



Three steps to sustainable and scalable change

Part 1: Rethinking a company's business model

About the series

Creating sustainable and scalable improvements to a company's cost structure is like building a skyscraper. The first step is choosing the right business model, which provides a blueprint for the effort. The second step is determining how decisions will be made. This serves as a strong foundation. The third and final step is mobilizing resources and putting the decisions into action, which is analogous to actually constructing the high rise. When improving their cost structure, many companies try to jump directly to the construction phase. However, the results are generally disappointing and, even if they are acceptable, they are usually hard to sustain.

Deloitte's three-part series, "Three steps to sustainable and scalable change," takes a detailed look at key activities we believe are necessary to produce cost structure improvements that can withstand the test of time.

- Part 1, "Rethinking a company's business model," provides fresh and practical views to help companies choose or confirm the right business model. This can serve as a blueprint to guide the overall effort.
- Part 2, "Aligning operational governance with the business model," presents a framework for aligning and improving the way decisions are made and executed. This step can provide the foundation for lasting improvements; yet, in our experience, it is the one step companies are most likely to overlook.
- Part 3, "Redefining functional service delivery to achieve organizational scalability and efficiency" explains ways companies can deploy their resources to create a cost structure and performance improvements that satisfy the specific needs of the business.

When improving their cost structure, many companies try to jump directly to the construction phase. However, the results are generally disappointing and, even if they are acceptable, they are usually hard to sustain.

We believe these three steps can help any company make sustainable and scalable improvements to its cost structure.

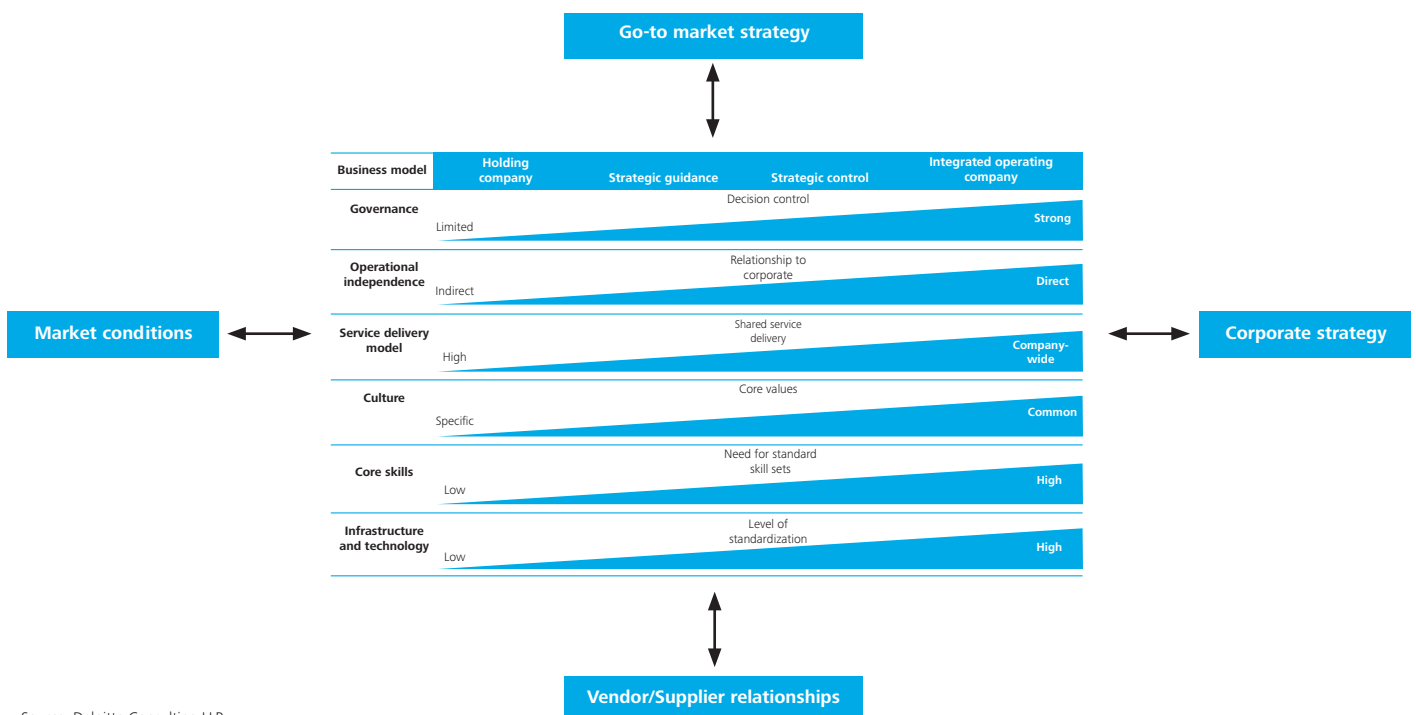
The first step in improving your cost structure is to verify you have a well-defined business model. Serving as the blueprint for all future business activities, your business model should support your efforts to realign operational governance or restructure your functional service delivery mechanisms. One upside of challenging economic times and slow economic recovery is the opportunity to either validate your current model or tear it down and build a new one. The key is to determine where to situate your company on the spectrum of business models – from decentralized holding company on one end to highly integrated operating company on the other. Where is your company most likely to thrive while serving its markets, operating most efficiently, and ultimately providing the greatest return to its shareholders?

