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3 Approaches to Create Cost-Reduction Campaigns During Turns

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As the impact of the COVID-19 (coronavirus) pandemic spreads, executive leaders face pressure to cut costs, but it's critical to avoid a knee-jerk response. Executive leaders must avoid three cost reduction mistakes that could impede their progress.

Overview

Key Challenges

- Seventy percent of executives surveyed confirm their organizations cut costs in all business areas as a short-term response to the financial crisis in 2009.
- Many organizations cut investments in growth areas without aligning with their enterprise's strategy, growth patterns, financial composition and business complexity.
- Many executive leaders undermine the importance of communicating cost-cutting priorities to the workforce, causing less employee commitment to implementing such initiatives.

Recommendations

Executive leaders must adopt these three approaches to create cost reduction campaigns during turns:

- Use a value-based framework to evaluate areas for cost cuts. In particular, ensure to establish cost-cutting objectives by reviewing critical elements such as investment and their impact on business outcomes.
- Categorize the function's cost, and set cost-saving targets to develop an in-depth cost analysis and identify investment opportunities in growth areas.
- Create an open dialogue with the business about cost-cutting initiatives' benefits and business impact to enable smarter resource-allocation decisions across the organization.

Introduction

This research is adapted from "Avoid Three Common Mistakes of Cost Reduction Campaigns," *which provides HR leaders with approaches to avoid three mistakes of cost reduction campaigns that impede their cost-saving progress.*

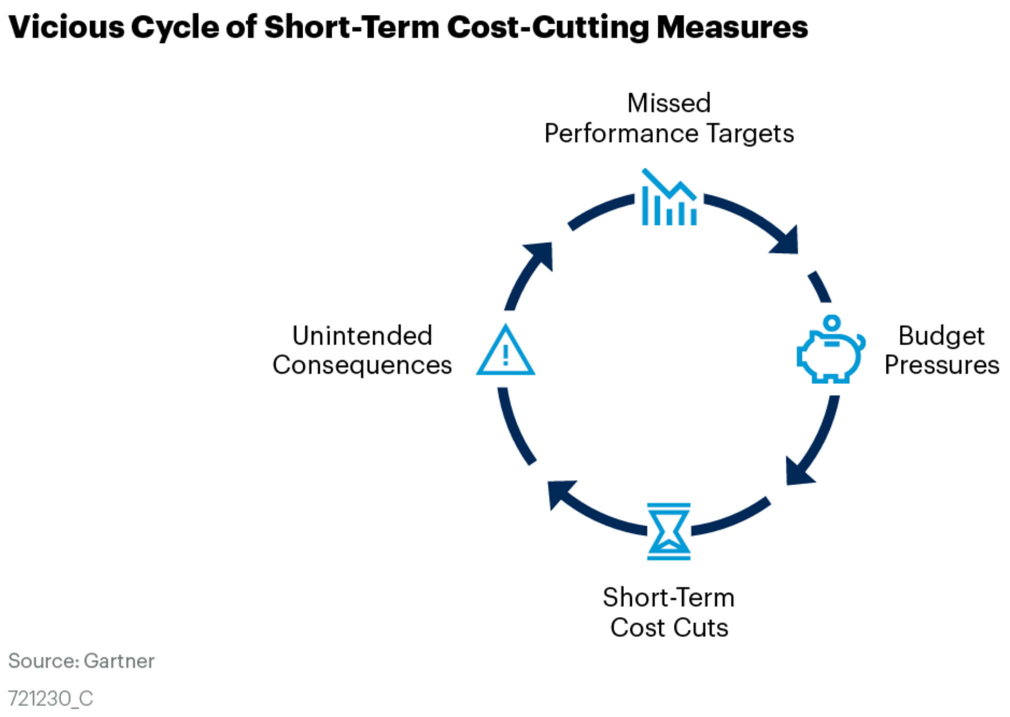
Since 2013, costs have outpaced revenue at S&P 1200 companies. After a period of prolonged growth, falling profitability is now an observable trend for large and small organizations in multiple industries, presenting them with an uncertain operating environment. As companies strive to win in such uncertain times, they are taking risks to catch up with their competitors. And if the race is a long one, the costs add up.

