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Is Your Company Fit for Growth?

A more strategic approach to costs can help you prepare for the next round of expansion.

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AND JOHN PLANSKY

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BY DENIZ CAGLAR, JAYA PANDRANGI,
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A more strategic approach to costs can help you prepare for the next round of expansion.

Is your company fit for growth? Many companies today are not. The way they manage costs and deploy their most strategic resources is preventing the expansion they need. But they don't realize it — at least not yet.

To be sure, many of those companies are in better financial shape today than they've been in for a long time. Having implemented cost-cutting and austerity programs during the recession, they have relatively healthy balance sheets and sizable reserves of working capital. They have strengthened their ability to weather downturns and improved their productivity in ways that could potentially last for years. All these restructuring actions were required for survival between 2008 and 2011.

But as they shift their focus from the cost side of the ledger to the revenue side, searching for ways to move beyond cost cutting — entering new markets, commercializing innovative products and services, offering more compelling customer value propositions — these companies are strategically and financially out of shape. They have not made the hard choices involved in channeling investments to the capabilities that are needed most, and deemphasizing or eliminating their other expenses.

How can you tell if your company is fit for growth? Here is a simple, three-question diagnostic:

• Do you have clear priorities, focused on strategic growth, that drive your investments?

• Do your costs line up with those priorities? In other words, do you deploy your resources toward them efficiently and effectively?

Illustration by Paul Wearing

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• Is your organization set up to enable you to achieve those priorities?

The easiest way to answer these questions is to imagine the opposite.

If you do not have clear growth priorities, there are several warning signs. You have so many initiatives that you can't remember them all. Your executives go to multiple meetings on unrelated topics every day. Asked to name the most important capabilities your company has (the things it does well) or how they relate to your strategic objectives, different leaders give different answers. Your best people are working on so many programs and projects, they are burning out. Meanwhile, you are underinvesting in some areas — which might include parts of R&D, market development, and customer experience — where you could potentially build a distinctive edge against your competitors.

If your costs are not deployed appropriately, that's also painfully apparent — especially in the amount you spend on nonessentials. Staffing levels in different parts of the organization are out of sync; for instance, you might have twice as many finance people counting the money as salespeople bringing it in. Your highest-priority initiatives falter because their investments do not get sufficient attention, while legacy programs with very little impact continue to be funded. Every function pursues an agenda of professional excellence, striving to be "best in class," no matter what the cost. Each department's annual budget is calculated as "last year's, plus 3 percent." Every once in a while, in moments of high pressure, you institute across-the-board cost-cutting programs that force the businesses to temporarily reduce overhead, but everyone knows that it won't make any long-term difference.

If you don't have a well-designed organization, that is evident as well. You are not nimble enough to move quickly, or aligned enough to work in harmony. It takes a week to get a sales quote approved, while your competition wins the business. Information is not readily available to the people who need it. Managers oversee fewer than four employees, on average, and get far too involved in their subordinates' work. Incentives (such as bonuses and rankings) motivate people in ways that actually undermine the behaviors needed to achieve the company's stated growth priorities — for instance, people put internal reports ahead of customer responsiveness. You have "shadow" HR, finance, and IT staffs popping up in places outside your shared-services organization. Since most suggestions are rejected, people become afraid to take calculated risks — and that derails the most innovative growth- or savings-oriented ideas.

These are common symptoms, even among well-run and well-managed companies. Unfortunately, company leaders cannot afford to be complacent about them right now — not if their goals involve expansion and profitable revenue growth. In just about every industry and region, companies are contending with a deflationary economic environment. It is relatively easy to find capital, but difficult to find attractive markets and opportunities that can offer promising returns. Emerging economies are still alluring but remain challenging, and achieving scale in them requires patience. Many companies have understandably implemented share buybacks to increase their stock price so as to offer a higher near-term return to shareholders, but that won't make them competitive. Nor can companies wait for expansionary economic conditions to return; the global economy will probably be facing macroeconomic head-

When you focus on priorities, costs are not problems. They are choices.

winds for some time.