Even the best business models eventually become obsolete. Yet we have found that companies are often reluctant to tinker with something so crucial to their business — particularly if it has served them well in the past. Instead, they pursue isolated improvements within a single area or function, only to find that the changes aren't sustainable because of their business model's inherent limitations. The usual result? Much lower operational efficiency and effectiveness than a company should have.

A well-designed business model defines how you go to market, interface with your stakeholders, and react to market conditions (see Figure 1).

To achieve sustainable and scalable cost improvements, you must carefully analyze your existing business model — and then adjust it to fit your company's current and future needs. This should provide a blueprint for effective structural change.

Figure 1. A company's business model defines how it goes to market, interfaces with stakeholders, and reacts to market conditions



The path to structural change may not be simple, but it should be clear. Key factors include: how your company views itself, how it makes decisions, and how it deploys resources. These factors are all inextricably linked to your company's business model.

For example, you might decide to shift from a decentralized finance or marketing function that primarily resides within business units to a centralized function based at corporate headquarters. However, such a shift should not be made arbitrarily, but only if it is consistent with your business model.

Several signs may indicate that it is time for your company to rethink its business model. In general, your business model needs to be revisited if:

- It does not support your company's go-to-market strategy
- It does not allow your company to adjust to market changes, such as price deflation, competitive pressures, or cost pressures
- It does not allow for continuous improvement of vendor and supplier relationships
- It no longer supports your overall corporate strategy
- It becomes too expensive to maintain or support, or places your company at a competitive disadvantage
- Shared services do not yield expected savings

Your business model has a major impact on your company's cost structure and operating complexity. It is used to determine how you deliver services and deploy resources. It also affects your company's decision and ability to scale — or not — during economic downturns. Moreover, an outdated business model can drag down all aspects of your business. For example, it could prevent your company from adjusting to critical changes in the market such as key differentiators becoming commodities. Or it could undermine customer relationships by preventing your company from adapting its sales channels to fit the way today's customers prefer to buy.

Although modifying your business model might seem daunting, it is often a prerequisite for sustainable structural change. It also represents an excellent opportunity to transform your business and make your company more efficient and effective.

Bottom line: If your current business model is preventing your company from fully achieving the results it should, the business model needs to be revisited.



First things first

Achieving sustainable improvements to your company's cost structure is a three-step process similar to building a skyscraper. The first step is choosing or confirming the right business model. The second step is determining who will make decisions, and how — what we call operational governance. The third step is deploying resources and putting changes into action. We believe these three steps are the keys to sustainable and scalable change.

Many companies make the mistake of leaping into action before going through the other two steps. They start to reorganize and deploy resources to improve their cost structure without taking time to rethink or confirm their business model or decide how decisions will be made. That's like trying to construct a building without drafting blueprints or laying a foundation.

A well-designed business model provides the blueprint for improvement. In particular, it is used to determine how your company is structured internally, and how it interacts with key external stakeholders such as customers and suppliers.

