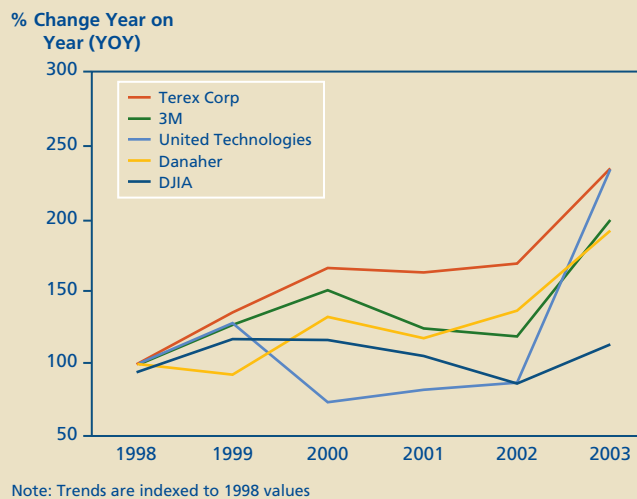
## Learning from the past

A comprehensive approach to cost management is important regardless of the economic environment. According to a Deloitte study of shareholder value over the past five years, there is a clear correlation between cost management activity and market capitalization. The data shows that capital markets reward companies that make significant improvements to their cost structure – even in good times.

This broad approach to cost reduction can be particularly valuable when times are tough. For example, as shown in the graphic below, in the 2001 recession a number of companies used a transformational cost-cutting approach to effectively outperform their peers and the overall market.

Terex focused on product lines that were less exposed to price competition and used outsourcing to reduce its fixed costs by 20 to 25 percent<sup>1</sup>. 3M used global sourcing to smooth out raw material cost changes<sup>2</sup>. United Technologies streamlined its supply chain management and made cost-consciousness a company-wide initiative<sup>3</sup>. And Danaher invested in smart product development and used web-based tools to improve material procurement<sup>4</sup>. These companies went well beyond the incremental approach to cost-cutting, implementing structural cost improvements. The results? Sustainable cost savings and improved market performance.

**Figure 2. Market Capitalization Trends**



<sup>1</sup> Salomon Smith Barney, 6 Feb 2001

<sup>2</sup> 3M Annual Report, 1999/2000

<sup>3</sup> Deutsche Bank, 22 May 2000

<sup>4</sup> Bear Stearns, 14 August 2000

## Seven secrets to downturn survival

Although many businesses can benefit from a more aggressive approach to cost reduction during a downturn, the specific improvement opportunities vary from one company to the next. Here are seven practical and demonstrated tips to consider to help you choose the right approach – and accelerate the benefits.

### 1. Decide how much cost improvement is needed

When it comes to reducing costs, different companies have different needs. The main variables are: (1) the breadth of change needed, and (2) the time available to take action and capture value. Figure 3 outlines a spectrum of situations that companies can find themselves in. At one end of the spectrum, healthy companies generally have the luxury of time and can afford to pick and choose their opportunities. At the other end of the spectrum, businesses in a turnaround or crisis situation often have no choice but to promptly reduce their costs using every cost lever they can.

A downturn, of course, can push companies further to the right on the urgency scale, creating the need for greater change in less time.

When choosing a course of action, each company should evaluate its own individual situation. Companies facing severe margin pressure or other urgent problems have a greater imperative to reduce their costs through a wide range of cost levers. On the other hand, healthy companies can continue to focus on incremental process improvement, or look for strategic opportunities to capitalize on their strength by investing in long-term structural improvements that will give them a lasting cost advantage over the entire business cycle.