However, the fact that everyone is struggling also provides a great opportunity for companies that are willing to prepare for growth through a more deliberate, lean, fit-for-purpose operating model. Some companies are already doing this. They are streamlining their operations by making disciplined choices concerning their capabilities, and undertaking continuous improvement of their efficiency and effectiveness. This is the corporate equivalent of a fitness regimen that focuses, in effect, on building muscle — developing the capabilities that define a company's distinction — while cutting fat. By contrast, across-the-board cost reductions are the corporate equivalent of crash diets — they are ineffective because they do not last, and at worst they can cut into productive muscle. A successful program to become fit for growth contains three main elements:

• Set clear strategic priorities, and invest in the capabilities that allow you to deliver them.

• Optimize your costs, developing lean and deliberate practices that will deploy your resources more appropriately and efficiently.

• Reorganize for growth, establishing a nimble, well-aligned organization that can execute your new strategic priorities.

These elements reinforce one another; when launched together, they provide the wherewithal for growth, even for companies facing today's macroeconomic challenges.

Setting Clear Priorities

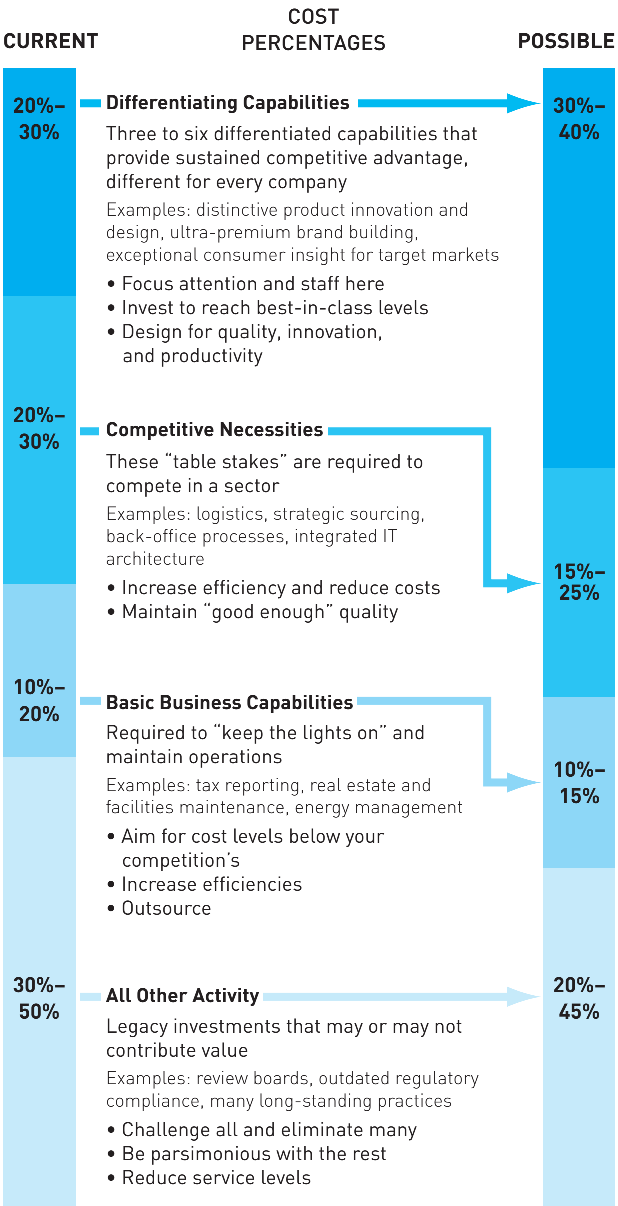
A growing body of research and experience has shown the importance that capabilities have in strategy. A capability, in this context, is the combination of processes, tools, knowledge, skills, and organization that allows your company to consistently produce results. Walmart's virtuosic supply chain management, Southwest Airlines' energetic customer service and asset utilization (of which its rapid turnaround time is an example), and Procter & Gamble's open architecture innovation model are all well-known examples of distinctive capabilities that few, if any, of those companies' competitors can match. These capabilities don't stand alone; in each case, they are part of a mutually reinforcing system that works to give the company its advantage. Walmart's supply chain management, for example, combines with the retail chain's signature approach to store design, its in-depth knowledge of its rural and suburban customers, and its renowned expertise in real estate and store location.