Why Companies Trip Up During a Downturn

This is a problem late in the economic cycle because, during a recession, the average time before organizations require a material overhead cost cut is three quarters — a very small window compared with the average of seven quarters after the financial crisis.

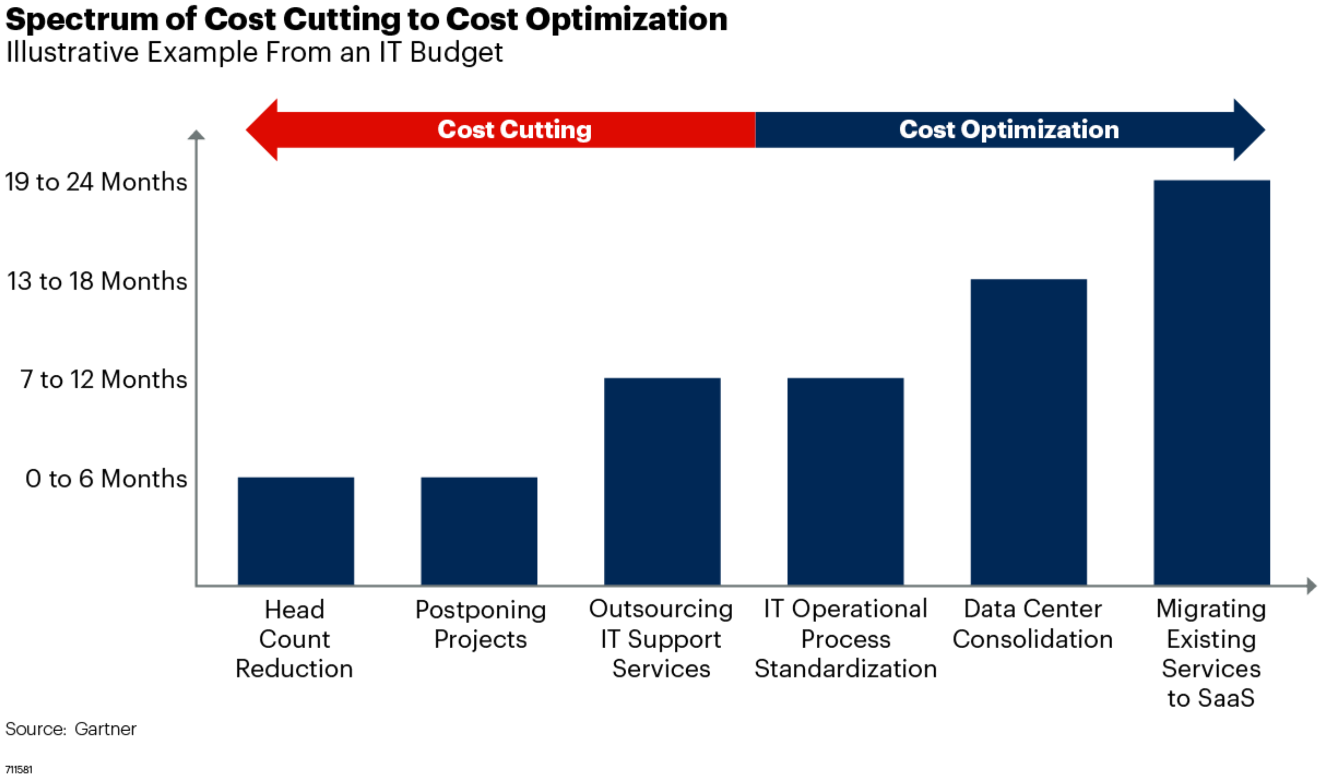
Executive leaders, in such a case, turn to "quick wins," and ad hoc cost cutting. While these decisions can save money in the short term, they can inhibit the function's long-term strategy to come out of a tough economic environment (see Figure 1).

Figure 1. Vicious Cycle of Short-Term Cost-Cutting Measures



Consider a spectrum with cost cutting at one end and cost optimization at the other. On one end are actions that can help achieve quick wins in a downturn. On the other end are long-term tactics companies pursue to boost efficiency during growth (see Figure 2).