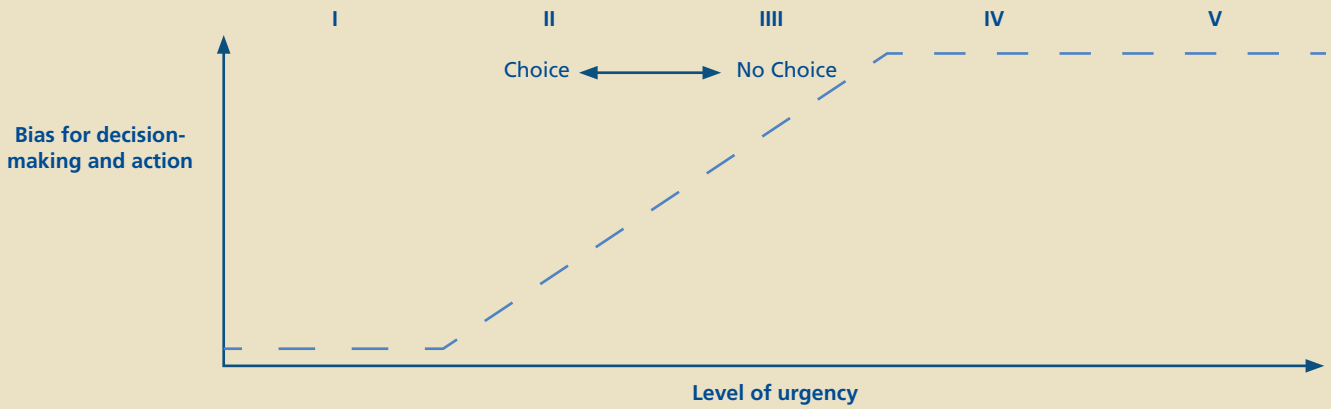
### 2. Start with the obvious

For many companies, the most immediate cost savings can likely come from streamlining General and Administrative functions (G&A) and aggressively tackling external spend (the materials and services a company buys). Improvements in these areas can deliver significant savings almost immediately, with little or no downside for the business. These opportunities might seem obvious; however, they are worth mentioning because a surprising number of companies continue to overlook them.

The potential savings from external spend can be greater for companies that have significant improvement opportunities in their procurement systems and practices. However, even companies that believe their external spend is as good as it can get may find additional opportunities to save during a downturn. After all, suppliers that are hungry for business have a greater incentive to bargain.

G&A functions are another prime target for cost savings. These functions don't have a direct impact on customers or day-to-day business operations, so it's easier to make changes without disrupting the business or putting customer relationships at risk.

Figure 3. Assessing the need for improvement



Business Situation	Healthy	Adjust cost to fit strategy	Facing severe margin pressure	Turnaround	Crisis
Bias for Decision-making/Action	Low "Too risky"	Some "We must be bold"	High	Very High "Act now"	Infinite "Just do it"
Primary Cost Levers	<ul style="list-style-type: none"> <li>Process-focused continuous improvement</li> </ul>	<ul style="list-style-type: none"> <li>SG&amp;A</li> <li>Indirect spend</li> </ul>	<ul style="list-style-type: none"> <li>SG&amp;A</li> <li>Indirect spend</li> <li>Direct spend</li> <li>COGS</li> </ul>	<ul style="list-style-type: none"> <li>SG&amp;A</li> <li>Indirect spend</li> <li>Direct spend</li> <li>COGS</li> <li>Infrastructure</li> <li>Balance sheet</li> </ul>	<ul style="list-style-type: none"> <li>SG&amp;A</li> <li>Indirect spend</li> <li>Direct spend</li> <li>COGS</li> <li>Infrastructure</li> <li>Balance sheet</li> <li>Cash flow</li> <li>Financial restructuring</li> </ul>
Time to Value	<ul style="list-style-type: none"> <li>Long term</li> </ul>	<ul style="list-style-type: none"> <li>Medium to long term</li> </ul>	<ul style="list-style-type: none"> <li>Short to medium term</li> </ul>	<ul style="list-style-type: none"> <li>Short to medium term</li> </ul>	<ul style="list-style-type: none"> <li>Short term</li> </ul>

