The Cost Take-out Challenge

By Jack Calhoun, Jim Dowling and Richard Lynch

There is a better way to financial health than begging (for sales), borrowing (from taxpayers), and stealing (from the future). The big three U.S. auto makers made two trips to Washington without a plan for how they would work differently with taxpayer money even as consumers were taking a pass on their virtually interest free sales offers and banks were holding onto their (taxpayer provided) money as well. Congress wanted to hear something different, something that indicated that there would not be another visit in a few months – another request. In the end, the big three got their money and four months to come up with a plan that assures viability.

The big three are being urged to do three things at the same time. Cut costs, innovate, and behave differently. Shareholders want lower cost and higher share price, customers want innovation, and congress and the banks want new behaviors that indicate appreciation of new business realities. The better way to all three is through capabilities. What if the big three took the following plan to congress – We want money or loan guarantees so that we can:

- Align the cost of our manufacturing capabilities to that of our foreign competitors by…
- Collaboratively develop competitive capabilities for development of more fuel-efficient, emission-reduced, electricity powered, and hybrid vehicles by …
- Work with the unions, the health care industry, the insurance industry, and congress to reduce the financial burden of two generations of retirees by …
- Prepare the next generation of U.S. Auto Design and Production Leadership by…

Entering 2009, Cost Cutting will be the order of the day for these and many other companies. Will they succeed both in the short and long term? The business realities are that economic downturns have become periodic, deeper, and have broader global impact; between downturns, innovation and efficiency have become critical to business vitality; and Washington is going to be more likely to build and preserve capabilities that create jobs than to save companies.

Typical Reaction to Economic Pressure

Challenged with a large cost take-out, there are fundamentally three choices:

EQUAL PAIN

Characterized by across the board cuts, cancelling initiatives aimed at growth, delaying technology improvements, and curtailing “discretionary” expenses, more often than not Equal Pain rules the day. This approach achieves short term saving at the expense of morale and strategic execution. It is a declaration that there is no strategy for lean operations and growth.

SOCIAL RESPONSIBILITY

This finer grained approach pushes cost cutting to departmental and functional management who develop proposals to right size their organizations. Unless there is commitment to one value proposition and growth strategy, the proposals that bubble up through silos lack integration at best and at worst cripple other parts of the company.

GE learned this the hard way as many of its famed "work-outs" blindly cut out work that other departments depended on to service customers. The move to Six Sigma in part was a response to take a more fact-based and systemic view of operations.

VALUE OPTIMIZATION

This approach uses the organization's customer value proposition to establish cost performance goals for capabilities based on value contribution. Driving cost out of capabilities that contribute low customer and financial leverage and preserving or investing in those with higher leverage achieves immediate goals and not at the expense of recovery and growth.

In the months ahead, in what is now the deepest recession since the great depression, leadership judgment will no doubt be under intense scrutiny. How they deal with the cost take-out challenge will determine whether the companies they direct emerge as radically more efficient or as the lesser players in consolidated industries. More than the livelihood of individuals and shareholder value is at stake. The economic turnaround lies in the balance.

Lessons from the Past

General Downturns such as the recessions of 1973–1975 (oil crisis), 1979 (energy crisis) and 1987 to early 1990s (collapse of junk bonds and a sharp stock crash) have equal impact across the economy. Survival largely depends on cost cutting and recovery depends on capability retention.

A financial underperformer in the late 1980s, The Intercontinental Hotels Group (then Six Continents Hotels) was hit by the 1990s recession and then the SARS epidemic. Survival was not enough for the executive team. They wanted to emerge a leader and were willing to "change everything" to become a more capable leadership team and company.

Legislation, Social Choices, and Technologies such as Sarbanes-Oxley, Green, and bio-fuels have broad impact across industries but leave suppliers and customers with choices and no general solutions. Response to these change drivers demands precise cost cutting and simultaneous investment in new growth platforms and new operating models.

Kraft Foods is a case in point. Kraft clearly saw consumers turning to organic and natural foods and vitamin and caffeine enhanced beverages for nearly a decade and chose not to respond as their competitors and start-ups had. Kraft management confused cost cutting to maintain margins with cost management to sustain vitality.

> *"The biggest problem I faced (in the Kraft turnaround) was that the cost focus had overtaken so much of our decision making. Our reaction was to centralize more of our functions, to take quality out of our products and to cut into overhead, like sales, because they were viewed as costs rather than capabilities. .... the most important thing I did as I came back was to try to get a better balance. Costs will continue to be a critically important focus area for us, particularly in the face of the challenging economic environment. But we need to be as focused on effectiveness as we are on efficiency."*
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> — Irene Rosenfeld, CEO Kraft, USA Today, December 11, 2008

Disruptive Competitor Entry or Event has affected markets. For example: Amazon.Com initially redefined book buying even as Barnes & Noble was redefining the Book Store. Here, successful competitors depended on sharpening their customer value proposition and targeting specific customers to leverage their strength capabilities while rapidly acquiring new capabilities and cutting operating cost.