Your business model also serves as a starting point for the next step in the process — operational governance — by providing a high-level framework for who makes decisions, how they are made, and who executes them. Lack of clarity over decision-making roles and responsibilities can cause a variety of debilitating problems, including confusion, inefficiency, and duplication of effort. Clear operational governance can help avoid these problems and provide a solid foundation for implementation, reorganization, or restructuring.

Once a blueprint and foundation are in place, it's time to build the high rise by deploying resources and restructuring or reorganizing your business to capitalize on cost improvement opportunities.



Choosing or confirming a business model: One size does not fit all

A company's business model serves a variety of purposes. In particular, it should:

- Help the company operate more efficiently and effectively
- Define the relationships between corporate, divisions, and business units
- Influence how the company reacts to internal and external stakeholders and market forces
- Define how certain functions, such as general and administrative (G&A), should operate
- Help divisions and business units understand what to expect from corporate, and vice versa
- Help define key elements and enablers of a company's culture
- Help support and align company values and core competencies
- Serve as a source of competitive advantage

Although there are an infinite number of business models to choose from, most can be grouped into one of four broad categories. These range from the highly decentralized **holding company model** to the centrally managed **integrated operating company (IOC)** model. The **strategic guidance** and **strategic control** models fall somewhere between the two extremes (see Figure 2).

Major differences exist among the four models. For example, in a holding company, corporate sets and monitors financial targets and defines overall objectives, but the business units make their own operating decisions and corporate has little input on strategy. As a company moves toward the IOC model, corporate becomes more directive and the operating units become less autonomous. In an IOC, the company is controlled from the corporate center. Corporate executives develop plans, policies, and guidelines; monitor operations; and make major operating decisions. Strategy cascades down from

Figure 2. A range of options in business models

Business model	Holding company	Strategic guidance	Strategic control	Integrated operating company
Operating structure				
Executive leadership strategic role	<ul style="list-style-type: none"> • Sets and monitors financial targets and defines fundamental objectives 	<ul style="list-style-type: none"> • Coordinates business strategies, sets and monitors financial and business objectives 	<ul style="list-style-type: none"> • Participates in development of business strategies and their implementation 	<ul style="list-style-type: none"> • Develops plans, policies, and guidelines, and monitors operations
Executive leadership decision role	<ul style="list-style-type: none"> • Delegates operating decisions 	<ul style="list-style-type: none"> • Provides input into some operating decisions 	<ul style="list-style-type: none"> • Participates in all major operating decisions 	<ul style="list-style-type: none"> • Makes major operating decisions
Operational model	<ul style="list-style-type: none"> • Stand-alone business units 	<ul style="list-style-type: none"> • General management team 	<ul style="list-style-type: none"> • General management team 	<ul style="list-style-type: none"> • Operating units
SG&A model	<ul style="list-style-type: none"> • Central services typically not provided 	<ul style="list-style-type: none"> • Some central services provided on as-needed basis 	<ul style="list-style-type: none"> • Significant portion of services provided centrally 	<ul style="list-style-type: none"> • Vast majority of services provided centrally

Cost reduction increase as the strategic integration of the company increases

Source: Deloitte Consulting LLP

the top, and every division is expected to execute the same strategy. When corporate issues a directive, it's the law.

Significant variations in processes, technology, and culture exist across the four business models (see Figure 3). In a holding company, business units operate autonomously and have responsibility both for G&A and non-G&A functions. Typically, there is very little standardization and integration. In an IOC, corporate owns G&A and non-G&A functions, and most — if not all — key processes reside at the corporate level. Standardization, integration, and consolidation are the norm. Common values and a common culture pervade the company, and there is a high degree of technology integration — perhaps even a single technology platform.

Looking at the middle of the spectrum, the strategic control model clearly “pulls to the right” toward the IOC model. Non-core functions are often centralized and consolidated; however, some core functions and activities may occur at the business unit level. This model features very strong corporate involvement in operations, with corporate executives developing and implementing business strategies and participating in major operating decisions.

