With High Stakes, Accelerate the Transformation

If you bought the business today, what would you do differently?

By Simon Henderson, Miguel Simoes de Melo, Lodewijk de Graauw and Drew Woodhouse

BAIN & COMPANY

Simon Henderson is a partner with Bain & Company's Performance Improvement practice. Miguel Simoes de Melo is a partner with Bain's Strategy practice. Lodewijk de Graauw is a partner with Bain's Organization practice. Drew Woodhouse is a partner with Bain's Performance Improvement practice. Henderson, Simoes de Melo and Woodhouse are based in Sydney, and de Graauw is based in Amsterdam.

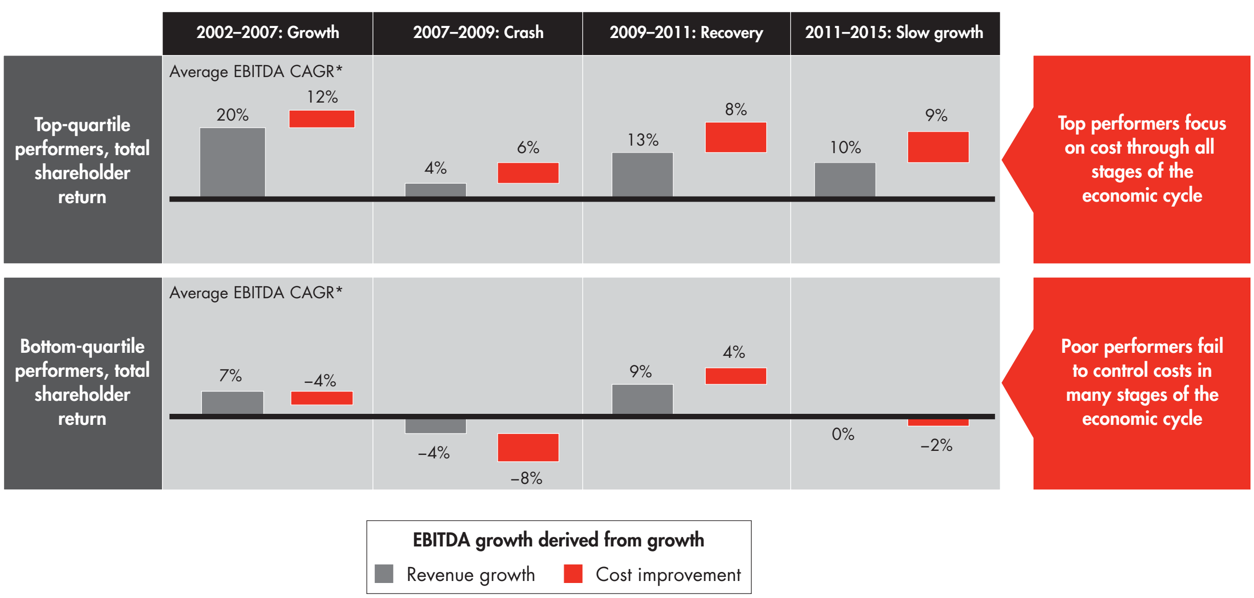
Scorched-earth cost-cutting has returned with a vengeance of late. The individual situation varies, of course, though in most cases the companies in question are struggling to meet short-term commitments to earnings targets or ensure their survival.

Some of these firms were knocked off course by sudden market changes, as those in mining or oil and gas have experienced. Others underestimated the severity of structural changes, such as media firms bleeding advertising and subscription revenues. Incumbent firms in several industries, like grocery, are contending with new competitors that have lower-cost business models. And all face the possibility of lower economic growth for some years to come.

Without question, continual cost and productivity improvements remain fundamental parts of any firm's success. A low-cost position wins in nearly every industry, as it allows a company to outearn and out-invest its peers for growth. Bain & Company analysis shows that top performers in total shareholder return focus on cost, not just revenue growth, no matter which phase of the economic cycle (see Figure 1).

