Too many cost-reduction efforts fall short of their goals. The leaders follow four key elements to reduce costs and keep them low

Sustained cost transformation: Delivering savings that stick

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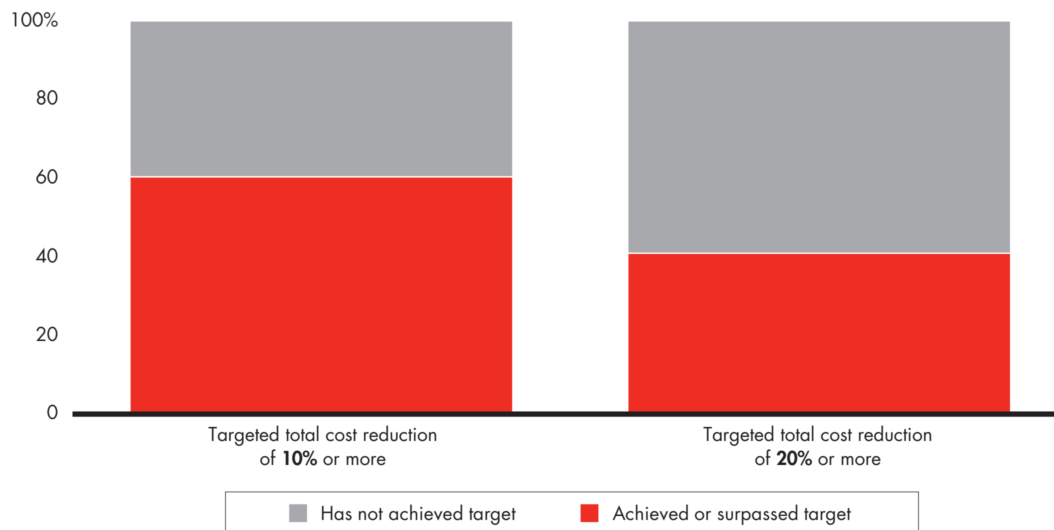
A low-cost position wins in nearly every industry. Cost leaders can out-invest rivals in areas such as R&D and marketing while still maintaining attractive margins. They have the resources to capitalize faster and more readily on new opportunities. They can capture share because they have more price flexibility. Among the many ways that companies can differentiate themselves, such as by strategy, market position and technological leadership, more than 40 percent of industry leaders consider cost leadership to be their key competitive advantage.

It's no surprise that most companies routinely try to lower their costs. But few succeed in driving costs out and making the savings stick. A recent Bain analysis and an independent survey of nearly 300 executives reveal the magnitude of the problem. In 2008 and 2009, many companies responded to the economic downturn with a variety of cost-reduction initiatives. Looking back on those efforts, however, executives are not happy with the results. Fully 40 percent of the executives in the survey who are attempting to reduce costs by at least 10 percent acknowledged their failure to achieve their goal. And among those pursuing cost reductions of 20 percent or more, nearly 60 percent acknowledged failure (see Figure 1).

Yet some companies succeed not only in significantly lowering their costs but also in maintaining those reductions over time. We analyzed the performance of 68 large US public companies that announced major cost-reduction initia-

Figure 1: Forty percent of respondents with cost-reduction targets of at least 10 percent have not yet achieved their stated goal



Note: Only includes respondents whose cost programs started in 2008 or 2009 with a minimum cost reduction target of 10 percent
Source: Bain/EIU SCT Survey, September 2011

tives in the first quarter of 2009. Twelve to 24 months after the announcement, more than 20 percent of those companies were able to maintain or grow their EBIT despite revenue drops of 10 percent or more—a remarkable achievement by any measure.

What do the successful companies know that the others don't? To find out, we dug deep into our data and conducted a series of executive interviews. We discovered that companies that reduced costs and kept them low take a fundamentally different approach from the rest. We call this approach *sustained cost transformation*. The companies that achieve it typically follow a common path with four key elements. The cost leaders:

- Set targets based on external, market-based data, not on internal benchmarks;
- Tailor cost-cutting efforts to their strategy;
- Get the metrics right;
- Focus on the "seams" of the organization, not just individual units.

Successful companies also know how to make cost-reduction initiatives stick. Rather than relying on exhortation and top-down missives, they launch comprehensive efforts to embed the message in the entire organization. Before long, the company develops a new consciousness—and a new culture—in which keeping costs low is a primary objective. This is the key to delivering sustained cost savings year after year.

Let's look in more detail at what a sustained cost transformation entails.

