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Cut Costs, Grow Stronger

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CUT COSTS, GROW STRONGER

If you are a corporate leader, you have probably been spending a lot of time lately thinking about costs. In the aftermath of the global economic crisis of 2008–09, the pressure to cut costs — whether driven by cash flow, shareholders, uncertainty, or investment needs — has been extraordinary. Many businesses are struggling to survive. Others, even if they're doing relatively well, are reducing expenses to make sure they are well prepared for future uncertainties.

But there is a positive side to this situation. Dramatic cost cutting gives you a chance to refine or even reformulate your company's overall strategy. After all, you're never *just* cutting costs. You're making a decision that something is no longer strategically relevant, and that other things are essential to keep. Yes, you may have to lose some product lines and activities, and perhaps some of your employees and customers. You also, however, have the opportunity to help your company grow stronger in the process.

We reject the idea that cutting costs in itself makes a business weaker or more limited. To be sure, if you reduce expenses in a panic, or without an eye to strategy, you could do great harm to your company's competitiveness. But if you focus on your priorities and on your future potential, cutting costs can be a catalyst for exactly the change a company needs.

Unfortunately, many companies are cutting expenses ineffectively. They either spread the pain as evenly as they can across all parts of the business or they target high-cost areas first. And they look for short-term reductions without fully considering the impact on their long-term position or prospects. Surveys conducted with

Illustration by John Hersey

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executives of leading corporations show how strongly these approaches prevail. (See Exhibit 1.) When companies cut costs in this mechanical, programmatic way, they risk making the enterprise weaker in the long term and (in many cases) doom themselves to needing more draconian cost cuts down the road.

The right way to think about costs — whether your company is under pressure now or marshalling resources for the future — is to look at the capabilities you need most and to invest only in those that will give you a clear advantage in reaching the customers you care about most. This approach involves a new way of thinking about capabilities. They need to be seen for what they are: a defining factor in productivity, a critical element of success, and a major factor in determining strategy.

Your company's key capabilities:

• Drive most or all of your worthwhile discretionary costs.

• Can be counted on one hand (as opposed to reflecting the multitude of activities that are currently funded within your business).

• Should be spared in any cost-cutting program (related expenses may even be increased).

• Work best when they are combined in sets to deliver a unique, hard-to-copy capability system.

• Are rarely, if ever, bounded by individual corporate functions.

• Can determine the composition of a high-performing portfolio of businesses — those that pull from similar capability systems.

• Lend themselves to scale advantages, but need not be built or maintained in-house.

• Represent, in combination, the difference between what matters and what doesn't.

Being Strategic When the Clock Is Ticking

It's all very well to suggest a surgical approach to cost cutting that keeps strategy in mind and leaves key capabilities intact. But is it realistic? After all, depending on your reserves and your cash flow, you may have to act very quickly. Perhaps you don't have a clearly articulated strategy — and it is very unlikely that you have a spreadsheet that organizes your costs by capability. You probably have your costs organized by function or by business unit, like everyone else. So what are you supposed to cut?

In our experience, the most dramatic, significant, and successful cost reductions, in either the short term or the long run, aren't those that are simply prompted by financial analyses. They have all occurred in situations when management realized that it had to truly transform. The process wasn't expense reduction as usual; it involved real fear — a sense that "If we don't change, we may not survive." These urgent situations provide exactly the right impetus to make critical strategic changes.

