

MAXIMIZING THE VALUE OF G&A

Reductions in general and administrative expenses flow right to the bottom line, but slash the wrong areas and you'll get burned. We suggest a more strategic approach.

by Robert Levin and Allison Watson

If there has ever been an earnings presentation where a CEO was asked why general and administrative (G&A) expenses were too low, we have yet to see it. On the contrary, it's practically a truism that reducing the cost of support functions will improve profitability and let management put the savings to more productive use—or return at least a portion of the savings to shareholders.

New McKinsey research suggests that while those cost-reduction opportunities are real, they don't all pack the same punch. Scale back too aggressively, in the wrong areas, and you may wind up sacrificing long-term value for short-term earnings. Increasingly, G&A functions (such as IT, HR, and finance) house some of an organization's most important work, including enabling digital innovation, finding and developing key talent, and allocating scarce resources. These and other missions are becoming ever more critical in our increasingly cross-border and digitally connected world.

The cost gap

Different industries are marked by different value chains and competitive landscapes. Within an industry, companies tend to allocate a similar percentage of revenues to G&A. Similar,

however, does not mean identical. Even within the same industries, we find measurable gaps in G&A spending among competitors—as much as 4 to 8 percent of revenues (Exhibit 1). Those big gaps, if closed, can make a meaningful difference in corporate performance. In our experience, successful programs to increase the efficiency of support functions can raise earnings before interest, taxes, depreciation, and amortization (EBITDA) by three percentage points, which can translate into a 25 percent or higher increase in valuation.

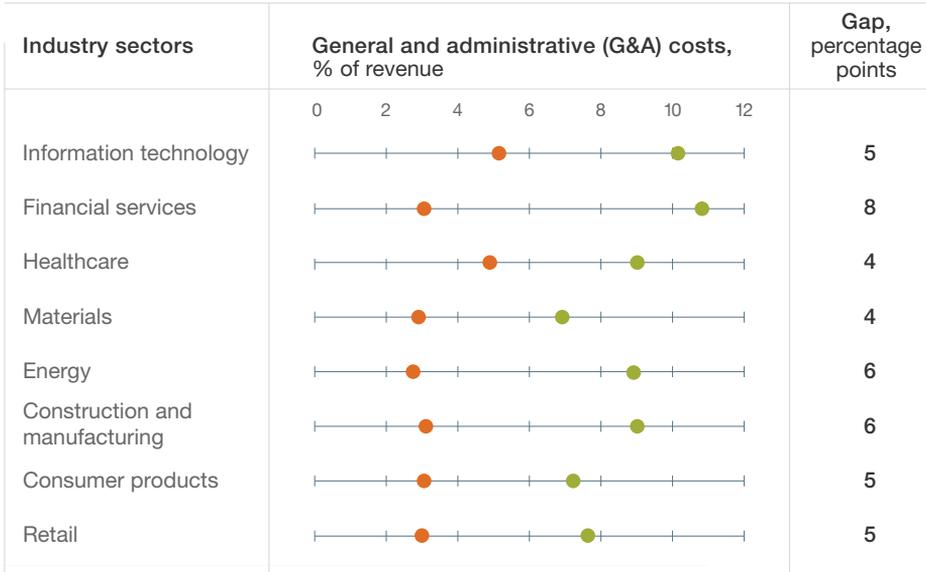
The value gap

Costs aren't the only area with big differences in G&A performance. Our research also suggests that there is a meaningful gap among companies in the share of support-function activities that can be categorized as transactional, on the one hand, versus value added, on the other. This distinction is easiest to understand in the context of specific support functions. In human resources, for example, value-added activities include recruiting, learning and development, organizational development, and compensation planning. Transactional activities, by contrast, include the tracking of hours worked and days missed, the

Exhibit 1

Across industries, top performers spend a significantly lower share of revenues on G&A support.

● Top-quartile performers ● Bottom-quartile performers



Source: Capital IQ; S&P1200

administration of benefits, and safety and health. A similar bifurcated categorization for finance activities would put the management of accounts receivable and payable in the transactional bucket, while financial planning and analysis would be in the value-added one.

We measured the amount of time the HR and finance functions spent on transactional versus value-added activities at 16 of the largest global financial-services companies and 8 of the largest global consumer companies. This analysis revealed striking differences across different companies—a value gap, if you will (Exhibit 2). The gap even appears to correlate with differences in profitability and total returns to

shareholders. However, we hesitate to place too much emphasis on those correlations, since they could reflect a variety of factors beyond G&A. The value gap is understandable when you consider the strong performance impact of value-added efforts—for example, analyzing new markets or products—compared with the effects of more transactional initiatives, such as programs to realize modest improvements in days payable.

Virtuous cycle or complexity cliff?

Differentiating between high-value and transactional activities is one key to mastering a classic challenge in G&A: how to develop needed capabilities without letting costs creep out of control.

Our research suggests that only about one in ten companies simultaneously performs exceptionally well on revenue growth and G&A efficiency over a sustained period of at least five years. However, we don't see any indication that decreasing G&A expenses will limit a company's revenue growth—at least for companies that approach the cost reductions in the right way. In fact, these high achievers enjoy a virtuous cycle: transactional activities stay on a tight leash, freeing up investment for more meaningful, value-adding drivers, such as marketing, research, and product development.