Figure 2. Spectrum of Cost Cutting to Cost Optimization



Just because certain cost types can be removed more quickly (the short-term cost-cutting goals on the left-hand side of the spectrum) doesn't mean they're less valuable to business growth. Factors such as head count and compensation management are, of course, critical to any company's success, as they impact the organization's talent assets. So, when the executive leaders must cut them in a compressed period of time, not all negative impacts are thought through in as much detail as is necessary. At their worst, these mistakes can harm all the hard work their enterprise has done to improve their long-term efficiency (the long-term cost optimization goals on the right-hand side of the spectrum).

Three major missteps executive leaders make while cutting costs:

- **Making across-the-board cuts —** Seventy percent of executives surveyed by the Harvard Business Review in 2009 said they cut costs across all business areas as a short-term response to the financial crisis. [1] This approach to cost reduction fails to acknowledge that some teams and activities create more value within the organization. As a result, executive leaders are unable to make criteria-based decisions about where to cut costs and where to invest.

- **Stifling growth investment —** During 4Q07 through the middle of the recession, S&P 500 capital expenditures were cut by 25% and R&D by 55%. Typically, organizations set cost-reduction targets based on benchmarks such as percentage cost reduction or absolute dollar amount reduction, which might mean cutting investments in growth areas to suboptimal levels. This happens because targets based on industry-specific benchmarks or criteria are not aligned with a company's strategy, growth patterns, financial composition and business complexity.

- **Losing stakeholders' commitment —** In the wake of the recession, 57% of corporate strategists we surveyed said business leadership was too cautious. Rushing into cost-cutting exercises leaders fail to communicate their cost-cutting rationale as well as priorities to their direct reports and the board. This approach undermines business initiatives, thereby impeding the involvement of stakeholders and losing their commitment to planning and implementing cost-cutting initiatives.

