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CAN YOU ACHIEVE AND SUSTAIN G&A COST REDUCTIONS?

Yes, but not by playing it safe. Set big goals, insist on a cultural shift, and model from the top.

by Alexander Edlich, Heiko Heimes, and Allison Watson

The companies that currently make up the S&P Global 1200 index spend an estimated $1.8 trillion annually in aggregate general and administrative (G&A) expenses. Likely, many corporate leaders believe their organizations can do at least a little better in keeping G&A expenses under control. But we found that only about one in four Global 1200 companies during the period we studied were able to maintain or improve their ratio of G&A expenses to sales and sustain those improvements for a significant period of time. That matters: forthcoming McKinsey research has also found that reducing sales, general, and administrative (SG&A) expenses by more than the industry median over a ten-year period is a leading predictor among companies that jump into the top-quintile of economic value creation.[1]

Findings

We analyzed every company in the S&P Global 1200 that reported G&A as a line item from 2003 through 2014 and announced reduction initiatives through 2010. We sought to identify those companies that had announced a G&A cost-reduction program and then were able to not only achieve reductions within the first year but also sustain their reductions for at least three full years thereafter.[2] Our focus was on the commonalities—and differences—of those organizations that achieved and then sustained their success in the months and years after the initial announcement. In all, we found that 238 companies in the S&P Global 1200 had announced such initiatives from 2003 through 2010, and only 62 of those companies (one in four) were able to sustain their reductions for four years.

The fundamental metric of our analysis was G&A as a percentage of revenue. Tying G&A to sales at the announcement starting point allowed us to take a wide lens on how those two lines, costs and revenues, proceeded over time. This approach also meant that the long-term G&A winners would fall into one of three categories: companies whose revenues were contracting but whose G&A expenses were contracting at an even faster rate (we called these companies the "survivors"), companies whose revenues were growing and whose G&A expenses were growing at a slower rate than that of their top line (the "controlled growers"), and "all-star" companies, whose revenues were growing and whose G&A expense had, as an absolute amount, decreased (exhibit).

It turned out that the numbers of survivors (20), controlled growers (21), and all-stars (21) were almost identical—an encouraging indication, indeed, that companies can fight and win on both the cost and growth fronts. We were also intrigued to discover that winners were not necessarily those that, at the time of their initial announcement, had so-called burning platforms. Companies with initially poor G&A-to-sales ratios compared to their peers were moderately more likely to make major improvements over the first year and maintain those improvements over time. Even companies that were already performing at or better than their industry G&A-efficiency median, though, were among those that succeeded in implementing and sustaining G&A reductions for the long term. These included several companies that were in the top efficiency quartile at the time of their initial announcement. Success also bore little to no correlation with industry category, company size, or geography. However, in studying each of the winners more carefully, we noted certain key commonalities that suggested that the results were not random.