### 3. Take an enterprise view

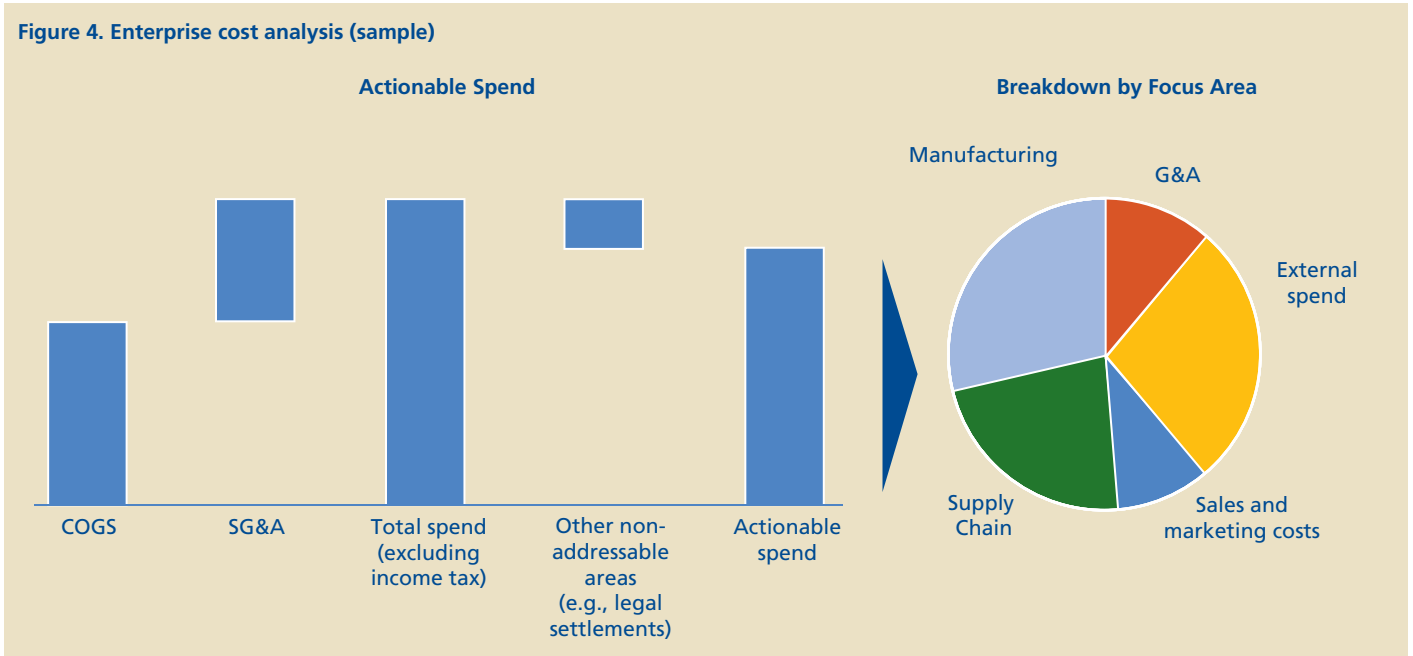
In difficult times, a company should look beyond organizational silos to include cost reduction opportunities across the entire enterprise. A quick but comprehensive analysis of actionable spend (i.e., costs that are within the company’s control over the next 12 months) can help identify the biggest opportunities and set priorities. This can be particularly important for companies in a crisis or downturn, who need every bit of savings they can get. See Figure 4 for a sample summary of an enterprise-wide cost analysis.

Since most managers and executives only have visibility to a narrow set of costs related to their day-to-day responsibilities, this enterprise view can be quite an eye-opener. A broad, enterprise view can help a company put its existing cost reduction initiatives into perspective, and can help decision makers understand the broader opportunity. It can also provide initial guidance and direction on where the company should focus its efforts.

Note that “taking an enterprise view” is not the same as blindly mandating double-digit cost cuts across the entire company. Although an across-the-board approach to cost reduction might seem the most fair, it often ends up cutting too deeply in areas that are critical to the business (or already operating efficiently), while leaving a lot of money on the table in areas that are less critical or less efficient.