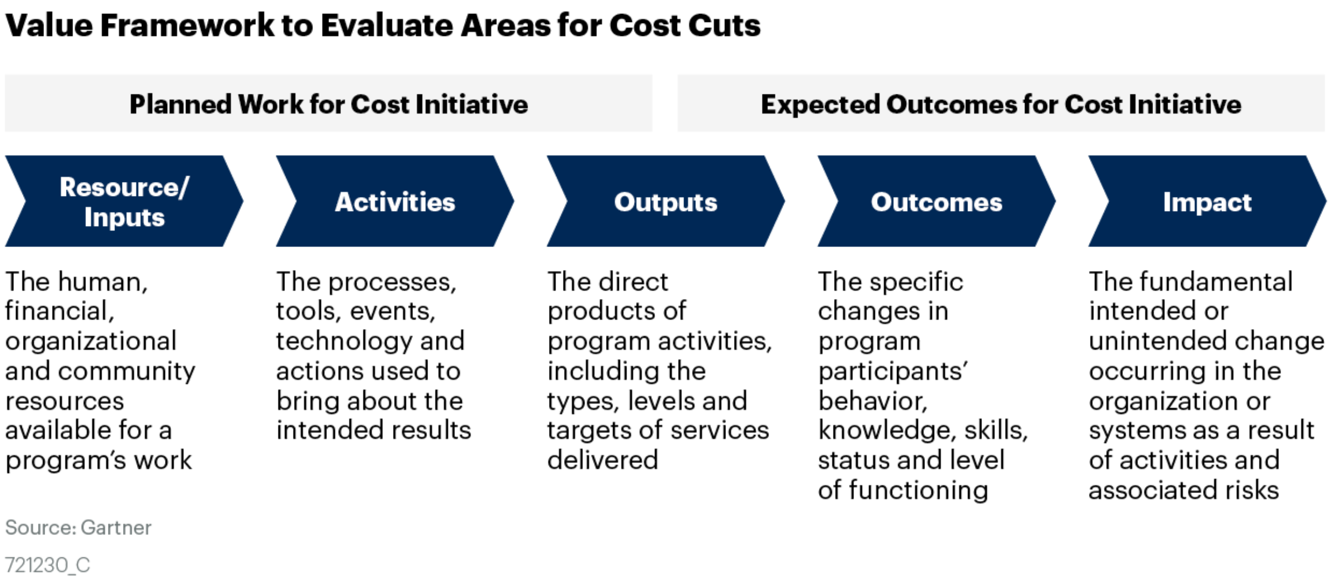
Analysis

3 Approaches That Executive Leaders Must Adopt to Avoid Each Mistakes

1. Use a Value-Based Framework to Evaluate Areas for Cost Cuts

When urgency pushes executive leaders toward a posture of "just cut something — or anything," they must make systematic connections between the inputs deployed to conduct an activity and the final outcomes it generates by using a value framework (see Figure 3). Executive leaders must reestablish the objectives of any current activity and resource by reviewing critical elements such as the investment, time required and impact on the business outcomes. By conducting this exercise for all activities and services, executive leaders can evaluate cost cut areas that are relatively more pressing.

Figure 3. Value Framework to Evaluate Areas for Cost Cuts



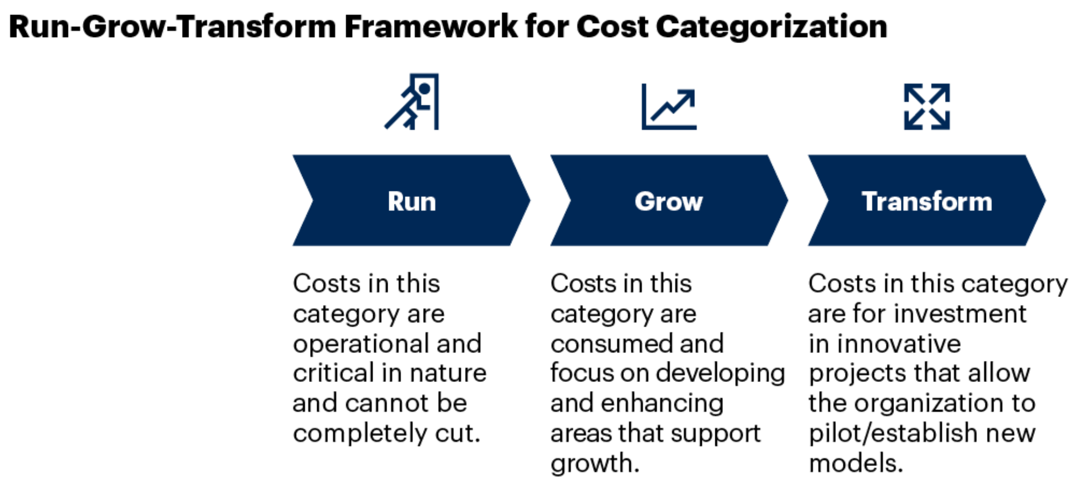
2. Close Information Gaps to Focus on Investments in Growth Areas

After a recession, executive leaders often regret investments that were stalled or never made because of performance worries. This happens because they base their cost targets on headline benchmark numbers that crudely measure their enterprise's productivity. Therefore, we recommend executive leaders to categorize their enterprise's cost and set cost-saving targets to establish an in-depth view of its costs and identify investment opportunities in growth areas.

a. Categorize Enterprise’s Costs

Executive leaders must use the “Run-Grow-Transform” framework (see Figure 4) to categorize their enterprise’s costs and establish a more differentiated view of different functions’ costs.