Set targets based on external data

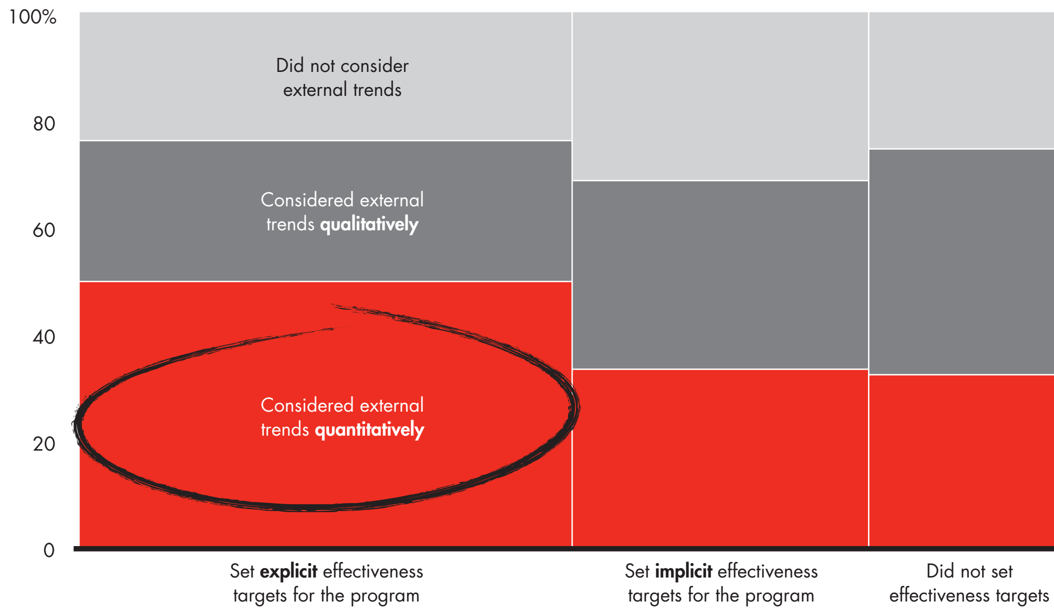
Many companies begin their cost efforts with a nice round number, such as a 10 percent or 20 percent reduction from previous levels. But these are often arbitrary figures pegged to internal benchmarks or to what feels achievable. More than half of our survey respondents fell into this trap: They failed to consider other data, such as market trends and externally defined performance targets, in setting their quantitative cost goals (see Figure 2).

The cost-reduction leaders don't make that mistake. They understand that market disruptions—technology or regulatory shifts, the collapse of a price umbrella or the emergence of new competitors—often reveal structural weaknesses, such as costly production footprints or unnecessary complexity. Many companies, for instance, have found themselves facing new competition from rivals based in China and other developing markets. An arbitrary cost-reduction target of 10 percent is unlikely to restore their competitive position.

Leaders consider both the cost structure required to compete today and the cost structure likely to be required three years from now. An example is Charles Schwab, the discount brokerage firm. The market crash that began in late 2000 revealed that Schwab, a onetime cost leader, now faced a significant cost disadvantage relative to online competitors. Schwab needed to lower its price per trade significantly just to stay in the game. So it launched a diagnostic exercise to determine the price point required by the market and to identify future price trends. Armed with that information, Schwab could begin creating a cost structure that would foster profitable growth. One area the company focused on was IT. By understanding target costs, executives could redesign systems and infrastructure to deliver on evolving customer demands at a competitive cost level.

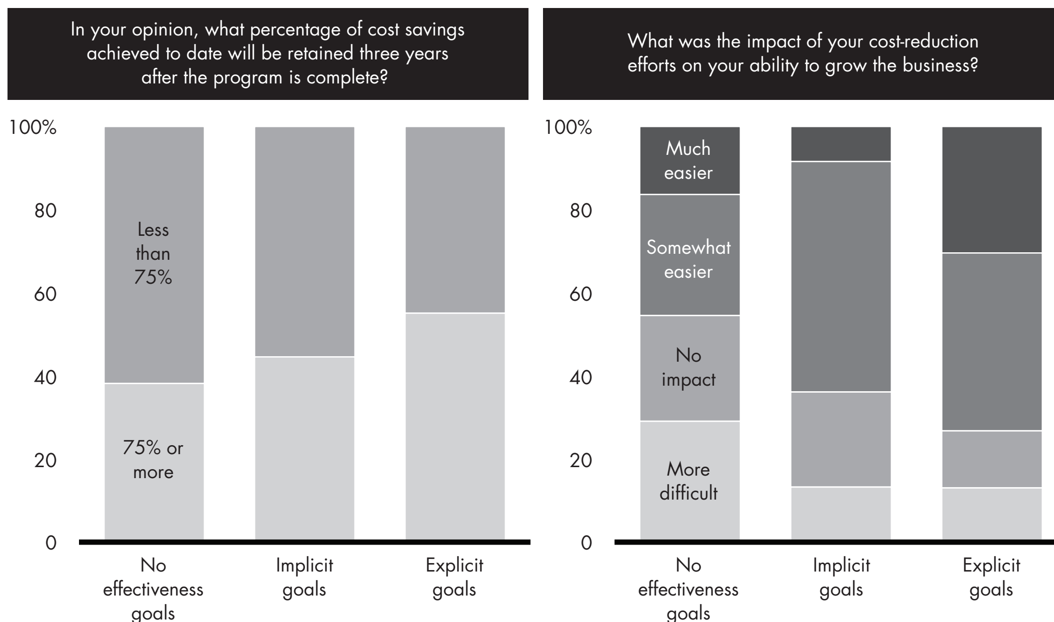
Cost targets are not the only goals a company needs to set. The leaders also set effectiveness targets, such as improving service levels or reducing time to market for new products (see Figure 3). These goals, too, need to be measured against competitors and market standards. Many