Because a company's most distinctive capabilities are cross-functional and are applied to most products and services, they require a great deal of attention and investment; even the largest companies have only three to six distinctive capabilities in their capabilities system. Hence the need to set clear priorities. Business leaders recognize that working capital is finite. They know they must marshal their resources according to strategic need, not to corporate politics or past legacy. (For more about capabilities and their strategic role, see Paul Leinwand and Cesare Mainardi, *The Essential Advantage: How to Win with a Capabilities-Driven Strategy* [Harvard Business Review Press, 2011].)

When you focus on priorities, costs are not problems. They are choices. The priorities most worthy of high levels of investment are those that align with the growth priorities of your business, helping to build the capabilities that distinguish your company and contribute substantially to its success. These capabilities

Exhibit 1: **Becoming Fit for Growth**

A cost-fitness effort must address four types of investment priorities, each changing to meet its own level of strategic relevance. This chart shows how a hypothetical company might evaluate its expenses.



Note: Cost percentages are illustrative, based on hypothetical examples.
Source: Paul Leinwand and Cesare Mainardi, *The Essential Advantage: How to Win with a Capabilities-Driven Strategy* (Harvard Business Review Press, 2011), Booz & Company

are steadily funded — their investment levels may even increase — while other categories of expense are seen as necessary but not special. The other expenses receive just enough cash to be on par with competitors' spending or to simply "keep the lights on" in the company's operations. (See Exhibit 1.) They are subject to strict scrutiny, constant pruning, and a continuous search for leaner efficiency.

In setting clear spending priorities, your first step is to identify which capabilities are worthy of greater investment. The precise mix is unique for each company; articulating the priorities requires strategic clarity on the part of your management team. We have found that management teams at most companies generally agree about which capabilities matter most. After their first exercise in distinguishing strategic costs, they often become devoted to the practice, and thereafter they continuously review resource deployment to fund capabilities for growth while keeping other expenses relatively low.

Ikea, the Swedish manufacturer and retailer of affordable customer-assembled furniture, went through this kind of exercise in the late 2000s, when it reworked its priorities. It was already a frugal organization; from its founding in 1943, the drive to reduce costs has been integral to Ikea's culture. As company founder Ingvar Kamprad once wrote, "Wasting resources is a mortal sin at Ikea.... Expensive solutions to any kind of problem are usually the work of mediocrity."

But this new fit-for-growth initiative was defined as far more than a cost-cutting effort. Ian Worling, Ikea's director of business navigation, introduces the strategy by quoting Kamprad's original statement of the company's ambition: "to create a better everyday life for the many people." As Worling explains, "That means we offer home furnishings at such low prices that as many people as possible can afford to buy them. That colors everything we do." Thus, for example, Ikea's executives travel economy class and stay in moderately priced hotels, and the company maintains relatively inexpensive office space.

Like many other housing- and consumer-related

When a Step Change Is Needed

by Deniz Caglar, Jaya Pandrangi, and Ashok Divakaran

Companies may need to address their cost structure suddenly for one of many reasons, such as reacting to dramatic changes in the marketplace, correcting a large drop in profitability, or enabling a new strategy. Companies in such straits can still operate from a position of strength, by following these principles in a cost-transformation program:

• **Look for early quick wins.** Rapid cuts in nonessential costs help motivate people and provide cash to fund the initiative. If you reinvest those funds in more productive directions, these early wins also demonstrate that you are serious.

• **Start with the end in mind.** You are cutting costs not just to survive, but to focus your future efforts. Start by determining your value proposition and the capabilities you need.