In contrast, the strategic guidance model is more like a holding company, “pulling to the left.” A few non-core functions such as accounts payable and payroll are likely to be consolidated. In this model, corporate executives do not exert heavy-handed control over operating units; they simply offer coordination and guidance on strategy, set and monitor financial and business objectives, and occasionally provide input on operating decisions.

Moving “toward the right” generally increases opportunities for consolidation (see Figure 4). In fact, companies often shift from strategic guidance to strategic control specifically to capture more cost synergies.

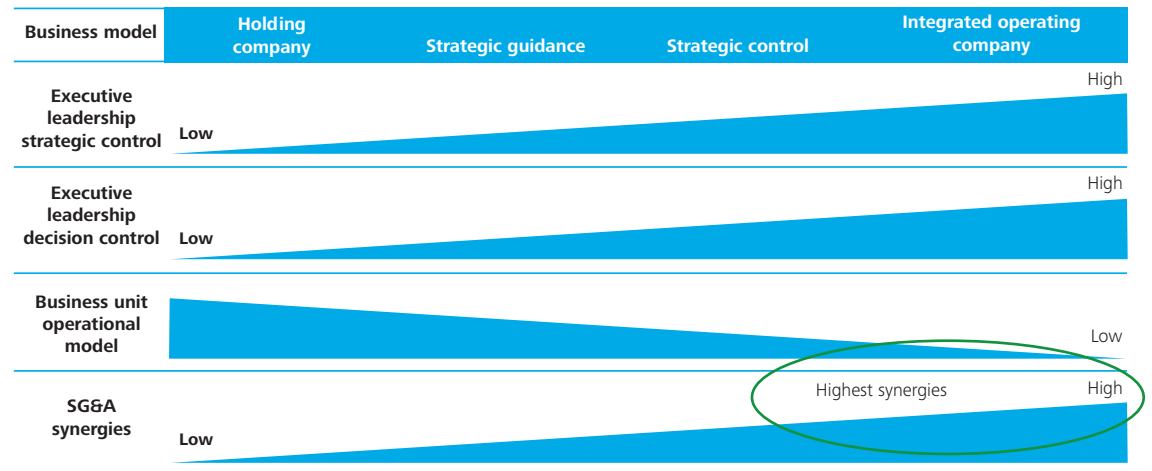
Case in point: a large independent global oil and gas producer decided to increase the level of corporate control because the company's existing strategic guidance model had trouble capturing economies of scale. The company had grown significantly over several years, mainly through acquisitions, and its G&A costs were among the highest in its peer group. Rationalizing its support structure for G&A — plus a few core areas — and shifting its business model toward strategic control helped bring the company's costs back in line, producing recurring annual savings of approximately \$150 million.

Figure 3. Different business models have different types of processes, systems, and culture

Business model	Holding company	Strategic guidance	Strategic control	Integrated operating company
Processes	<ul style="list-style-type: none"> Few or no key processes are generic 	<ul style="list-style-type: none"> Some key processes are generic 	<ul style="list-style-type: none"> Many key processes are generic 	<ul style="list-style-type: none"> Most of all key processes are generic
Technology and infrastructure	<ul style="list-style-type: none"> Not integrated 	<ul style="list-style-type: none"> Very little integration 	<ul style="list-style-type: none"> High degree of integration 	<ul style="list-style-type: none"> Mostly integrated
Culture	<ul style="list-style-type: none"> Different value systems Different cultures 	<ul style="list-style-type: none"> Some common values Different cultures, but fewer 	<ul style="list-style-type: none"> Many common values One culture broader interpretation 	<ul style="list-style-type: none"> Common values One culture, common interpretation

Source: Deloitte Consulting LLP

Figure 4. Different business models determine the range of strategic, decision-making, and organizational dependencies



Source: Deloitte Consulting LLP

Large specialty retailer cuts costs by more than \$60 million a year



A large specialty retailer shifted from strategic guidance to strategic control and within the first year captured more than \$60 million in annual savings for controllable expenses and staff. The impetus for the shift came after the company made two major acquisitions in two years and realized that its administrative structure could not support all three businesses effectively or efficiently.

Decision making was a major problem. To address this issue, the company established a new operational governance model that clearly defined decision-making roles and responsibilities between corporate and the divisions, and improved communications and coordination.