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Johnson & Johnson's Cordis division experienced such a disruption. Cordis invented the drug eluting stent (DES) for cardiovascular disease and owned the market in 2003. It quickly became a favorite topic for analyst's reports and a source of large profits for J&J. However when the efficacy of Drug Eluting versus Bare Metal stents was challenged, sales plummeted creating a financial crisis for J&J.

Rather than preserving the capabilities that created this market and other growth platforms for J&J, Cordis surrendered capabilities as it slashed expenses across the board.[1] As new competitors emerged, the Cordis share of a growing stent market is expected to drop to 23 percent in 2009 from the 45.8 percent market share the company had in 2007.[2] Although Cordis is developing a new generation of stents, the capability depleted unit is widely regarded as behind other rivals in that effort.[3]

It is clear that under these circumstances, companies cannot Lean, Business Process Reengineering, Total Quality Management, Six Sigma, or HPO a way out of rapidly declining revenue and rapidly increasing cost. There just is not enough time.

Consequently, the really strong or really bloated companies (*cuts don't cripple them*) survive through multiple cycles and the less robust do not fare so well. However in both cases, lacking a strategic approach to cost reduction often results in gutting the company of valuable talent, partnerships, and other capabilities; establishing ill-conceived partnerships and outsourcing relationships; and losing precious time-to market opportunities.

Today most companies are facing one or more of these three business challenges. If companies continue to use traditional expense management thinking to address them, the roll-up of these decisions will be catastrophic to the US economic recovery.

Developing an Agile Capability-based response

Some companies have faced their own financial perfect storm and emerged as stronger players in their markets. They did this by developing business responses that achieve expense targets and preserve growth-enabling capabilities, establishing laser sharp focus on where to shed, preserve and source capabilities. These actions met the immediate need and funded investment roadmaps to propel growth with revolutionized productivity, emerging from the crisis more competitive than before.

HARVARD PILGRIM HEALTH CARE

In the late 1990s Harvard Pilgrim Health Care (HPHC) membership had grown with little attention to enabling infrastructure. There was too much complexity in non-differentiated provider relationships and there were huge control gaps between finance and the business units. In addition, the value of the merger of Harvard Community Health Plan and Pilgrim Health Care was never realized. Assets were perceived as costs; not capabilities that needed to be consolidated, integrated, maintained, improved or shed.

The company was placed in receivership. A traditional budgetary process was of little use and the slash and burn tactics employed by "turnaround" experts would leave Massachusetts' healthcare in a shambles. HPHC leaders chose a different path. They prioritized areas of distinction and identified the capabilities they would leverage in the future. HPHC replaced its traditional bottom up budgeting with a new top down Capability-Based Budgeting approach. This framework exposed misaligned investments across business units and

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[1] "Johnson & Johnson reduces its global work force by up to 4 percent, or almost 4,820 jobs, in a restructuring to cut costs due in part to a slump in sales of its heart. Johnson & Johnson to restructure" (*International Herald Tribune*, July 31, 2007)

[2] "Abbott fights fifth patent accusation" by Manuel Baigorri. (*Medill Reports,* Jan 16, 2008)

[3] "J&J's Cordis unit loses No. 2 executive" by Jeff May (*The Star-Ledger*, Friday June 13, 2008)

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functions. More importantly, it allowed HPHC to rapidly build an improvement agenda based on the value contribution of capabilities and capability performance gaps.

Excess capability was identified and shed and non-strategic capabilities were sourced externally. For example Pharmacy Benefits Management was sourced to MedImpact. This was not a case of exporting jobs overseas, rather it created jobs in another company with stronger capabilities in buying pharmaceuticals, filling prescriptions, and paying pharmacies.

Although initially this restructuring cut costs and some jobs, 2008 marks the 5th year in a row that HPHC is rated #1 HMO in the *U.S. by US News and World Report*, in Member Satisfaction. HPHC's Net Income showed a 500% improvement from 1999-2004. Thousands of jobs were saved and more were created in this same time period.