Yet all too often, cost-cutting programs today rely on a blunt, rote approach that can severely limit a company's chance for recovery and future–– growth. To start, cost target-setting often relies heavily on external benchmarks with little regard for their relevance to the company's distinctive ways of creating value. Clumsily applied benchmarks can lead to all functions and activities being treated as roughly equal in importance to the cost program, even if some activities are more critical than others to the firm's chosen strategy. As a result, these programs inevitably cut

Figure 1: Top performers consistently focus on cost



Notes: Average EBITDA CAGR by source for top TSR quartile and bottom TSR quartile S&P 500 companies; measured for S&P 500 constituents at the end of each period; excludes companies where CapIQ TSR was zero and for financial services companies, where EBITDA metric is unsuitable
Sources: CapIQ; Bain & Company analysis

organizational muscle, not just fat. For example, slashing customer service could provoke more customer churn. And executives, in their haste, sometimes gloss over the chance for productivity gains—getting more out of existing equipment or processes by finding and clearing bottlenecks.

Top-down mandates to fill the savings hopper have an even more insidious effect: They undermine people's motivation and accountability for both sustaining and growing the business. An exclusive focus on efficiency might work for, say, mining companies whose source of competitive advantage is scale. But it can severely damage companies in industries such as retailing and hospitality, where advantage stems from an excellent customer experience.

Companies in distress—and those trying to reposition themselves for future growth—need more than a straight cost program. They need an *accelerated* transformation—an urgent, cross-functional effort to deliver cash savings and topline growth. And they will want to sustain the gains. Why put a company through a major overhaul of its cost structure while missing the opportunity to install the sustaining mechanisms that turn cost management into a strategic advantage?

Transformation requires careful planning and orchestration, yet at a fast pace. In our experience, a few practical guidelines can help senior leaders balance the short- and long-term concerns in order to achieve a successful transformation.

Behave like an owner

The most successful transformations bring an owner-activist perspective to bear. Owner activists consider costs selectively, with an eye to which areas of cost advance their firm's competitive advantage. They take out costs *here* in order to reinvest for revenue growth *there*. Note that we are not advocating an *investor*-activist approach, which tends to exploit volatility for short-term gain. Owner activists usually want to build the best business possible for the short and long term, because they intend to retain ownership. That leads to more reasoned, sustainable decisions on resource allocation.

Grounding transformation in an owner-activist mindset raises the odds of producing sustainable results. One objective is to quickly lift the business on all fronts: cost, productivity, customer advocacy and core revenue growth. That unifying objective informs every plank of the transformation, as well as the selection of tactics to win on each plank.

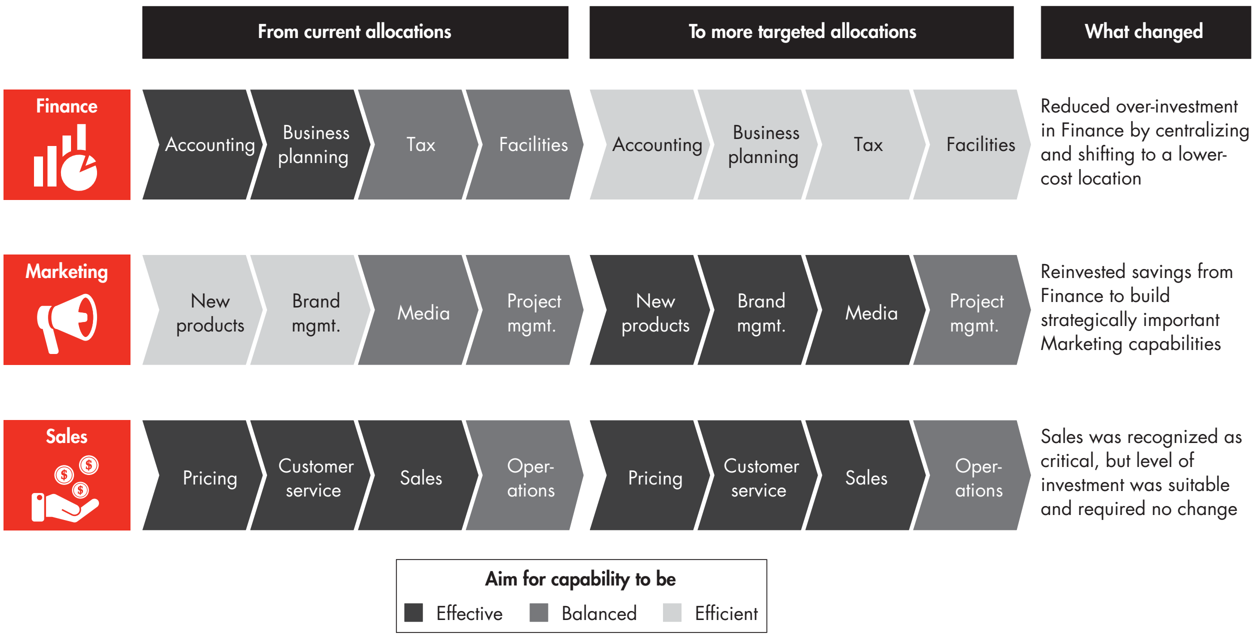
In successful transformations, people on the front line lead the initiatives and own the outcomes. They behave as if it is their own business.