**Figure 4. Enterprise cost analysis (sample)**



**4. Balance short-term and long-term improvements**

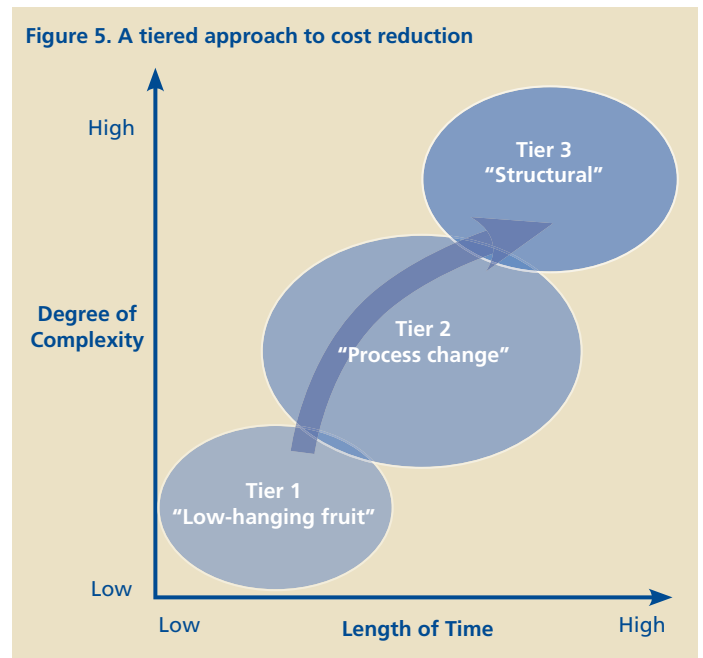
During a downturn, many companies can be in such a hurry to cut costs that they end up ignoring some significant improvement opportunities. That’s a mistake few companies can afford. Generally speaking, the most effective cost management programs apply a tiered approach that includes a mix of short-, medium-, and long-term opportunities.

Each tier provides a different level of potential savings, complexity, risk, and required investment. Tier 1 typically includes incremental, short-term opportunities such as decreasing discretionary spending, and improving span of control. Tier 2 consists of medium-term opportunities such as process improvement, shared services, outsourcing of ancillary processes, and strategic sourcing. Tier 3 generally comprises long-term opportunities such as reengineering or outsourcing of core business processes, changing the company’s business model, restructuring the global supply chain, and large-scale technology investments.

This tiered approach can provide the best of both worlds, allowing a company to generate immediate savings while capitalizing on more substantial and sustainable opportunities that take longer to implement. Also, with proper planning, Tier 1 savings can provide some or all of the funding for the more significant structural improvements in Tier 2 and Tier 3.

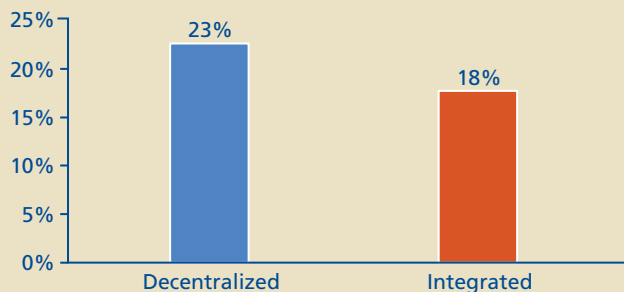
It’s important to note that in a turnaround or crisis situation, Tier 2 and Tier 3 activities can often be completed in the short or medium term. This accelerated timing is possible because the situation usually creates a sense of urgency that can help align people across the organization and motivate them to take immediate action.

**Figure 5. A tiered approach to cost reduction**



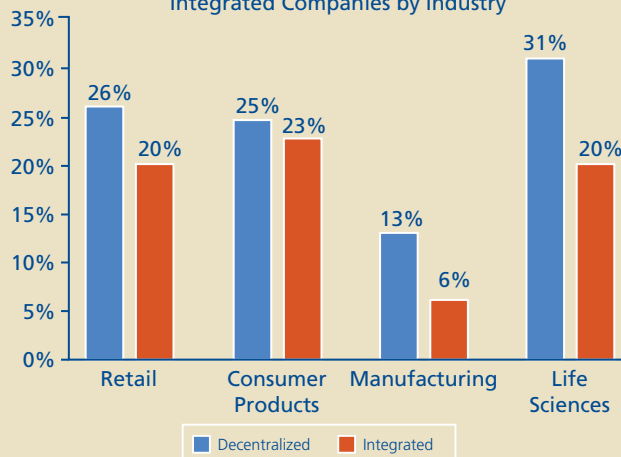
**Figure 6. SG&A costs for integrated and decentralized companies**