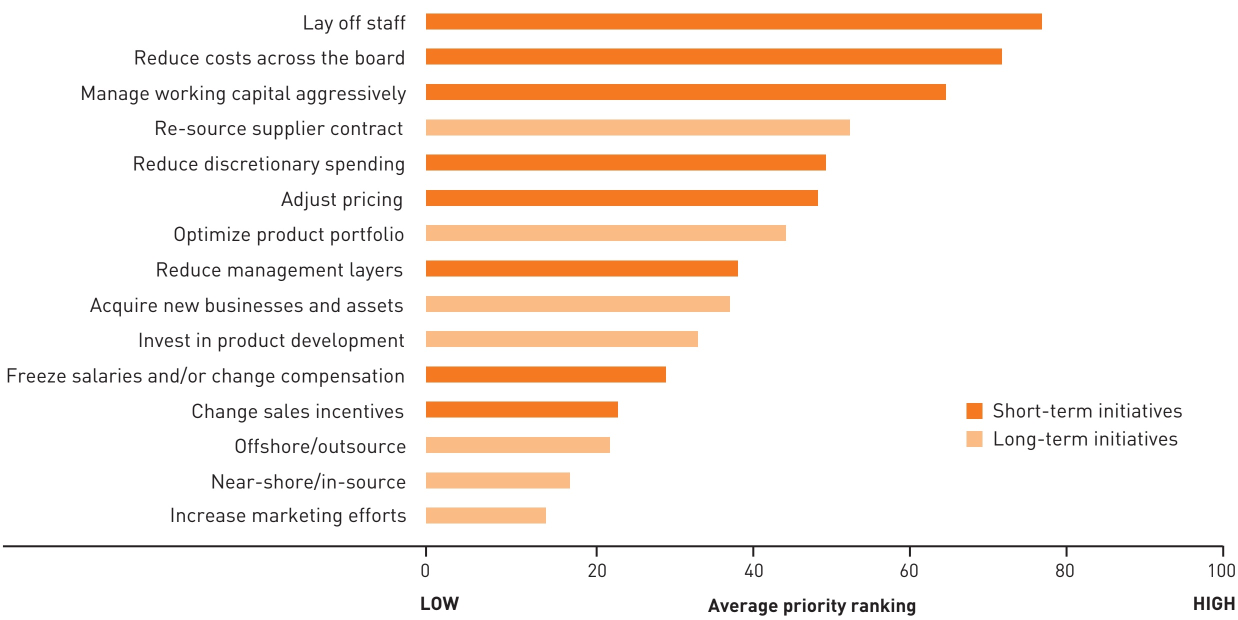
Case in point: Years ago, there was an emergency cost-cutting program at the automobile and electronic components manufacturer Johnson Controls Inc. The crisis began when Sears, Roebuck and Company, which represented 20 percent of Johnson Controls' business in motor vehicle batteries, pulled its contract. Overnight, Johnson Controls faced huge overcapacity and steep losses.

The executives of Johnson Controls recognized the gravity and urgency of the situation. They had huge decisions to make and almost no time to make them. But they made the time to look at their business from a higher level, and in less than a month they came to some realizations. Most important, they saw that the com-

Exhibit 1: **Cost Reduction and Revenue Growth Priorities**

Faced with mounting pressure to cut costs, most companies continue to go about it the wrong way. Their executives are assigning higher priority to short-term cost reduction tactics and demonstrating less appetite for longer-term initiatives. They have defaulted to standard downturn defenses such as across-the-board cost cutting and layoffs.

Priority ranking of cost reduction and revenue growth measures



Source: Shumeet Banerji, Paul Leinwand, and Cesare R. Mainardi, *Cut Costs, Grow Stronger: A Strategic Approach to What to Cut and What to Keep* (Harvard Business Press, 2009)

plexity of the company's product line was hurting its long-term profitability and needed to be addressed. Johnson Controls' huge volume of sales (in particular, to Sears) had covered up the fact that certain parts of the business were subscale; they required an investment in capabilities that was greater than what they earned back in profits. The capabilities (which were focused on manufacturing, sales, and certain types of R&D) required to produce and market high-volume batteries turned out to be very different from those required to make and distribute the wide variety of batteries for more specialized or lower-volume vehicles.

In part by focusing on their mass-market, high-volume customers, the managers at Johnson Controls were able to immediately identify 35 percent cuts in overhead, in areas as diverse as accounting, human resources, and information technology, without hurting the most profitable parts of their business. They under-

The most successful cost reductions aren't prompted by financial analysis, but by real fear: "If we don't change, we may not survive."

stood that they might make some mistakes in doing this, but they knew that this strategy would let them act decisively, with confidence that they could fix any errors later. From there, the management team went on to reconfigure the manufacturing footprint, closing certain plants and rethinking the roles of others. In the past, the company had been reluctant to transport auto batteries because they were so heavy. It maintained plants around the United States that each produced a wide range of automobile batteries and shipped them within the region. But now, the company's leaders realized they could save more by reducing in-plant complexity than they would spend transporting batteries long distances to their customers. The production of lower-volume batteries was concentrated in a few plants. The total savings from all these changes amounted to about US$150 million annually.