• **Tackle the root causes of high costs.** Think freshly about the business; look for dramatic step-change shifts that can free up capital.

• **Establish stretch targets.** Target an aggressive but credible figure, representing enough funds to reinvest in growth and build a cushion for savings erosion. Such stretch targets stimulate new ideas and help high-potential managers reach beyond comfortable limits.

• **Hold managers accountable for specific targets.** Otherwise, savings tend to evaporate.

• **Make a public commitment to the program and explain the "fit for growth" philosophy to your shareholders.** Commitment reinforces the strategic importance of the program and protects your ability to reinvest some of the savings in your most important capabilities.

• **Explicitly describe how you expect to identify and implement cost savings.** The top team should deliver this message, convey a sense of urgency, and set an example by cutting back costs associated with their own day-to-day practices.

• **Design a single cohesive process, not a collection of separate expense-reduction projects.** Put a single steering committee in charge, overseeing cross-functional teams that suggest specific measures. Schedule frequent reviews to assess progress and make decisions.

• **Assign good people to carry it out.** Staff the cross-functional teams with up-and-comers; give them the information and authority they need.

• **Take on sacred cows.** Some nonstrategic capabilities have entrenched supporters. Encourage people to bring these controversial opportunities and thorny issues to light, and give them ways to do so without becoming vulnerable.

• **Track progress in a standardized way, tied to the bottom line.** Report results on an ongoing basis.

• **Stick to your purpose.** Some managers will say, "Give me my cost reduction number, and let me take care of it." This is not that kind of effort. Its purpose is to redefine the work and to position the company for enhanced growth, using a shared understanding of the value and differentiation provided by each activity and capability. If you keep your eye on that goal, others will follow.

— D.C., J.P., and A.D.

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Before authorizing an expense, says Ikea's Ian Worling, "we always ask ourselves, 'Would our customers want to pay for that item themselves?' "

businesses, Ikea was hit hard in the global recession, while the price of many of its materials went up. "We asked ourselves what we could do during this period to lower our costs and, instead of increasing the bottom line, turn every euro back to lower prices for our customers," recalls Worling.

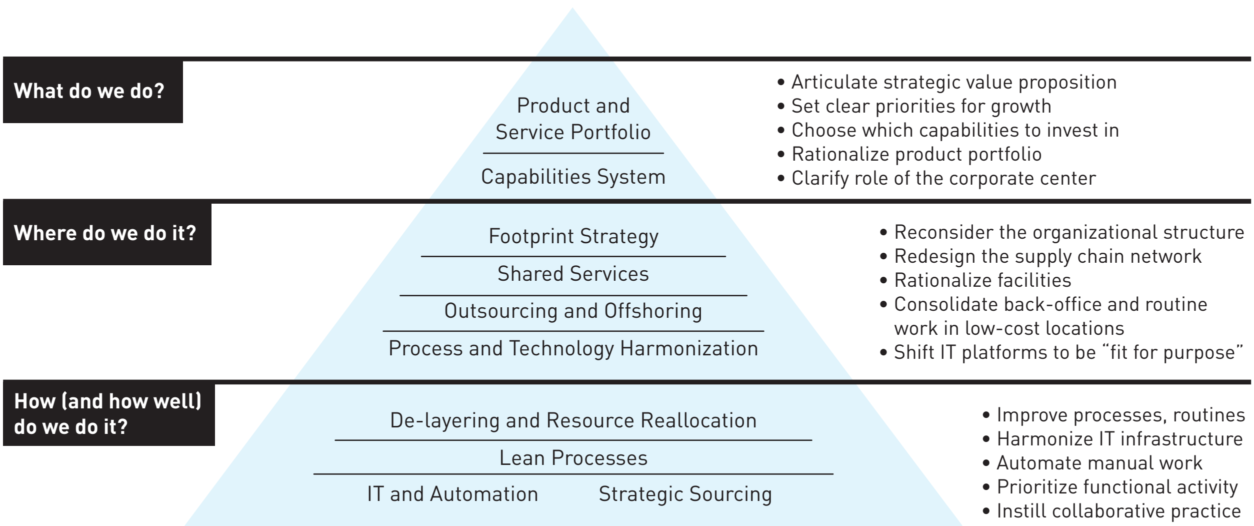
The chain's leaders chose to continue investing in the capabilities that differentiated Ikea — for example, its custom-designed stores, which included distinctive Swedish restaurants and child-care facilities, needed to be places where customers felt at home. "To make up the difference," says Worling, "we had to become very good at lowering operational costs." With that goal in mind, Ikea sought additional efficiencies in its supply chain, collaborating with suppliers where possible. Industrial designers worked diligently on reducing packaging: "Even a few millimeters can make a big difference in fitting more pieces into a container. We hate transporting air," says Worling. Nonessential costs were pared as much as possible. Before authorizing an expense, says Worling, "we always ask ourselves, 'Would our customers want to pay for that particular item themselves?' If the answer is no, then we try to find a way to do without it or to do it in a cheaper way."