Apply a strategic lens to costs, recognizing that not every dollar is equal

Most companies apply more rigor to quantifying efficiency than to increasing effectiveness. Anyone can cut 10% from a department, but to make intelligent and sustainable cuts, executives need to understand which activities are critical to the health of the business and which are expendable because they don't add value. And more complicated trade-offs require even more analytical rigor.

In particular, operating expenses should be managed with the same level of rigor as capital expenditures. Think of opex as the funding source for building human

Figure 2: Targeted cost reductions free up funds to execute the strategy



Source: Bain & Company

capital, and analyze opex investments for their return on spending. This entails viewing opex not merely as an in-year expense, but also as a multiyear investment in an asset designed to help a firm execute its strategy better than competitors.

Successful companies have a clear posture for investing in their capabilities. For example, AB InBev, the world's largest brewer, knows that sales of beer stem from brand recognition and advertising, so it has found strategic value in a strong marketing function. In the mobile telecoms market, a provider offering premium services for premium prices benefits from continued investment in its cellular network, handset subsidies, and in the retail franchises that account for most of its retail business. However, it could cut costs in areas of procurement that afford no competitive advantage.

Likewise, for an accelerated transformation, senior management must understand how their company makes money today and how this will change in the future—and therefore in which capabilities they should invest *(see Figure 2)*.

A major European meat-processing firm asked these questions after a merger. This led the transformation team to divide the area of sourcing into three categories: nonstrategic (covering items such as office supplies, plastic wrap and packaging), semi-strategic (salts and food additives) and strategic (meat). The team focused first on reducing costs in nonstrategic items. For the semi-strategic category, chefs injected more flexibility into the sausage recipes, which allowed the firm to quickly respond to fluctuations in the prices of these inputs. And for meat sourcing, which was central to its strategy, the firm focused on strengthening relationships with key slaughterhouses. The cost savings that resulted freed up funds that the company used to relaunch its core sausage product and to innovate new flavors of sausage.

Shape the organization from the future back

Basing a transformation on a detailed assessment of the company's current state may be useful, but it's far from sufficient. Anchoring on today's business tends to promote incremental adjustments, one cautious step at a time, until it's too late for meaningful change.

Projecting the future state of the market, and the company's desired position in that market, prompts a very different approach. It forces management to consider all the activities and conditions that must change in order for the company to survive and thrive in the future. With a future-back view, external benchmarks must be combined with other determinations of cost, notably what activities *should* cost given their role in the company's strategy.

Reengineer how the work gets done

Complexity is at the core of high costs and ineffective decision making. To permanently reduce costs, managers often need to change how work gets done. This could involve a range of measures: eliminating unnecessary or merely nice-to-have activities, reducing service levels where appropriate, automating low-value activities through digital processes, bundling and shifting volume to the best-value suppliers, and controlling internal demand for services (see Figure 3).