To achieve its growth objectives, the company also needed a scalable administrative infrastructure that would reduce its overall selling, general, and administrative (SG&A) expenses and non-merchandising costs by eliminating redundant activities at the business unit level. The solution was a shared services center to capture G&A synergies.

The center's scalable footprint initially included human resources and finance, as well as site services such as non-merchandise procurement, e-procurement, corporate facility management, stores facility management, mailroom services, printing and production services, and document management. The footprint was later significantly expanded to include new areas such as real estate.

Subsequent acquisitions have gone much more smoothly with the new operational governance model and shared services center in place.

Source: Deloitte Consulting LLP

Analyze the model along six dimensions

To determine where your company falls on the business model spectrum, consider analyzing your current business model along six dimensions (see Figure 5):

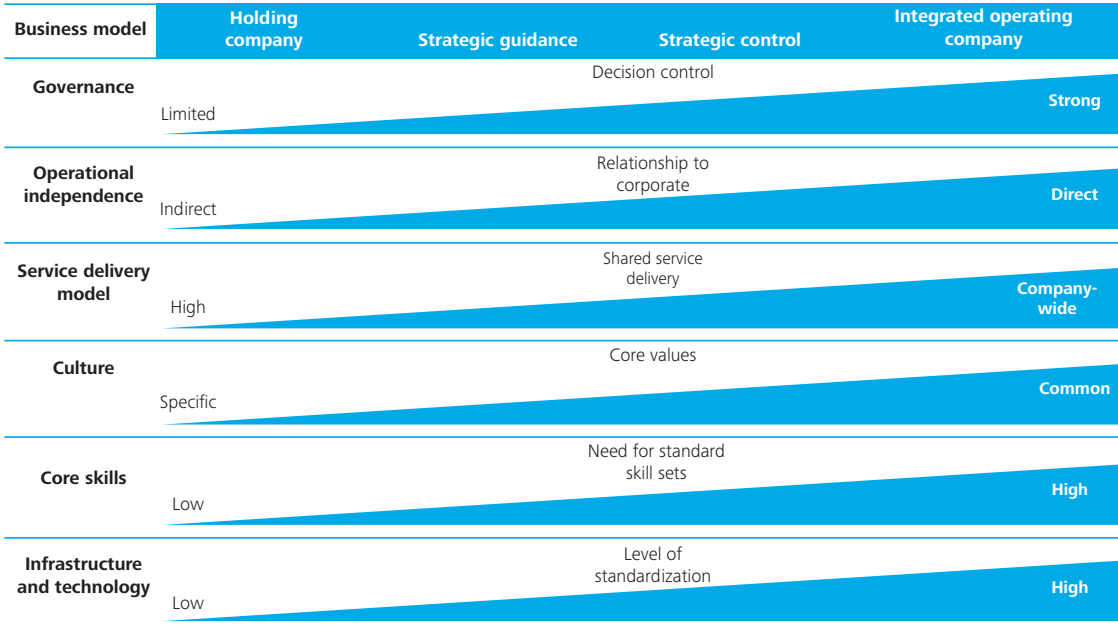
- **Governance** – How much decision-making control does corporate have? How much do the business units have? In a holding company, corporate has little decision-making control. In an IOC, it has a lot.
- **Operational independence** – What is corporate’s relationship to the operating units? Does corporate direct the operating units, or are they independent? In a holding company, the business units are autonomous and have an indirect relationship with corporate. In an IOC, divisions are directly linked to corporate.
- **Service delivery** – Are support services embedded in the business units or provided centrally? Holding companies typically localize services, while IOCs tend to centralize them.
- **Culture** – Are the culture and core values unique to each business unit, or are they common throughout the company?
- **Core skills** – Are standardized skill sets applied across the company, or do the business units have special

needs? Holding companies generally don’t standardize; IOCs generally do.

- **Infrastructure and technology** – Is the level of technology standardization high or low? Holding companies typically do not integrate infrastructure and technology. IOCs tend to have a high level of technology integration and, in some cases, may even operate on a single enterprise-wide platform.