Optimizing Your Costs

Fit-for-growth companies are lean and deliberate in spending money. They manage their costs for both ef-

Exhibit 2: **Leverage for Cost Management**

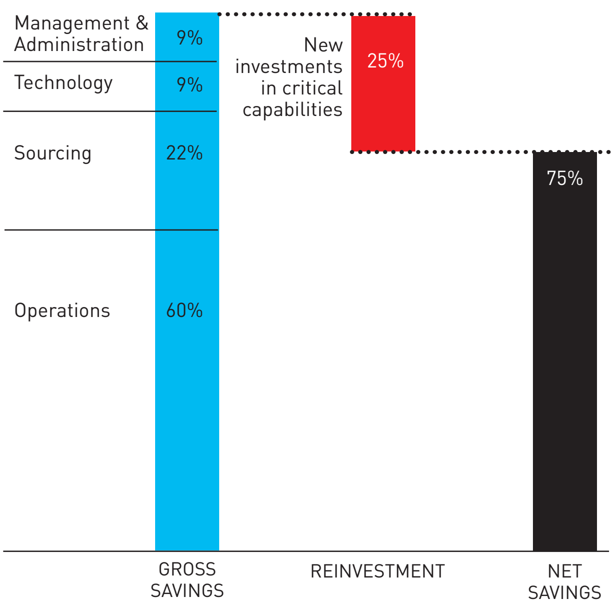
A multifaceted effort to become fit for growth can involve a large number of tools and practices, generally grouped into three categories: Focusing on distinctive capabilities ("What do we do?"), shifting the sources of activity ("Where do we do it?"), and streamlining your operations and organization ("How [and how well] do we do it?"). The width of the pyramid at each level illustrates the comparative number of people involved.



Source: Booz & Company

Exhibit 3: **Cash Released by an Exemplary Cost Transformation Program**

This initiative, conducted by a Fortune 500 company, released more than a billion dollars in gross savings. About one-fourth of that money — a remarkably large percentage, compared with most cost initiatives — was reinvested to bolster and expand the company's distinctive capabilities.



Source: Booz & Company

ficiency and effectiveness. In all their investments, they seek long-term value. This means continually pursuing the lowest-cost way to run their operations and organization, taking full advantage of economies of scale and scope. In our experience, companies that become fit for growth do not see cost optimization as a single, "big bang"–style event. Instead, they make it a continuous process, embedded in the daily fabric of business.

This type of ongoing discipline represents a natural outgrowth of your work on setting priorities. Indeed, by choosing to cut costs proactively, you can operate from a position of strength. Without the panic and aggression displayed by business leaders who feel pressure from outside, you can allocate your cuts more rationally — and be far more effective in reinvesting your savings. (To be sure, sometimes a more dramatic shift in your cost structure is called for. See "When a Step Change Is Needed," page 6.)