Figure 4. Run-Grow-Transform Framework for Cost Categorization



Source: Gartner
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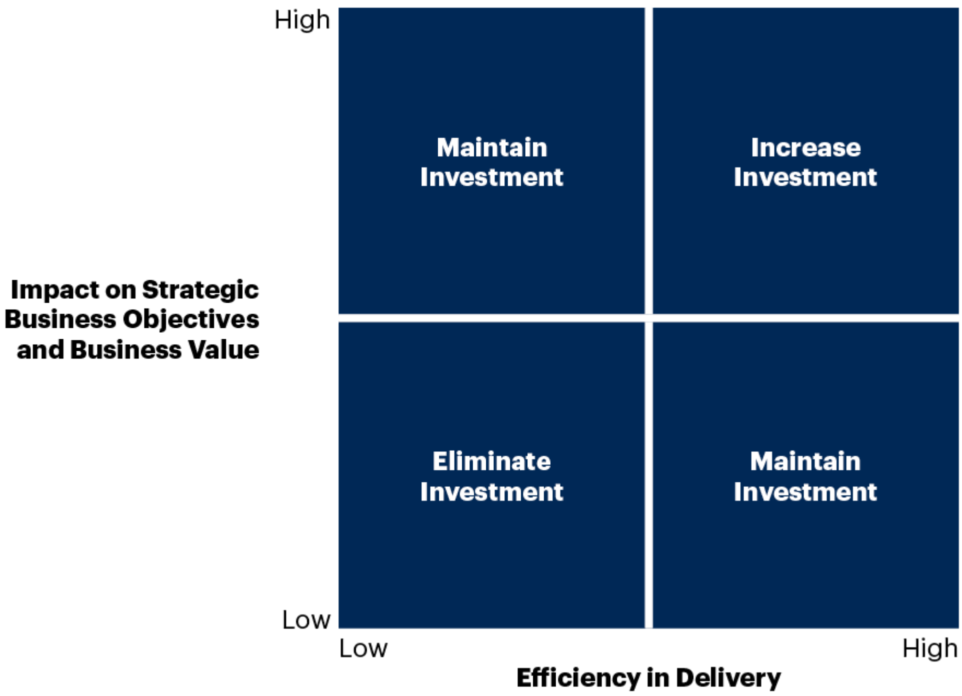
The “Grow” and “Transform” costs may also be clubbed as “Change” costs to simplify this further. Categorizing costs will help them understand the nature of cost-saving targets better and realize the share of spending intended to help grow the business.

b. Select Cost-Saving Targets for Business Transformation

It is challenging to link investments in different areas of the enterprise to concrete financial outcomes. This linkage can be established using an investment prioritization framework (see Figure 5). Executive leaders need to identify those capacities and resources across their project portfolio that can be reduced immediately or optimized in the short term through reallocation. Activities and projects should be evaluated for their impact on strategic business objectives and delivery efficiency. Based on this evaluation, they should maintain or increase investments which have relatively higher impact on business objectives and delivery efficiency to protect them from cost cuts. However, investments with lower impact and poorer delivery efficiency should be reduced or eliminated to optimize overall costs.

Figure 5. Investment Prioritization Framework

Investment Prioritization Framework



Source: Gartner

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This holistic assessment, which should be simultaneously carried out with the value-based framework evaluation, ensures that efficient growth areas are identified and executive leaders stick to targets when implementing cost-saving initiatives.

3. Get the Board and Direct Reports’ Buy-In on Cost Reduction Campaigns

In a period of cost cutting under pressure, executive leaders tend to underinvest in workforce engagement, but it’s important. All stakeholders leading cost management efforts do not commit to the cost reduction campaign plans.

Executive leaders should socialize their cost-saving priorities and validate their plans with their cross-functional peers. This would create a more open dialogue about what aspects of cost reduction most support the enterprise’s competitive advantage. This exercise can also encompass evaluating the cost and growth ideas simultaneously to allow for smarter resource allocation decisions across the enterprise.

The key steps for executive leaders to undertake this evaluation are:

- **Identifying inefficiencies —** Conduct an in-depth analysis of business processes and activities to identify key cost drivers.
- **Prioritizing efficiency improvements —** Compute savings and prioritize improvement opportunities.

- **Engaging with the workforce —** Communicate the rationale of cost-cutting initiatives to direct reports to gain their support during implementation.

Furthermore, executive leaders can encourage their cross-functional peers to participate in an integrated planning exercise to identify enterprisewide cost-cutting initiatives. This will help break down planning silos, optimize cross-company spend decisions and ensure the planned cost-cutting initiatives are aligned to the business objectives.

Evidence

[1] S. Banerji, P. Leinwand and C. Mainardi. “Cut Costs and Grow Stronger: A Strategic Approach to What to Cut and What to Keep.” Harvard Business Press. 2009.

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