Secrets of success

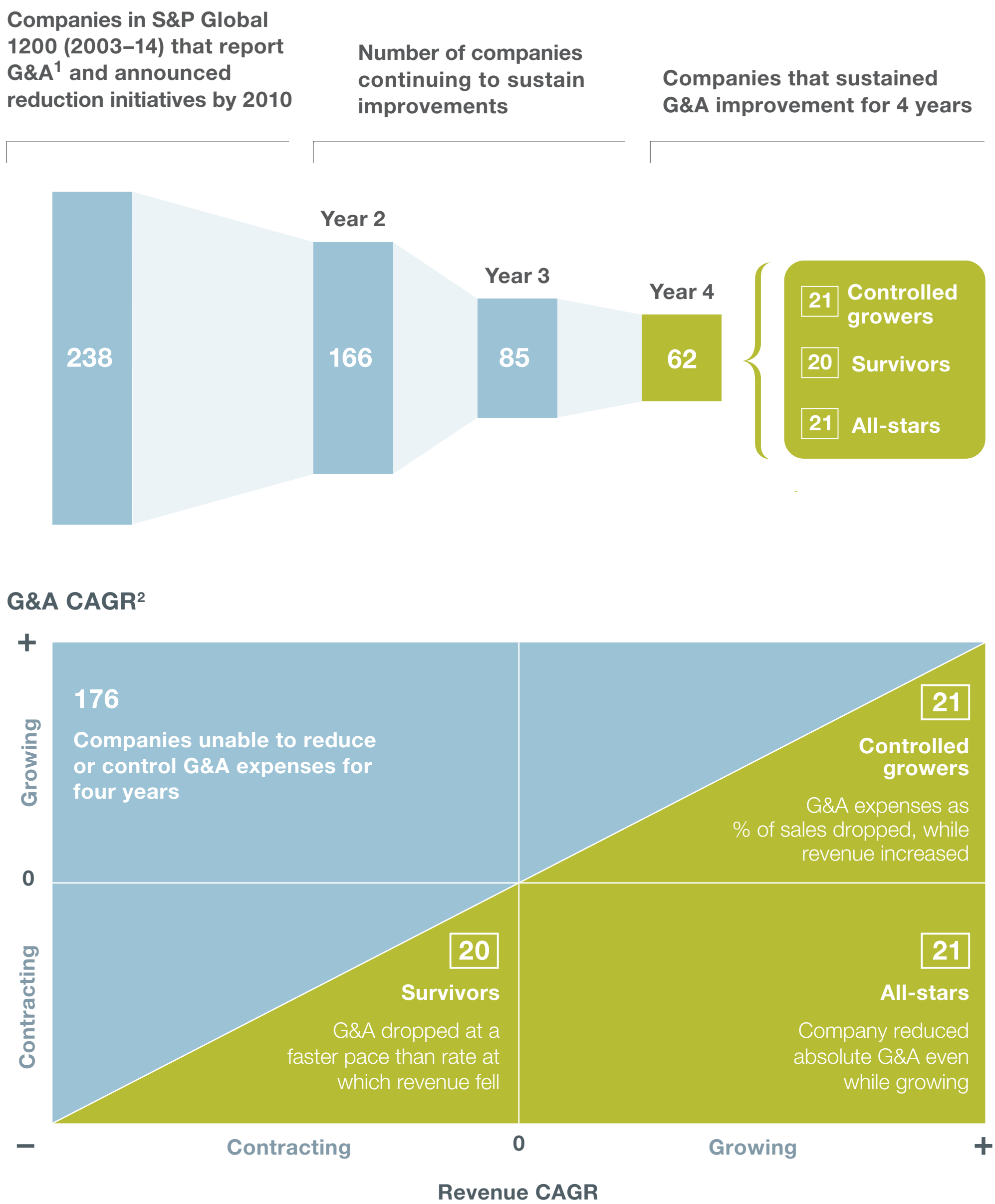
What makes a long-time G&A winner? In our experience, there are no pat answers, just a recognition that G&A productivity is in fact harder than many executives believe. Different organizations confront different challenges over their life cycles. When a company is in a "growth at any cost" mode, it is understandable that a gold-plated mentality may settle in. When a company confronts stark privations, on the other hand, the reactive (but understandable) instinct is to turn to the proverbial "back office" and slash away. Whatever the situation, however, head-count reductions are not a cure-all. Terminating the employment of people who are performing duplicative roles (or whose positions are eliminated for any number of reasons) can result in a quick jolt of cost savings. But eliminating salaries and related expenses will not by itself sustain long-term G&A success, especially for companies tempted to believe they've trimmed as far as they can go. Best-in-class companies think in terms of making support processes more efficient and eliminating the inefficiencies that lead to job cuts in the first place. That suggests a cultural shift—and indeed three profoundly cultural themes for long-term G&A success emerged from our findings.

Go bold

Don't be afraid to embrace radical change right out of the gate. Slow and steady does not always win the race. In fact, when making and sustaining G&A

Exhibit

Only one in four companies were able to sustain their improved rates of G&A spending relative to sales.



[1] General and administrative expenses.
[2] For 4-year period beginning with a company's announcement of G&A-reduction initiative; CAGR = compound annual growth rate.

cost reductions, incremental change can be a recipe for failure. Companies that trimmed G&A by more than 20 percent in year one were four times more likely to be among the one-in-four long-term success stories than those organizations that were more steady in their reductions.

Going bold also means going beyond mere cheerleading, and calls for closely keeping score. That starts with clear metrics. There should be hard targets on aspirations and starting points, and reduction metrics should not be open to different interpretations. For example, organizations should be clear on points like cost avoidance (reductions that result in a future spending decrease but do not reduce current spending levels) and when—if at all—it's appropriate to use such a strategy. Either way, the company must articulate up front what its cost goals will require.

Moreover, the consequences for failing to meet predefined metrics should have teeth. Incentives work, and companies that succeed in maintaining G&A cost reductions often make sure to incorporate cost-control metrics into their performance-management programs and payment-incentive frameworks. For example, one global chemical company that succeeded in reducing G&A by more than 20 percent within one year and sustaining its improvements for more than three years thereafter did so after investing substantial effort in identifying discrete cost-saving opportunities within multiple functions, rigorously tracking performance against predefined objectives, and involving hundreds of employees company-wide in the performance initiative. In all, the company realized savings of well more than $100 million and earnings before interest, taxes, and amortization (EBITDA) margin improvements of about 3 percentage points over two years, and then sustained it.

By contrast, we found that companies that do not build sufficiently robust incentives and metric infrastructures often see their improvements peter out over time—or even boomerang back to higher cost levels. This was the case for one consumer-packaged-goods (CPG) company: it announced a reduction program with fanfare, cut successfully over the first year, but then saw its expenses return to and then exceed initial spending levels. Company leaders admitted that after seeing reductions in one area, they moved on too quickly to the next, without finishing what they had started. That called for shoring up new ways of working, cost-conscious policies, cost-reduction capabilities, and management commitment. The next time they declared "victory" on reaching a cost-cutting target, it was with a solid core of incentives, metrics, and aligned employees in place and a clear understanding that released employees would as a general matter not be hired back—at least, not for their prior roles.