When you are ready to rethink and streamline your operations, organization, and management practices in this way, you have a large menu of techniques, practices, and analyses to choose from. (See Exhibit 2.) They can be implemented at many levels of the organization, by many different teams that, ideally, learn from one another as they work. These methods include the kinds of continuous improvement associated with lean management, the efficiencies of scale that come from consolidating separate activities, the savings that emerge from relocating nondistinctive work to lower-cost sources, and the value derived from strategic sourcing that reduces the expenses of materials and components. Whichever techniques you choose, depending on your circumstances and needs, the object is the same: to be deliberate in taking out costs, making sure you don't cut into productive muscle.

Some of these methods may seem familiar to you, but they take on new meaning in the context of a capabilities-driven growth initiative. By reducing expenses in this way, you release cash for potential investment. This is generally the most reliable way to fund the development of distinctive capabilities that are strategically important for growth. (See Exhibit 3.)

One company that has used cost optimization to fund its development of strategic capabilities is Aetna

Becoming Fit for Growth at Pitney Bowes

by Michael Monahan

Before the global recession hit in 2008, my company, Pitney Bowes Inc., had already embarked on a concerted effort to evolve the business and rebalance revenues toward growth areas. Nearly a century old, with 33,000 employees and US$5.6 billion in revenues, Pitney Bowes had two different businesses. Our traditional business, serving small and medium-sized customers, was very focused on hardware — the sale, servicing, and financing of postage meters and other mail and workflow equipment. Our enterprise segment, on the other hand, was much more of a services- and software-based business model, selling to large, multinational companies. Those revenues had grown considerably over the last decade, in part through acquisition.

In May 2009, we decided to launch a thoughtful and comprehensive review of our progress. Everything was on the table: sales, general, and administrative expenses (SG&A); engineering and manufacturing; indirect and direct procurement; the size and skills of our workforce; IT, HR, and finance; and, most importantly, the overall structure of the company. We had grown up as a set of vertically integrated individual businesses managed as a loose portfolio. We needed to become a much more integrated company with an infrastructure and business model that served the distinct needs and growth potential of our two very different customer segments.

In addition, one of my personal key goals was to create a lot more variability in our cost structure, so we could migrate resources across businesses as we saw opportunities arise. Naturally, at the height of the recession, we looked for cost-saving measures that we could implement quickly and temporarily, like deferred wage increases and temporary changes to employee benefit programs. But more importantly, we also explicitly looked for the type of cost savings that were sustainable over time.

We created nearly a dozen cross-functional teams to examine every company resource and process, and a project management office to coordinate these teams. They were responsible for developing and defending the business case for their proposed actions and investments. These were then brought to senior management for review. The senior management team dedicated a half day every month to considering these action items and investments. I was part of a smaller subset of that team, called the Transformation Steering Committee, which was focused on formally approving, monitoring, and implementing the resulting projects.

To create room for the new priorities, we looked at our historical investments and either limited or eliminated many old systems and processes. We redirected that investment into the new platforms and new capabilities that we needed.

Our senior management team identified three key areas for investment. The first and most basic was infrastructure. We replaced our old Web infrastructure with a much more contemporary and flexible platform that consolidated the websites from all of our various acquisitions and enabled direct interaction with our customers. Behind the scenes, we consolidated

Inc., a US$34 billion diversified healthcare-benefits company. "With the enactment of healthcare reform, 40 million Americans are theoretically going to be entering the market for health insurance," says Meg McCarthy, executive vice president of innovation, technology, and service operations. "There will be significant growth in the cost-competitive individual business. Our aim is to be the global leader in empowering people to lead healthier lives. That's our strategy."