This became a moment of transformation for Johnson Controls, an example that the company drew on in rationalizing the rest of its businesses. The executive team members knew individually what had to be done, but together they needed to think through the implications to convert that knowledge into action. And by doing so, they developed a new capability that has been a foundation of the company's success ever since: the ability to effectively manage complexity by making appropriate trade-offs in both the choice of products to manufacture and the way they configure their supply chain.

Most management teams display a surprising amount of lucidity about which costs are important when they have to. They may not be 100 percent right, but they won't be anywhere near 100 percent wrong.

Did Johnson Controls really need a crisis to figure out which costs were essential? Theoretically, of course, the answer is no. A company might choose to cut costs and grow stronger as way to realize its aspirations, not just to deal with a crisis. In reality, though, crises can provide powerful stimuli. To paraphrase Samuel Johnson, nothing focuses the mind quite like the prospect of your imminent removal from this world. Absent crises, companies often lose focus and habitually accept expenses that don't really serve their interests.

Your opportunity — at all times, but especially during a crisis — is to grow stronger by building your critical capabilities, even as many of your competitors pursue a more incremental, across-the-board approach to cost cutting. Now is when you need to invest heavily in the capabilities that matter, and make the difficult choices that great companies make.

The Meaning of Capabilities

These days, any discussion about great companies and what they've done well usually turns to capabilities. "Procter & Gamble wins," someone might say, "because it knows how to innovate." Or "Renault has taken advantage of its ability to manage joint ventures." Or "Haier is unmatched in customer service in China." To a great extent, capabilities have bypassed assets (such as technology, capital, facilities, property rights, or brand names) as a means of creating value.

There are a few reasons for this. First, as industries mature, assets often become "table stakes"; everyone in the game has them. You and your competitors have long since caught up to one another with your brands, patents, and manufacturing. Second, in an era of outsourcing, the importance of asset scale (as achieved, for instance, through the economies of a broad-based manufacturing footprint) has faded. Thus, in many industries, the traditional role of large assets as barriers to entry by competitors has disappeared as well. Third, assets (such as patents, brands, land, facilities, and machinery) are often by their nature more difficult than capabilities to leverage across diverse portfolios. Finally, time has a way of eroding the value of assets. New technologies may come along and make old machinery obsolete, the value proposition may move away from the assets themselves toward related services, or the assets may be based on patents that eventually expire.

Capabilities, by contrast, need never expire; in total they represent an engine for creating assets. Consider the difference between an oil company strategy that relies on the oil fields the company already owns (its assets) and a strategy aimed at expanding the ability to discover and develop new fields (a capability). A strategy for building highly sophisticated capabilities — perhaps for extracting maximum value from assets or for conducting operations with a lower carbon emissions footprint — might be more valuable still.

When you think about your costs in terms of capabilities, it becomes much easier to create capabilities that will set you apart. A company with a concentrated cluster of capabilities is more likely to come up with blockbuster hits in the market. And the lack of focus on capabilities is probably the single biggest driver of strategic confusion — the ongoing, habitual way of thinking that makes prioritization painful and difficult.

One company that has shown how far a capabilities-driven cost initiative can go is Tata Steel Ltd., a division of India's well-known Tata Group. Like all the other Tata companies, it had local origins, and it had worked hard to be a values-based corporation, balancing financial success and a commitment to employees, its community, and to India's development. Tata Steel was also a leader in cost per ton of product; it was frequently cited as the lowest-cost steel producer in the world. Then in 1997, after several years of a very successful technology-modernization program, the senior leaders of Tata Steel realized that they were ready to expand around the globe. Indeed, if they didn't expand, they might become vulnerable to competitors in their home market.

The executives identified a number of areas where they needed a step change in capabilities to accomplish this expansion. They needed to learn, for example, how to find and work with raw materials suppliers outside the familiar, but limited, low-cost sources in India. And they needed skills in developing and managing joint ventures — a complex capability involving several different functions, which they built by borrowing, in part, from other companies in the Tata Group. The company leaders deliberately applied these capabilities in ever more complex environments, moving from Thailand to Singapore to China, and ultimately acquiring the Corus Group, a major Anglo-Dutch steelmaker, in early 2007.

Between 1997 and 2008, the company went from producing less than 3 million tons of steel per year (at a single plant in eastern India) to producing almost 20 million tons, making it the fifth-largest steel producer in the world. Several million more tons are expected to come on line soon. One Tata Steel executive, looking back on this evolution, specifically credited the rapid but sustained growth of the company's capability-driven strategy. Step by step, Tata Steel built skills and systems, moving them from one region to another and, ultimately, around the world.

