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A better way to cut costs

Cutting all parts of a company equally may seem fair, but it doesn't make sense. Targeted cuts and efforts to build capabilities do.

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According to a recent *McKinsey Quarterly* survey, 79 percent of all companies have cut costs in response to the global economic crisis—but only 53 percent of executives think that doing so has helped their companies weather it. Yet organizations continue to cut. Cost reductions often go wrong, we believe, and our experience suggests that they can be done in a better way.

In the heat of a financial crisis, companies must focus on their financial viability, but they tend to cut about equally everywhere—without considering their strategic needs—because that seems more straightforward, and in some senses more fair, to all executives concerned. A second problem, with longer-term consequences, is that quick head count reductions often come at a price: missing the opportunities that crises can create to improve business systems or to strengthen parts of an organization selectively.

Here's an example of how things can go wrong. An international energy company that needed to save money fast started by simply defining the amount of savings it needed and then required each department to cut costs by a similar amount, primarily through head count reductions, which varied from 17 to 22 percent. The reality, however, was that the company needed to invest more in certain technological areas that were changing quickly, as well as in operations, where performance was far below industry benchmarks. What's more, the HR and IT departments substantially duplicated certain activities because different layers in the organization were doing similar things. Much deeper cuts could therefore be made in these functions, with little strategic risk. But the company cut costs across the board, and just six months later, technology and operations were lobbying hard to bring in new staff to take on an "uncontrollable workload," while substantial duplication remained in HR and IT.

We suggest a better way: companies should start any cost-cutting initiative by thinking through whether they could restructure the business to take advantage of current and projected marketplace trends (for instance, by exiting relatively low-growth or low-profit businesses) or to mitigate threats, such as consolidating competitors. An important part of the analysis is to understand a company's financial situation and the range of potential outcomes under a number of different external economic scenarios. Second, within the resulting strategy, take time to understand which *activities* drive value—in the public and nonprofit sectors, a good proxy might be mandated outcomes, such as the number of workers, health metrics, or school performance—and which activities do or could make the organization competitively distinctive. Organizations should invest in value-creating activities and cut costs in others while meeting clear financial goals in a set time frame (see sidebar, "Exploring three sources of value").

The changes that result from this kind of thinking can be dramatic. A government-funded environmental organization, for example, spent a lot of time on monitoring individual species and campaigning against their extinction rather than on climate change, which the organization's leaders actually regarded as more important and where they could have a greater impact. The organization took cost cutting as an opportunity to look intensely at what it did. It decided to stop the extinction-related lobbying and policy activities, undertaken by about 20 percent of its employees, and instead move the work of another 20 percent of its staff—along with some of the people undertaking that work—into other organizations with suitable mandates. The organization then reinvested a large portion of the savings to increase the number of staff members working on climate change. It also invested in building the capabilities of its relatively weak HR and finance functions.

When cost cutting in existing functions is appropriate, companies should explore both radical approaches to restructuring and more traditional tactics, as our recent work with a professional-services firm shows. For each support activity (such as IT, procurement, and finance), we identified ways to cut costs by working more economically and looked for entirely new ways to deliver support. In offices—representing almost 10 percent of support costs—this approach meant considering both a reduction in the amount of space allocated to each person in the present location and a more radical change to promote work at home or a hub-and-spoke office arrangement, with spokes in much lower-cost locations. In other

Exploring three sources of value

Senior executives should ensure that cost-cutting efforts reflect a company's strategy. Here are three ways to do so.

1. Restructuring to reflect your future.

When considering each of the areas below, think about the right structure, given the strategy to pursue in the most probable future; what structural changes to make regardless of the future; and specific events that would trigger structural moves.

- Reconsider the core business model and focus; whether to enter or leave businesses, geographies, or joint ventures; and vertical integration.
- Rethink organizational design, including the relationships among the corporate center and the business units.
- Resolve unfinished business, such as incomplete merger integration.

2. Cutting the fat.

To determine which of the potential actions below will be most effective, create an accurate cost baseline, with details at the regional and business unit level, and assess the value of potential costs against that baseline. Set priorities by assessing each action's potential value and ease of implementation.

- Remove layers from the organization and expand managers' span of control.
- Eliminate redundant or irrelevant functions, processes, or activities.
- Apply lean techniques to repeatable or low-value activities.
- Reconsider the role of the corporate center.
- Consolidate activities to gain scale, scope, or knowledge.
- Clarify roles across the company to create accountability; reset pay grades.
- Enforce high-productivity standards.

3. Building capabilities.

To determine which capabilities to focus on, quantitatively assess the potential gain from improving them and qualitatively assess the value of greater organizational effectiveness.

- Identify where the organization is now weak—perhaps because complexity is slowing action, the right people aren't in the right places, pivotal roles are weak, performance scorecards for the business or employees are ineffective, or leaders don't have time to focus on critical tasks.
- Determine where stronger capabilities—in functions such as IT, finance, or sales or in specific activities—could help.

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cases, efforts to complete merger integration or to use the new economic situation as a spur to renegotiate supplier or other long-term contracts can yield substantial economies. In our experience, savings of up to 20 to 35 percent in selling, general, and administrative costs are possible with such measures if companies select the right tactics to support their strategies.

Finally, organizations shouldn't overlook the substantial benefits that can come simply from identifying key activities and making them more effective. A global retailer, for example, has faced significantly reduced sales in the current downturn—more than 20 percent in some countries. Cutting costs was essential, but the retailer feared driving sales even lower if it cut in the wrong places. It began by working out which activities were essential for a distinctive retail experience and which would be most easily damaged by cost cutting. One critical activity was organizing in-store promotions (not just sales but also new-product promotions and seasonal events), from which the retailer derived more than 10 percent of its sales. Organizing these activities involved highly elaborate processes: every region of the business and a number of corporate functions had to sign off on each promotional program, so across-the-board cost cuts could easily remove the people who understood how in-store events worked. By identifying this process as both crucial and vulnerable, the retailer cut costs with minimal impact.

Over the following six months, the retailer undertook a full efficiency review that reduced the number of senior- and middle-management roles by 20 percent (the amount of individuals cut was closer to 15 percent). Throughout this process, special attention was paid to efficiencies that would affect promotional activities. Only clearly duplicative roles (the regional organizations, for example, had some that replicated those in the center) were removed. The company also invested to improve the returns from its promotions by increasing the number of people who tailor events to the needs of local markets and by building its capacity to forecast product sales in events.

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Intelligent cost cutting need not reduce the overall scale of the savings that organizations can achieve. But by shifting the focus from organizational structure to current and future strategic needs, it makes for smarter savings, even at companies that have already started down another path.

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