2006 SG&A% Averages of Decentralized vs. Integrated Companies



Source: Deloitte. Data for 75 Fortune 500 Retail, Consumer Packaged Goods, Manufacturing, and Life Sciences companies

2006 SG&A% Averages of Decentralized vs. Integrated Companies by Industry



Source: Deloitte. Data for Fortune 500 comprised of 19 Retail, 20 Consumer Packaged Goods, 21 Manufacturing, and 15 Life Sciences companies.

### 5. Choose the right business model

In some cases, the most effective way for a company to achieve the required savings may be through a transformation of its business model. In choosing a business model, the main trade-off is between “operational independence” and “cost efficiency” (through centralization and economies of scale). At one extreme, a holding company model allows each business to operate independently, which helps foster innovation and an entrepreneurial spirit but minimizes the opportunities to save money through standardization and shared services. At the other extreme, an integrated operating company model gives a company much greater control over its business units, which may increase the number of opportunities for synergies and economies of scale.

A Deloitte analysis of Fortune 500 companies showed that companies with an “integrated operating company” or “strategic control” model on average had significantly lower SG&A costs than companies with a “holding company” or “strategic guidance” model (18% of revenue versus 23% as shown in Figure 6). So, although the most effective business model varies from one company to the next, slow economic conditions tend to drive companies toward more centralized business models where the potential synergies are higher. Business model redesign is usually a long-term effort; however, in a downturn there may be sufficient impetus to complete the restructuring in six months or less.

### 6. Protect strategic investments

In their zeal to cut costs, companies can often make the mistake of slashing investment in areas that are critical to the long-term financial success of the business. Activities such as R&D, marketing, and advertising can be critical to sustained performance and profitability, so it may be important to continue to provide the required funding to these activities. Although companies in dire straits may have no choice but to scale back in strategic areas, they should do everything possible to avoid cutting too deeply.

Sometimes it even makes sense for a company to increase its investments in strategic areas by shifting resources from parts of the business that are less important. For example, in the last downturn a global telecommunications equipment company hired more engineers and made product development a top priority, while at the same time shedding many of its manufacturing operations as part of a strategic move away from in-house manufacturing. This allowed the business to focus more attention on high-value activities while improving its flexibility to respond to ups and downs in the overall economy.

### 7. Actively manage change

Once a company has made the decision to transform its cost structure, one of the biggest challenges can be overcoming resistance to change. In fact, 60% of the respondents to the Deloitte Fortune 500 survey reported that lack of understanding and acceptance by key stakeholders was a barrier to achieving the desired cost savings.

Support for cost improvement should begin at the top. Company leaders should have a solid understanding of what is being changed – and why. They should also provide strong and visible support for the improvement activities throughout the project lifecycle. This is particularly true for large-scale structural improvements, which often require significant collaboration across organizational boundaries. If the various stakeholders don’t buy into the need for change – or the recommended approach – the chances of an effective implementation can be greatly reduced.

Effective communication is also essential. In the rush to improve their cost structure, many leaders and managers neglect to keep their employees informed. While this approach may save a little time in the short run, it often results in a lot more time and effort in the long run. Employees who are left in the dark are more likely to spend their days spreading rumors and worrying about the unknown, which undermines their productivity and morale. We have found that it is better to invest the time upfront to keep people informed and build support for the changes.

## Conclusion

In the face of a downturn, how should your company respond? Should it follow the usual approach of incremental improvements and across-the-board cuts? Or should it pursue strategic cost reductions that allow it to outmaneuver the competition? In most cases, the answer is clear. Over the past decade, countless studies have shown that short-sighted remedies and belt-tightening generally don’t pay off over the long haul. The key to achieving significant results is to make strategic, structural cost improvements that give you a sustainable advantage and put you a step ahead of your competitors.

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