Capabilities as Strategy

When they hear the word *capabilities,* many businesspeople think of intangible assets: employees' skill sets or the quality of work done by a corporate function such as research and development or supply chain management. But we use the term in a more specific way: Capabilities are the defining strengths your company must have to help it compete.

Consider the essential two or three capabilities exhibited by the world's most successful companies. What makes Frito-Lay a great company? Or Google? Or Nokia? Or any company that you admire? The answer is typically more difficult to discern, and more precise, than it might seem at first glance.

In the case of Frito-Lay (a subsidiary of PepsiCo Inc.), one key capability is the ability to serve the needs of small stores up and down city streets and rural roads on several continents. That's it. Of course, that is not something that can be described in broad terms as a world-class capability in sales or distribution or marketing. Frito-Lay's capabilities are more specific than that. The company has fleets of trucks with drivers who are highly motivated to sell, and it gets products to flow appropriately via those trucks with technology support, a good value proposition, and good judgment (and great information) about which products to put in or pull out. These capabilities are hard to replicate, in part because (like all other key capabilities) they're intricate, interdependent, and cross-functional.

Similarly, Google Inc.'s capabilities include not just maintaining and improving the company's search engine, but continual innovation of Web-based applications that will attract consumers and the ability to translate those consumer populations into advertising revenue. These capabilities allow the company to boost the value of its online advertising by creating new services and offering them free.

The Nokia Corporation is known for its distinctive capabilities in rapid prototyping, customer-centric design, and global merchandising, all fitting together around products that must consistently stay one step ahead of competitors in both usability and cost. Every company known for its capabilities — Caterpillar, Toyota, HSBC, Procter & Gamble, Nestlé, Tata Group, Johnson & Johnson, Huawei, and many more — has earned this reputation through a series of sustained investments that apply across product lines, functions, and geographies, and that work together to give the company a broad-based edge in the marketplace.

The best definition of *capabilities,* in our view, reflects this essential quality: *Capabilities are the interconnected people, knowledge, systems, tools, and processes that establish a company's right to win in a given industry or business.* The right to win, in turn, is a clear path to sustained profitability, higher market share, or both, supported by the critical set of capabilities that will make a difference in that market.

It might seem that companies in the same sectors would need the same capabilities to win in the market, but that is rarely the case. Apple and Dell both compete in the computer market, but their capability sets are completely different. Apple's success depends on continued product and service innovation combined with a deep understanding of the way in which people interact with technology; Dell's success depends on rapid delivery, low-priced customization, and high-quality customer service. Something similar is true for automakers BMW and Lexus (Toyota): same markets, different

PepsiCo's capability for launching new products and its world-class retail outlet distribution have made it one of the most successful food companies in the world.

points of attack. Fashion company Zara International Inc. furnishes yet another example of winning in a unique way. This division of Spain's Inditex does most of its production in-house, distributes in small batches, and does not hesitate to build up excess capacity at the right point in production. It does these things — all of them taboo from a traditional cost perspective — to execute its strategy of delivering the right trends at the right time. As a result, Zara has consistently sold almost 85 percent of its goods at full price (versus the industry average of 60 to 70 percent), with gross margins about 55 percent higher than those of its competitors.

These examples make clear that it's not just the dynamics of a market, but how a particular company chooses to play in that market, that determines the required capabilities. This point is important in a cost discussion because it's not at all uncommon for companies to tie up resources in capabilities that their competitors have, and that they covet but may not need. All too often, functional leaders ask, "What are my competitors doing?" and request funding for initiatives to build capabilities in perceived gaps. However, if all you ever try to do is match your competitors' capabilities, you can never create or sustain a real right to win.