Developing the necessary consumer retail capabilities — "the art and science of getting and keeping every single customer every single day," as McCarthy puts it — requires significant new investment. As part of building and strengthening these capabilities, Aetna has prioritized investment in several areas, including information, health information exchange, and clinical decision support. Of course, in a market that is highly price-sensitive, such as small group and individual insurance, cost vigilance is a necessity. "Our infrastructure — both process and technology — needs to operate at the lowest possible unit cost," says McCarthy, "so that we're market-competitive and attractive to consumers. We still have further progress to make, but we've taken significant first steps to reduce the costs of complexity." For example, Aetna is restructuring its back-office operations — including claims processing and customer service — to realize greater efficiencies.

"We used to take a step-change approach to cost

85 disparate data centers into six regional centers.

We called the second capability "the agile workforce": communication tools to provide employees with the flexibility to work anywhere rather than being bound to a particular facility or office. For example, we began using voice over IP and aggressively reduced our real estate footprint.

Third, we gave more employees the ability to interact with our customers on a more holistic basis and cross-sell to them. We built an enterprise selling organization, unifying around common processes and technologies (such as using Salesforce.com as a sales automation tool).

In addition to these priorities, we launched a number of new digital products (some internally developed, others created through partnership) to drive revenue growth per customer as well as our overall customer base.

As a result of this initiative, we've gone to a much higher degree of global shared services. The finance and marketing groups, for example, have moved from regional to global models, leaving decision support to the individual businesses. We have a global learning and development organization focused not only on product training, but also on education about our company's core mission — customer communications management.

Pitney Bowes has also expanded its use of outsourcing and offshoring. First, we aggregated and standardized certain high-cost and transactional work internally. Then we outsourced much of it; nearly half of our finance transactions, for example, are conducted by suppliers.

We continue to look for ways to move from fixed to variable costs on a day-to-day basis, so we won't have to undertake another restructuring.

Our hard goal when we started this process was $150 million to $200 million in annual cost savings, net of reinvestment back in the business. We announced in our 2011 fourth quarter that we had exceeded our revised target of $300 million, one year ahead of schedule. Almost 45 percent of the savings came from nonpersonnel-related actions, such as better procurement, smaller facility requirements, systems automation, and similar efforts. Out of the total savings, we reinvested about $200 million back into the business.

We had plenty of challenges along the way. We had the typical organizational boundary issues that you encounter when solutions cut across traditional lines of demarcation. Often, we worked through these issues by using cross-functional teams. We are still working on the concept of continuous improvement, incorporating into our culture the requirement that everyone look at efficiency and productivity as the funding source for future investment in the business, and driving home the concept of competition for finite resources.

At the end of the day, the best parts of the Pitney Bowes culture prevailed. We have an organization of people who are very committed to the company. Once everyone accepted that we were serious about this transformation, they got on board and drove its incredible success.

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management," McCarthy adds. "Now we are adopting a continuous improvement methodology, in which we remove waste constantly. We're searching for nickels and dimes and any way to reuse assets. It's like a can of Legos — we need to put the pieces together in new and different ways to grow our business."

Reorganizing for Growth

A well-designed organization model is critical to enabling growth in two important ways. First, it makes possible and sustains the cost reductions that are required to invest in differentiating capabilities. It does this by sharing resources across businesses and functions, and by trimming management overhead. In most large organizations, long-standing relationships have developed in an ad hoc fashion among the central core, the local business units, and the shared pools of resources that provide, for example, human resources and information technology services. Local leaders may have too much power over functional activities (thus duplicating one another's efforts and promoting inconsistencies), or the central hub may be too controlling (which generates unnecessary work).

The solution typically involves redesigning the company to create more appropriate structures and spans of control. This may mean having more people report to each manager and reducing the number of hierarchical layers. Pay scales may be rationalized so

The secret to fitness is to never return to old habits and to instead follow an ethic of continuous improvement.

that compensation matches the complexity of the job performed, or the company may take more deliberate approaches to sharing resources and outsourcing less-critical functions. When these measures are consistent and broadly understood, they are typically supported by people throughout the company.