Go deep

If going bold can be summarized as making your aggressive cost-control objectives clear from the very start, going deep means looking beyond interim targets and imbuing a cost-control approach in your organization's working philosophy. That starts with the mandate that all functions need to play—and that the game is iterative. While reaching clear targets is important, sustaining G&A

cost reductions requires more than just meeting a bar. In our experience, cost-cutting exercises are too often viewed by employees as merely target-based—something to work through, as opposed to a new way of working.

But best-practice organizations frame cost reduction as a philosophical shift. Transparency is essential: employees should not be kept in the dark about an initiative's importance and implementation. In our experience, a broad internal communication from the top has real impact when it includes a personal story on why change is needed and what is going to happen. A large CPG company, for example, drilled home the message that cost management would be a core element of its ongoing strategy and even a source of competitive advantage. The employees took the message to heart, and the company succeeded in counting itself among the one-in-four G&A success stories.

In our experience, however, no matter how resounding the message, the payoff will be minimal unless every function plays its part. For example, one large company, with a market capitalization in the tens of billions of dollars, responded to a call for G&A reductions by focusing its efforts in the finance function. Key individuals were able and enthused, but their reductions barely made a dent company-wide. It was as though the other support functions had been given a "hall pass." The result: consolidated G&A costs rose over the same time period at a faster pace than consolidated sales increased. That's not surprising; unless all functions are in scope, calls for cultural change ring hollow, and company-wide cost-savings initiatives often disappoint.

In addition to absolute clarity about purpose and buy-in across functions, skills and capabilities matter, too. One top performer, a major energy company, helped drive down G&A costs by augmenting its top team and replacing some executives with others who had previously led G&A improvement efforts. While some companies look outside for this talent, other successful organizations choose primarily to look in-house, training employees in both general and function-specific capabilities to improve efficiency, preserve or even improve customer experience, and see a more standardized approach lead to fewer internal inaccuracies. Of course, a combination of both "buy" (hiring new personnel) and "build" (training existing employees), while taking other initiatives, can work as well. One company we studied went as far as to institute a lean-management boot camp and to supplement employee learning with ongoing manager coaching.

Empowered change agents can carry the cost-reduction message beyond the C-suite walls. A global, diversified products-and-services company with headquarters in the United States embeds leaders throughout key administrative functions. These individuals are specifically charged with sharing the company's future-state vision, leading specific initiative teams, and overseeing change-management efforts on the ground. Their efforts include, where appropriate, the outsourcing of several formally in-house processes and the migration to shared services of duplicative activities and tasks. All told, the company's comprehensive redesign of its support functions delivered a 30 percent reduction in G&A costs over two years.

Model from the top

G&A expense management should never be far from top of mind. For CEOs and others in the C-suite, that means not only active sponsorship of the cost-reduction programs, but walking the talk as well. One major European utility started its multiyear cost-reduction endeavor by slimming down the corporate headquarters' overhead functions and corresponding management team *before* involving the business units. Not only did the savings improve the bottom line, the efforts involved signaled high credibility for the top team's willingness to make cost control a priority. Indeed, C-level support and reinforcement is often a key to communicating C-level commitment. While this generally does not go so far as naming a chief G&A officer, investing organizational high performers with the authority to drive cost-savings initiatives makes clear where senior leaders' priorities lie. When differences of opinion occasionally bubbled up between line leaders and G&A change agents in the case of the European utility, for example, senior leadership consistently and forcefully backed the change agents.

Ironically, modeling from the top can involve a profoundly bottom-up mentality, as well. One instance is clean sheeting, as practiced by, for example, a major CPG company. The initiative leader framed the challenge not as having, say, "20 percent fewer HR employees than today," but rather by assuming a clean slate in which the HR organization had no employees, and determining how many workers should be added, and where they should be deployed, in order to run the function as effectively and efficiently as possible. It was that level of thinking—posed from above and for the company-wide good, rather than from a more limited, "defend my turf" position—that helped lead the company to save more than $1 billion in less than two years.

That degree of reduction, especially when sustained for the long term, suggests that success is not a coincidence. It is indeed possible for companies—including those in healthy growth mode—to reduce their G&A costs dramatically and to sustain those improvements. One in four companies prove the point: bold targets, institutional change, and strong leadership can produce enduring results. Q

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[1] For more on economic profit, see Chris Bradley, Angus Dawson, and Sven Smit, "The strategic yardstick you can't afford to ignore," *McKinsey Quarterly*, October 2013, McKinsey.com.

[2] We chose a four-year postannouncement time frame because some of the companies issued proclamations of G&A reductions early in a fiscal year, others later in the year, and several had reductions in different fiscal years altogether.

Alexander Edlich is a senior partner in McKinsey's New York office, **Heiko Heimes** is a senior expert in the Hamburg office, and **Allison Watson** is a senior expert in the Southern California office.

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