Capability Systems

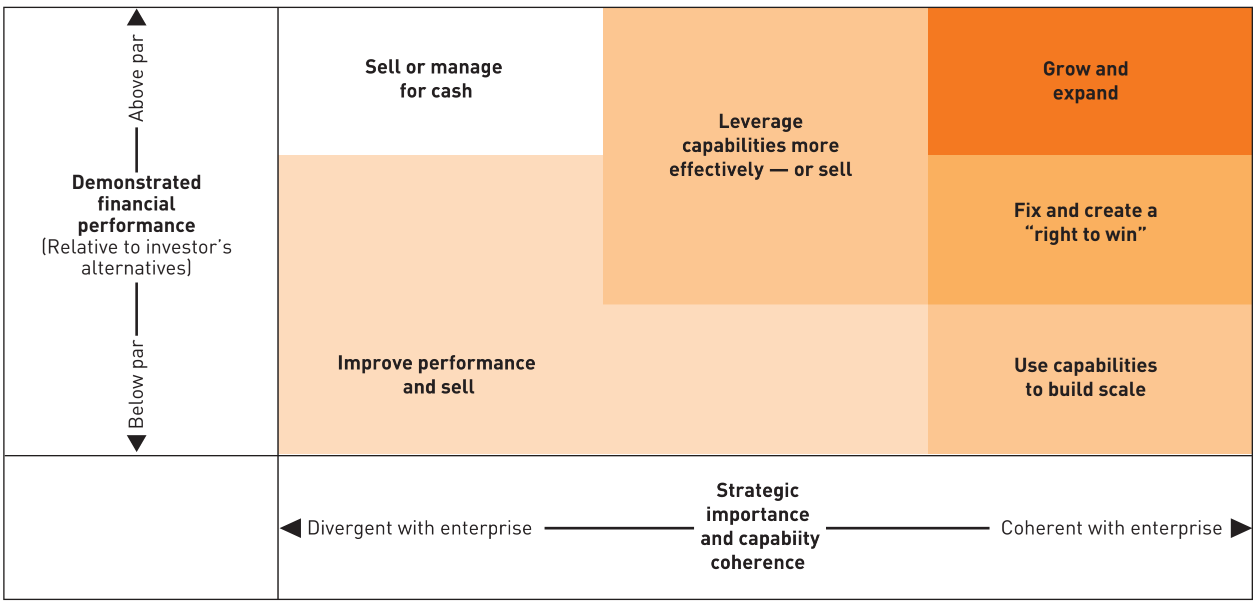
Cutting costs while growing stronger thus requires that you understand not just the dynamics of the market you're competing in — where it is now and where it's heading — but how you will play in that market. Hence the importance of a coherent capability system. Your company's most important capabilities generally come in groups (or systems) that logically fit together and reinforce one another. They match up well against the markets you're facing, the assets you're supporting, and the customers you're dealing with. On its own, for example, PepsiCo's high-performing capability for launching new food and drink products might not amount to much. But PepsiCo also has a related capability: a world-class skill at retail outlet distribution. That capability has made PepsiCo one of the most successful food companies in the world.

Stock market analysts and company managers typically measure portfolio strength financially. If a company has a group of high-performing business units, these analysts are likely to say, "There's a strong portfolio." If it has poorly performing businesses, the analysts label these units "fix" or "exit." This view of portfolios is incomplete; it has only one important metric: relatively short-term financial performance.

Our view of strong portfolios is quite different. Instead of measuring only the financial performance of each business, we ask why these businesses are in the same portfolio to begin with, and we judge their potential according to the coherence of the capabilities that are required to manage them all together. We see leaders at the most successful companies doing the same. This explains, for example, why a company like Procter & Gamble can be successful with so many different brands that compete in seemingly unrelated consumer product segments, such as cosmetics, cleaning products, and disposable diapers. The brands all take advantage of P&G's formidable capabilities in the areas of consumer insight, breakthrough innovation, and merchandising. At Procter & Gamble, the pieces of a winning portfolio are coherent. They benefit from the same capabilities. The job of the strategist, therefore, not just at P&G but everywhere, is to achieve capability coher-

Exhibit 2: **A Guiding Matrix to Portfolio Decisions**

Past views of portfolio management have been based largely on financial metrics, often in combination with market share. In our view, portfolio actions should be taken to enhance coherence, rather than to preserve the business units with the best financial performance.