After analyzing your business model, company executives might decide to preserve the status quo because a different model would not offer improvements. That’s fine, as long as it’s a conscious decision. For example, a large food company with multiple brands thought about shifting from a holding company model to strategic guidance, but with so many different brands – including some that competed side-by-side on grocery store shelves – it decided to keep its divisions operating independently. Although the company might have generated synergies by shifting to a new model, it felt that keeping the operating units competing and separate was more important. Instead of changing its business model, the company focused its attention on improving market penetration.

Figure 5. The business model can be examined in more detail by looking at the following variables



Source: Deloitte Consulting LLP

Pros and cons

Every business model has advantages and disadvantages, and requires certain trade-offs (see Figure 6). For holding companies, the main trade-off is business unit independence instead of cost synergies. Duplicate activities and staff give business units greater autonomy, but at the same time increase a company's overall costs. In addition, holding companies have a harder time taking advantage of their buying power when negotiating prices on resources and supplies. For instance, one U.S. company with multiple factories was paying 20 different prices for the same supply item from the same vendor. Why? Because the company was so decentralized that it could not compare prices among factories to determine what each was being charged.

At the other end of the spectrum, the IOC model helps create cost synergies because G&A resides at the corporate level and services are provided centrally. However, the trade-off is a lack of independence for the operating units, which may reduce their entrepreneurial spirit. (Of course, for some companies, entrepreneurial spirit is not a high priority.) The IOC model also helps foster positive vendor and supplier relationships and synergies. For example, corporate can dictate that all employees use a certain type of credit card or hotel chain, enabling the company to negotiate better deals.



Figure 6. Each business model offers various advantages and disadvantages

	Holding company	Integrated operating company
Pros	<ul style="list-style-type: none"> • Increase operational flexibility • Improve value in fast-growing environment • Foster entrepreneurial spirit and initiatives • Allow for easier company acquisition/integration in the short run 	<ul style="list-style-type: none"> • Promote stronger market influence • Improve synergies and efficiencies across all business units and divisions • Improve value in saturated or deflationary markets • Improve adherence to and execution of corporate strategy • Allow for easier acquisition or divestiture in the long run
Cons	<ul style="list-style-type: none"> • Require high cost structure • Promote fragmentation, leading to weaker market presence • Hinder technology and infrastructure standardization • Reduce value in stagnating or deflationary market 	<ul style="list-style-type: none"> • Limit company's flexibility in a fast-growing environment • Increase risks of "bureaucracy" • Increase risks of rejection on corporate cultures and values if not properly balance