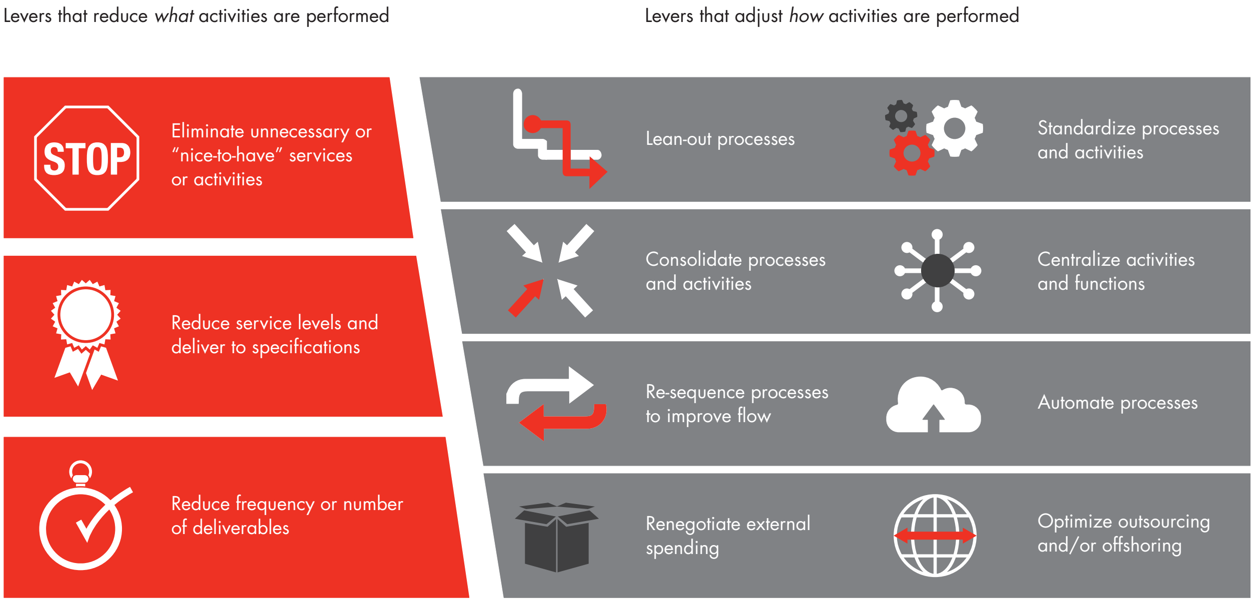
A specialty materials company chose to reduce complexity by selectively reducing service levels. Previously, it had been using the same 98% fulfillment level for all customers. After analyzing the overall profitability of each customer, the company realized that providing the same standard added cost to low-margin customers in a way that the customers did not value. By revising service levels accordingly, the company was able to direct the top service to the highest-value customers while improving the profitability of other customers.

Often the greatest frictions occur at the seams between functions or departments, so companies can find large sources of potential value in the mismatches and misalignments in the seams. One area with potential for improvement is to integrate the supply chain function more tightly with other parts of the business. That can stem the value leakage caused by excessive rework or expediting, which raises costs required to achieve service goals. The dirty secret of "perfect order" capabilities, for instance, is the large amount of money required to expedite an order.

Scanning the seams requires an enterprise view, across all the functions, to make valid comparisons of how each cost initiative would improve or hinder the sources of strategic value. This process can yield surprising results.

An Asian telecommunications firm unearthed a large and hidden inefficiency, thanks to a horizontal review of its service business. Its call center tried to reduce costs by keeping service calls short, dispatching trucks if a problem couldn't be resolved quickly. But that practice sent the cost for rolling trucks, a separate service unit, soaring. To fix the problem, the company integrated the two service units and gave one executive responsibility for the entire service chain. This move helped increase the number of service calls resolved over the phone by 15%, saving the company millions of dollars.

Figure 3: Reengineer to take work out, change what is performed and how



Source: Bain & Company

Move fast to take action even if you lack decimal-point accuracy

Time is a precious currency. It can take months to identify, prove and build out the right transformation initiatives, especially those that require changes to IT systems—and competitors are not standing still. Owner activists know the virtues of moving quickly. They're willing to test promising new ideas, assess them in short order and scale them up or kill them quickly depending on the early results.

The European meat processor we mentioned earlier had gathered all its meat buyers in one place for the first time, as a way to share best practices. The forum uncovered several unexpected new ideas for ancillary revenue streams that could be quite profitable. One was an arbitrage opportunity to buy meat in certain countries and sell it in others, profiting on the price difference. Despite the inherent uncertainty of the venture, the company tried it anyway—to great success.

Owner activists accelerate the transformation by encouraging a bias to action and accepting a lower burden of proof.

Change the culture to keep costs from creeping back

Ultimately, an accelerated transformation should put the company in a better position to sustain a lean cost stance over the long term. That's especially difficult in areas that touch the customer and in complex operations such as IT and the supply chain. Executives in charge of these areas will make legitimate arguments for treading lightly or leaving them alone altogether. Yet because these areas cover a considerable amount of cost, the senior team will have to address them. Taking a clean-sheet or zero-based approach to resource planning, with a true understanding of the cost of complexity, allows the senior team to challenge conventional thinking here.