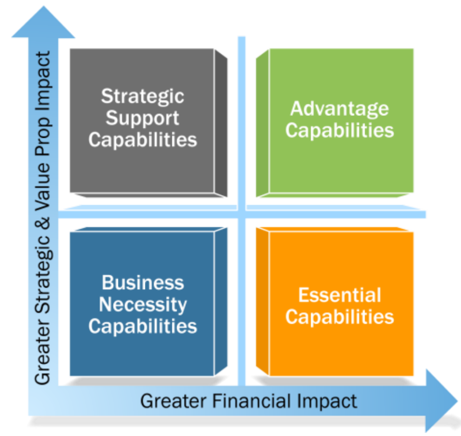
INTERCONTINENTAL HOTELS GROUP[4]

Six Continents Hotels (SCH) faced an equally daunting challenge when the Hotel group sought a separation (de-merger) from its parent company, Bass. Prevailing weak financial performance and the 1st Iraq war drove low occupancy rates created urgency for a $50mm cost take-out to avoid the need for property or even brand sell-offs. Even as the leadership team commenced their work, the SARS epidemic virtually stopped travel. Making matters still worse, a shareholder action for a hostile takeover and breakup of the company was building. Analysts openly challenged the prospects for success. The *Financial Times* ran an article entitled "Does leadership have what it takes?"

The leadership team employed a three month assessment of capability needs and gaps. Once clear about how SCH wanted to compete and make money, the executive and senior leadership committed to a radically new cost structure and operating model. In the subsequent six month period, the global leadership team reshaped its leadership, organization, and operating model resulting in a company that exceeded even the expectations of its designers.

These results were impressive and fast: SCH defeated the hostile takeover and accomplished a 30% reduction in operating expenses ($150 million versus the targeted $50 million) while strengthening their capabilities in brand

Capabilities contribute differently to value and should be nourished and sourced accordingly.



Some capabilities directly contribute to the customer value proposition and have a high impact on company financials. These **Advantage** capabilities are shown in the upper right. Value contribution is assured when performance is among the best in peer organizations at acceptable cost. Keep them inside and protect the intellectual property. Moving to the top left quadrant, **Strategic Support** capabilities have high contribution in direct support of Advantage capabilities. Keep them close. Value contribution is assured when performed above industry parity at competitive cost.

Other capabilities shown in the bottom right are **Essential**. They may not be visible to the customer but contribute to company's business focus and have a big impact on the bottom line. Focus on efficiency improvement; especially in high volume work. Value contribution is assured when performed at industry parity performance below competitors' cost. Other capabilities are **Business Necessity**. Value contribution is assured when performed at industry parity performance below competitors' cost. They can be candidates for alternate sourcing.

[4] *Reinventing a Hotel Company: BPM as a driver for restructuring*, James Larson and Richard Lynch, (BPM October/November 2004) and *Leading the Global Workforce,"* Chapter 5: InterContinental Hotels Group: Aligning Leadership around a Single Global Strategy," James Dowling and Andrew Simpson (Wiley, 2005)

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management, customer satisfaction, loyalty, and revenue per available room. Share Price increased 75% over the following 10 month period.

InterContinental Hotels Group emerged a major player in the competitive hospitality market, from the ashes of the financially unsound and brand-confused Six Contents.

Lessons to Apply in the current financial crisis

Like HPHC and IHG, Kraft also took a strategic capabilities approach to restructuring. While dealing with rising costs and need for greater productivity, they invested over $400 million over the last two years in product quality, in marketing efforts and in their innovation pipeline. They have also invested heavily in sales infrastructure, because they viewed it as a source of competitive advantage.

We can draw several lessons from how these companies navigated the paradox of taking out cost **AND** growing the business:

1. Clarify Business Strategy: Know where you are going so that you don't burn or build the wrong bridges.
2. Declare your Growth Strategy before considering cost take-out: Identify the capabilities required for growth. When it gets cold, don't burn the axe.
3. Focus on Strategy Execution not strategy elegance: Take out and reallocate cost without compromising strategy execution.
4. Develop operating models (capabilities): Stay out of the "people, process, and technology" weeds.
5. Document capability gaps: Sort out good enough, excess, and shortfall.
6. Establish an investment agenda: Focus and sequence, then execute with conviction.
7. Design organizational and IT infrastructure: Evolve and adapt. Don't accumulate.
8. Manage Transformation: Transform the organization. Don't just cut costs.
9. Design a Plan and Direct the Enterprise model: Manage capabilities continuously. Know when and how to shift from cutting to growing.
10. Adopt Agile Practices: Iterate. Don't ruminate.

About the authors:

Jack Calhoun (Jack.Calhoun@Accelare.com) is CEO of Accelare, Inc. where Jim Dowling (Jim.Dowling@Accelare.com) and Richard Lynch (Richard.Lynch@Accelare.com) are Vice Presidents. Jack was a contributor to *Reengineering the Corporation* and author of "The Next Revolution in Productivity" (*Harvard Business Review,* June 2008). Jim and Rich are authors of *The Capable Company: Building the capabilities that make strategy work* (Wiley, 2003).

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