Second, a well-designed organization model can fuel dramatic growth by empowering managers to act like owners of the business. The managers of business units are given explicit financial and operational targets, along with clear decision rights that spell out what they can and cannot do by themselves to reach those targets. They are also given greater control over the resources assigned to them, and they can deploy these resources more flexibly. With incentives (such as bonuses and promotions) determined accordingly, business unit leaders become accountable for results, which are aligned with the company's broader objectives in both the long term and the short term.

This tightly linked chain of empowerment, accountability, decision rights, and incentives allows the company to make decisions as close to the front lines as possible. Managers can capture opportunities in the market, while the corporate core focuses on building and maintaining the capabilities that all the business units share and on driving the company's overall strategy and performance. People respond quickly to opportunities, collaborate across organizational boundaries well, make decisions resolutely, and execute effectively. Executives spend less time fighting political turf wars and more time thinking about their customers and competitors. Finally, costs naturally come down, and the potential for growth improves, because the organizational structure reinforces the practices developed through cost optimization.

A number of large companies have used organizational design to become fit for growth, without publicly explaining their internal changes. One example is a global energy company, which adopted a new cost-restructuring initiative in the early 2010s. During the previous decade, the company had grown rapidly through acquisition, buying a number of companies and developing an overly complex structure along the way. As one executive leader later noted, the company had gradually become "a bit of a patchwork." Some of the business units were centered on countries or regions, whereas others were built around product lines. There were also functional groups — charged, for example, with marketing and sales or with manufacturing — that operated either globally or within regions, sometimes duplicating others' efforts.

The cost-restructuring initiative was conceived as a multiple-year project, affecting the company's processes, systems, people, and way of doing business. It reorganized the hierarchy into several global strategic business units, a tightly knit collection of corporate functions such as HR and finance, and a group of shared services to provide support. Although the concept of regions was preserved, P&L accountability shifted entirely to the strategic business units. To manage this new streamlined structure, the company created a single global framework for decision rights: It determined at a central level who would make critical company-wide decisions involving finance, planning, legal liability, procurement, the supply chain, sales credit risk, human resources, manufacturing, and technology. This new structure allowed the company to realize massive savings through scale and by eliminating redundancies.

At the same time, the organizational units — strategic business units, shared services, and corporate functional groups — all had their own explicit decision rights. In short, the company created a new common global framework for its organization, while providing the business units and functions with sufficient latitude to run their operations nimbly.

Some companies use cost-restructuring efforts to dig deep into business units, reorganizing every process. This effort did not micromanage in that way; separate operational change initiatives were embedded in the new business units and corporate functions. But this program aligned the organization for growth, enabling it to be, as one observer put it, "a truly global company."

Sustaining the Gains

When a large company pursues cost management and growth simultaneously, it must act as one unified entity. Avoiding disconnects and misalignments requires effective governance and business management practices. Financial, strategic, and operational planning processes should be treated as leading activities: They should set clear priorities and plans that involve all parts of the organization in the company's "way to play" and central capabilities system. A business unit or function that does not fit with the common strategy is probably too expensive to keep in its current form. Corporate, business unit, and shared-services leaders should also collaborate informally to exchange knowledge and make sure that business units receive the support they need, consistent with their local conditions and the company's overall way of creating value.

As anyone who has lost weight and kept it off can tell you, the secret to fitness is to never return to old habits and to instead follow an ethic of continuous improvement. Fit-for-growth companies commit to a lean mind-set and are always honing their capabilities and cost structure, so they don't have to undertake large programs every several years. They reorient themselves for growth as well, adjusting their resource deployment year after year. Most importantly, they do all this with a watchful eye on their unique value proposition and the distinctive capabilities that will allow them to grow.

Becoming fit for growth may seem like an onerous task. But as suggested by the examples of Ikea, Aetna, and Pitney Bowes (see page 9), it can also be the beginning of a new virtuous cycle. As resources move from nonessential to critical capabilities, your company can put more capital into growth strategies. The cost side of your ledger will read less like a list of burdens and more like a register of enabling choices, with a direct link between the money you spend and your prowess in the marketplace. +

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