Zero-based budgeting differs from traditional budgeting processes by examining all expenses for each new period, not just incremental expenditures in obvious areas. It forces managers to justify every expense item that should be kept.

Along with zero-based budgeting, certain tools and incentives will make it easier for employees to consistently do the right thing when weighing cost and value. Leaders should provide people with visibility of costs across the whole organization, in granular detail at both the whole-of-function and business unit levels. They should hold individual owners accountable for results, through cost-performance indicators in addition to traditional P&L measures, as revenue growth can hide a multitude of sins. To sustain behavior change, various types of reinforcement can be combined. These include feedback from other people including peers, supervisors and senior leaders, and formal rewards and recognition, such as monetary incentives and assignments to important projects (see Figure 4).

Figure 4: Several elements spur cultural change

Source: Bain & Company

Aligning compensation with outcomes, for instance, does wonders for sharpening the mind. At one engineering firm, senior executives now have half their bonuses tied to traditional measures and half to cash flow. For the next executive level down, bonuses are twice the relative weight they used to be, and are fully tied to cash flow. That change has naturally made executives eager to look for ways to improve cash flow, such as negotiating discounts for prompt payment to suppliers and factoring off specific debts.

Achieving maximum benefits from a transformation hinges on a disciplined, high-frequency rhythm to keep people accountable for delivering the benefits.

Many companies will also choose to have an outside partner support them in their cost-transformation effort in order to accelerate and amplify results. Outside experts can test long-held assumptions, provide benchmarks and best practices and can break up the P&L into small topics, with a playbook for each topic. They can help build the necessary processes, tools and dashboards quickly.

If senior management decides to take that route, they should seek partners who align their economics to share in the risks and rewards. But the presence of partners does not deflect accountability from the company's own leaders. Indeed, accountability and engagement up and down the organization—two core traits of owner activists—are what will allow cost and productivity improvements to endure for years to come.

Once a company lands back on its feet through an accelerated transformation, it will have better financials and a war chest to fund investments for an even broader transformation agenda—typically a set of strategy, product and customer changes designed to realize the full potential of the business. That path to full potential starts by behaving like an owner: being relentless, even ruthless, about taking out bad costs to free up funds for the next round of growth.

Shared Ambition, True Results

Bain & Company is the management consulting firm that the world's business leaders come to when they want results.

Bain advises clients on strategy, operations, technology, organization, private equity and mergers and acquisitions. We develop practical, customized insights that clients act on and transfer skills that make change stick. Founded in 1973, Bain has 53 offices in 34 countries, and our deep expertise and client roster cross every industry and economic sector. Our clients have outperformed the stock market 4 to 1.

What sets us apart

We believe a consulting firm should be more than an adviser. So we put ourselves in our clients' shoes, selling outcomes, not projects. We align our incentives with our clients' by linking our fees to their results and collaborate to unlock the full potential of their business. Our Results Delivery® process builds our clients' capabilities, and our True North values mean we do the right thing for our clients, people and communities—always.

Key contacts at Bain & Company for Accelerated Transformation

Americas

Greg Gerstenhaber in Dallas *(greg.gerstenhaber@bain.com)*
Ron Kermisch in Boston *(ron.kermisch@bain.com)*
Ives Moraes in São Paolo *(ives.moraes@bain.com)*
John Norton in Houston *(john.norton@bain.com)*

Asia-Pacific

Phil Barton in Sydney *(phil.barton@bain.com)*
Vinit Bhatia in Hong Kong *(vinit.bhatia@bain.com)*
Francesco Cigala in Kuala Lumpur *(francesco.cigala@bain.com)*
Marco D'Avino in Sydney *(marco.davino@bain.com)*
Simon Henderson in Sydney *(simon.henderson@bain.com)*
Askin Morrison in Melbourne *(askin.morrison@bain.com)*
Drew Woodhouse in Sydney *(drew.woodhouse@bain.com)*

Europe, Middle East and Africa

Pablo Cornicelli in Madrid *(pablo.cornicelli@bain.com)*
Juan Carlos Gay in London *(juancarlos.gay@bain.com)*
Dieter Meyer in Zürich *(dieter.meyer@bain.com)*
Miguel Simoes de Melo in London *(miguel.simoes-demelo@bain.com)*