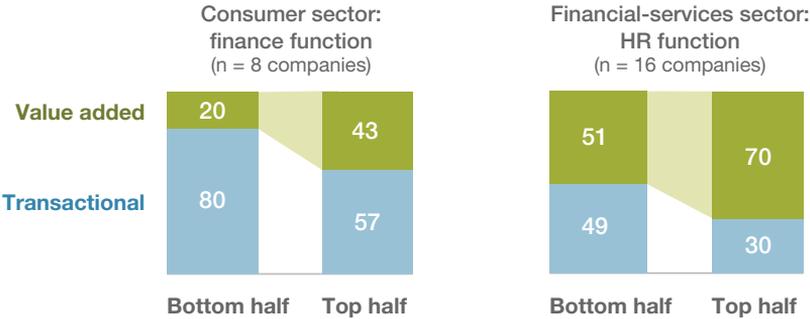
But more commonly, costs and complexity rise as support functions expand across numerous business lines or geographic markets. Our research

suggests that complex structures and processes are the primary contributors to G&A costs (Exhibit 3): that is, the number of business units in a company can contribute significantly to such costs, and the number of regions where a company operates can contribute, as well. Coping with such costs—both to ensure that G&A functions achieve their strategic mission and to avoid performance-dampening cost creep—is a formidable challenge. It's critically important for companies to institute a common philosophy for allocating resources to value-added (as opposed to transactional) activities. While every organization is unique, companies that adhere to this approach, no matter how many business lines they have or how many markets they compete in, can still capture benefits of scale.

Exhibit 2

Companies differ widely in the amount of time they allocate to value-adding activities as opposed to transactional ones.

Average time spent on G&A activities,¹ %

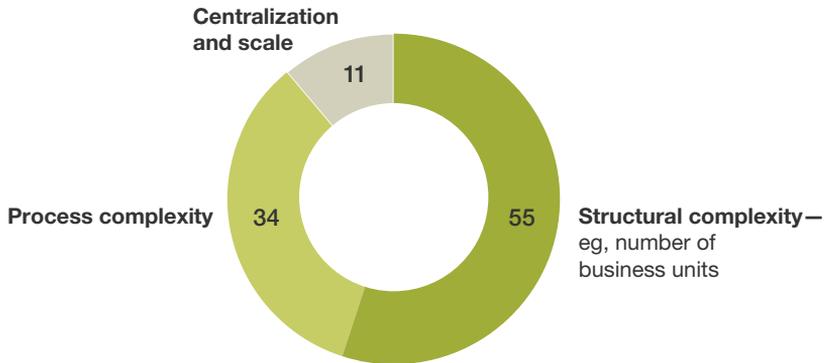


¹G&A = general and administrative. Example drawn from 3-year analysis of 8 major consumer and 16 major financial-services companies ranked into 2 groups, based on the amount of time full-time equivalent (FTE) workers (both internal and outsourced) spent on various transactional and value-added G&A activities.

Exhibit 3

Structural and process complexity are the biggest contributors to administrative-support costs.

% of costs driven by each factor (regression analysis)



Applying strategy to support

The implications of this research are consistent with our experience: effective G&A management has no one-size-fits-all solution, cutting costs across the board may mean underinvesting in critical capabilities, and the starting point of any G&A-improvement effort should be to bring a strategic mind-set to the back office. This typically involves focusing attention on where allocated resources will have the greatest impact given the state of a company's business and the lay of its competitive landscape.

For example, a major European insurer we know dramatically reduced its costs without sacrificing its responsiveness to consumers. After meticulously identifying the key drivers in the finance and risk functions, it separated transactional activities, business support, and expert roles. The company also made investments to strengthen its value-adding initiatives, such as exchange-

to-exchange (E2E) operations, while managing many of its other functions for cost. As a result, it not only slashed its full-time-equivalent (FTE) expenses by 26 percent but also saw its customer-satisfaction score surge from 24 percent in 2010 to 71 percent in 2014, with many of the efforts bearing fruit in the first 18 months of the program. Meanwhile, the company's Organizational Health Index score rose by 10 percent.

Similarly, a global logistics company willing to allocate significant resources to IT sought to revolutionize its responsiveness to customers by making digital investments (for example, to improve its tracking of performance, in real time) and by highlighting problems on large screens in major operations centers. But IT wasn't the only priority. The company also recognized that it had major people challenges, such as helping its employees become more engaged with their work—which would, among other benefits, improve customer

satisfaction—and developing new approaches to recruiting, which would make the company more of a magnet for leading-edge digital talent. By investing aggressively in these areas over several years, while adopting more standardized tools and processes for the transactional elements of the IT and HR functions, the company reduced the number of customer complaints by 25 to 30 percent and raised customer satisfaction by nearly 50 percent—to the top quartile of the industry. What’s more, costs fell dramatically.

In each of these cases, it was essential to manage G&A in ways that not only minimized expense creep and complexity but also drilled down to find largely hidden cost drivers and solutions. Relentless commitment works best at the grass roots when the messaging begins from the top. Thus, when a leading European energy company sought to simplify 30 core processes aggressively, it made a point of demonstrating that it had no sacred cows: the corporate center set the precedent, shedding 40 percent of its staff within six months. Remarkably, this move had little or no impact on employee-retention rates, even as the company proceeded to cut more than 20 percent of its multibillion euro expense base.

That level of savings obviously has an impact. Unfortunately, companies too often delay a rigorous approach to managing G&A expenses until their businesses are seriously underperforming and a round of “slash and burn” cost cutting seems inevitable. This reactive approach, we submit, is a missed opportunity. Instead, companies

should get in front of decision making about their support functions and establish a clear point of view about which value-adding activities should be great and which merely good enough. Meanwhile, they should standardize and simplify their transactional activities aggressively.

Those are often some of the hardest calls a leader has to make. But the outsized consequences of managing G&A effectively merit the C-suite’s attention. Back office or not, the results may well command the spotlight during earnings presentations and beyond. **Q**

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