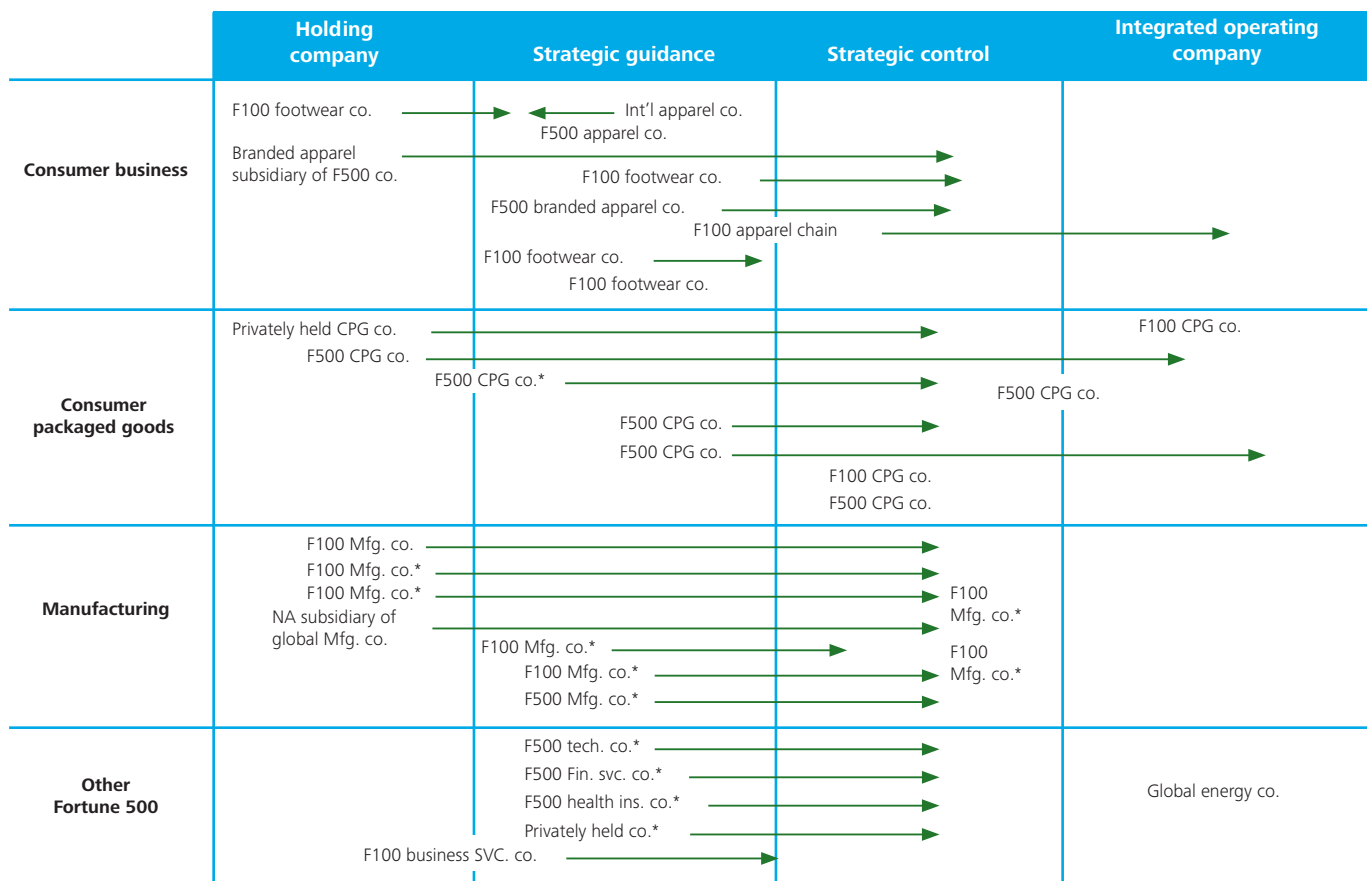
Source: Deloitte Consulting LLP

High-growth vs. mature markets

The value of moving to a different business model often hinges on whether a company is in a high- or low-growth market. For companies in low-growth markets, shifting to a synergy-friendly business model may be the only practical way to improve earnings and overall performance. Moreover, such markets generally don't require a strong focus on entrepreneurship or independence, thereby neutralizing the disadvantage of central control.

Most companies in mature markets and industries follow the same general pattern. For example, Figure 7 shows the results of our research regarding business model changes for a sample of Fortune 500 companies. Since the vast majority of Fortune 500 companies are in mature industries, many have moved — or are moving — to a strategic control or IOC model where potential synergies from centralization are greater.

Figure 7. To gain more synergies, many Fortune 500 companies have moved or are moving to more integrated business models



*G&A functions only

Source: Deloitte Consulting LLP

The strategic control and IOC models are both synergy-friendly; however, some important differences exist (see Figure 8).

Many companies find that the strategic control model strikes an excellent balance, enabling them to reduce costs through consolidation while still giving business units enough autonomy to foster creativity and an entrepreneurial spirit.

Companies with strategic control or IOC business models also tend to have lower SG&A costs (see Figure 9). We have found this to be consistent both across industries and over time. Across industry sectors, SG&A costs are, on average, three percent lower in companies operating under integrated business models compared to companies with more decentralized models. This difference, for a typical company in our review panel of 121 companies, represents approximately \$550 million in costs. We repeated the analysis for data in 2008 vs. 2006, and found that the results also remained relatively constant over time between companies with integrated models versus companies with more decentralized models. This consistency reinforces our view that the integrated approach offers savings opportunities.