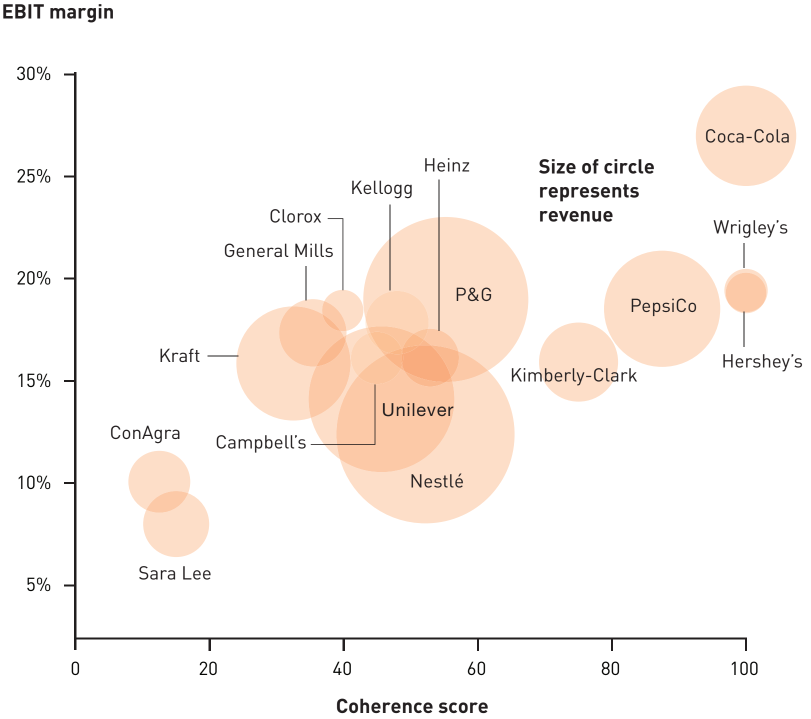
Source: Shumeet Banerji, Paul Leinwand, and Cesare R. Mainardi, *Cut Costs, Grow Stronger: A Strategic Approach to What to Cut and What to Keep* (Harvard Business Press, 2009)

ence: to assemble a portfolio of businesses that benefit from having a coherent "winning set" of capabilities. Accomplishing this goal means classifying each part of the business not just through financial metrics, but also through its alignment with the overall strategic direction of the enterprise. (See Exhibit 2.) This view of the corporate portfolio makes the task of cost cutting infinitely easier. It becomes much more obvious which capabilities to select for investment. No longer do you have disparate needs that all require some investment to sustain, leading to spending spread evenly across functions and businesses. Now you can focus.

Over the years, capability coherence has been shown to correlate strikingly with corporate performance. For example, Booz & Company tracked the coherence of a variety of consumer products companies. (See Exhibit 3.) We found that companies that focused their portfolio on a few key capabilities delivered higher earnings before interest and taxes (EBIT) margins than those whose portfolios were less coherent. We have found the same sorts of correlations in other industries, such as automobiles and telecommunications. In

Exhibit 3: **The Value of Capability Coherence in One Industry**

Our study of leading consumer goods companies shows that those that focus their portfolio on a few key capabilities demonstrate better financial performance (as indicated by the earnings before interest and taxes, or EBIT, margin) than those whose portfolio of capabilities is less coherent.



Source: Shumeet Banerji, Paul Leinwand, and Cesare R. Mainardi, *Cut Costs, Grow Stronger: A Strategic Approach to What to Cut and What to Keep* (Harvard Business Press, 2009)

the end, one of the most critical roles for senior executives is choosing which capabilities to invest in and providing the organization enough specific direction to follow through. This means building capabilities that are unique and synergistic, aligning the portfolio around those capabilities, and enacting an operating model that supports and leverages the capabilities that deserve the most support.

Providing this sort of consistent, reliable focus, is, of course, one of your own most important capabilities. Releasing what isn't essential in difficult times will give you greater clarity of purpose, and will expand your critical capabilities for use in good times. Every day, that more accurate self-definition will ensure that every investment decision, every portfolio decision, and every operating decision reinforces the coherence of your strategy. Yes, that will help in terms of cutting costs. But it will help even more in overall strategy.

Indeed, just being armed with the clear objective of protecting and growing your company makes the pain of the next cost reduction a bit more palatable. And that will have an effect on people within the company. More of them will feel engaged, because they will recognize what the leadership is trying to do. As the company's sense of purpose becomes clear, they will become optimistic again, and they may see opportunities where before they merely saw pressure. It won't hurt that they will see tangible results: Costs come out and stay out, and people are less likely to feel that their work is going to waste. Most important of all, the weight of the organization is now balanced appropriately, propelling forward the capabilities that create your right to win. +

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Resources

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