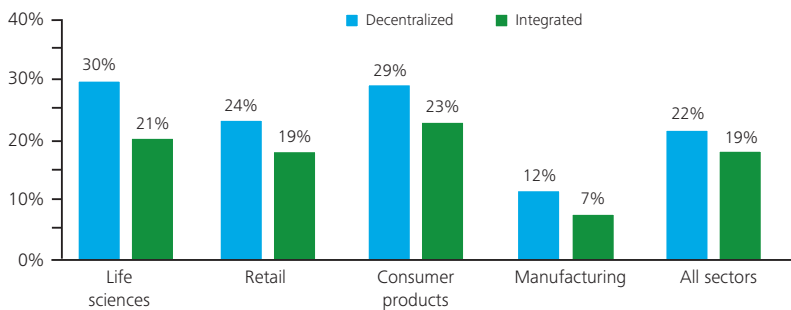
That said, an integrated business model is not right for everyone. Some companies that shift to a strategic control or IOC model may learn the hard way that their financial results were inextricably linked to a more decentralized model. In particular, faster-growth and higher-growth companies — as well as companies comprised of diverse businesses — may find that it is worth sacrificing a certain amount of efficiency in exchange for increased agility and entrepreneurial spirit. For these kinds of companies, a holding company or strategic guidance model might be the most appropriate choice.

Figure 8. More on the strategic control vs. the integrated operating company models

	Strategic control	Integrated operating company
Pros	<ul style="list-style-type: none"> • More balanced roles and responsibilities between corporate and business units • Easier application to companies with multiple business portfolios • Stronger market focus • Higher level of flexibility at business unit level 	<ul style="list-style-type: none"> • Higher level of synergy • Lower SG&A costs • Easier to attract and retain corporate executives • Faster decision-making process
Cons	<ul style="list-style-type: none"> • Lower level of synergy • Higher SG&A costs 	<ul style="list-style-type: none"> • More difficult applications to companies with different business portfolios • Higher risks of bureaucracy • Difficult to retain business unit executives

Source: Deloitte Consulting LLP

Figure 9. 2008 SG&A averages of decentralized vs. more integrated companies by industry



Note: SG&A as a percentage of revenue
 Source: Deloitte, data for Fortune 500 comprised of 34 retail, 35 consumer products, 32 manufacturing and 23 life sciences companies.

Mix and match

While each of the four business models offers a distinct blend of efficiency and effectiveness, you may want to mix and match elements from various business models to create a customized model that fits your unique requirements.

For example, highly decentralized companies may decide to centralize support activities but leave the rest of the business the way it is. In fact, many companies do just that — usually by centralizing G&A services and processes, which are typically generic. Other companies have found centralizing non-core competency areas to be effective. For instance, some have created wholly owned procurement companies that use the entire organization's combined buying power to get the lowest price on raw materials and supplies. Others have reduced their costs by establishing separate companies or operating units for administration and/or shared services. Matrix organizations have also found this analysis useful for refining or confirming their business model.

These are just a few examples. In reality, you can choose from an infinite number of models. The right choice ultimately depends on your company's specific needs and circumstances.



The next level

Companies often want to realign and restructure their business. But our experience suggests that before tangible changes can occur, companies must have the right business model — either by systematically validating their current model, or designing and building something new. This is the first step toward improving a company's cost structure.

A redesigned or confirmed business model can be used as the starting point for effective operational governance — i.e., how key decisions are made, and who makes them (which we examine in the second article in our three-part series) — laying a solid foundation for sustainable and scalable change.



Evaluating your business model

Is it time to change your business model? Consider the following questions as you decide.

Does your current business model:

- Support your company's business strategy?
- Support your go-to-market strategies?
- Enable timely adjustments or changes in response to market shifts such as competition and cost pressure?
- Serve a key element of your company's competitive strategy?
- Provide for continuous improvement in vendor and supplier relationships?
- Help interact with customers effectively and efficiently?
- Support the most efficient and effective cost structure?
- Support the company's desired culture?
- Take into account alternative service delivery models such as shared services, outsourcing, and offshoring?
- Help leverage processes and organizations globally or internationally?
- Support clear, effective, and efficient decision making at different levels of the company?

If you answered "no" to many of these questions, it could be time to take a hard look at your business model.

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