Figure 2: Only 25 percent of surveyed companies established explicit effectiveness goals for their cost programs while quantitatively considering external factors



Source: Bain/EIU SCT Survey, September 2011

Figure 3: Setting explicit effectiveness goals helps companies sustain savings and generate future growth



Source: Bain/EIU SCT Survey, September 2011

companies, for instance, focus sales-organization benchmarks on the cost of the salesforce. It's far more effective to focus on overall productivity or cost per sale—metrics that can be gauged against the competition.

External benchmarks have an additional benefit: They can provide insight into best practices well beyond what is conventional in a given industry. One consumer products manufacturer, for instance, required as much as four hours to change over production in its plants. Looking for ways to reduce that time, it invited a NASCAR pit crew to observe the process. The move was highly effective: Based on the pit crew's suggestions, the company was able to reduce changeover time to as little as 12 minutes, generating substantial cost savings.

Tailor cost reductions to strategy

Strategy reflects—and affects—a company's cost structure. A bank whose strategy focuses on high-touch customer service obviously has a different level of costs from one whose strategy focuses on low-price accounts and heavy reliance on self-service. Failing to consider strategy in cost efforts is a recipe for trouble. Among survey respondents who said it was difficult to grow their business after implementing their cost-reduction program, only 53 percent had linked it to their strategy.

Cost leaders take a different approach, ensuring that their strategy clearly informs every effort to reduce costs. One equipment manufacturer, for example, realized that some of its products had become commodities and some of its customers, more price conscious. The combination was taking a toll on the company's margins and growth prospects. After a re-examination of its strategy, the company determined to be first to market with innovations and to carve out the lowest-cost position in the industry. But that meant cost reductions of up to 25 percent, an aggressive and challenging goal.

The company aligned its cost-reduction approach with this new strategy. In product development, for example, the priorities were both lower costs and faster time to market. The appropriate tool to achieve these objectives was process re-engineering, which eventually shaved several months off product-launch timelines while lowering product-development costs. In the selling function, the company segmented its customers to determine whether it could modify or eliminate undervalued services. After a review, it began providing less service support to the segment that was most price conscious; meanwhile, it continued to deliver full support to customers that truly valued it, and it learned how to deliver the services at lower cost. In its back-office functions, the company took yet another approach: zero-based budgeting. Managers questioned every activity performed in these functions and rebuilt many from the ground up. For instance, the company created a new IT organization that operates at 75 percent of its original budget, thanks to lower service levels, process redesign, standardization, automation and offshoring.

All these and other changes combined to create approximately $1 billion in sustainable cost savings. They also contributed to the development of growth capabilities reflecting the company's new strategy.

Get the metrics right

Many less-successful companies approach cost reduction with blinders on. They may look at only one part of the P&L, such as general and administrative (G&A) expenses. Or they may confine their efforts to individual business units. They fail to view the business as a whole, often because they rely on metrics that reflect part of the business rather than the entire P&L.

Consider an Asian telecom company that was trying to contain support costs while maintaining high levels of service. When the company benchmarked its cost per call and cost per truck visit in

the field, it found that both numbers were within a reasonable range—$8 to $15 for a call and $120 to $150 for a rolling truck. The problem was that the two service channels operated separately and were measured independently. To reduce call-center costs, supervisors encouraged customer service agents to keep calls short. Agents often dispatched a technician to resolve a customer's problem whenever a quick phone diagnostic failed. To fix the problem, the company integrated the call centers with the field unit, giving one executive responsibility for the entire service chain; it also changed the incentive metrics to include first-call resolution and the number of trucks sent out unnecessarily. Those moves helped the telecom increase the number of issues resolved in the initial call by 15 percent, saving the company millions.

Often the relevant metrics are buried deep within the organization. One aerospace company, for instance, knew that organizational complexity was hampering its ability to execute on key processes. At the extreme, a seven-step engineering change process took up to eight months, requiring more than 700 interactions between more than 120 individuals. The company at first thought that one root cause of the complex process was too few people reporting to too many managers, resulting in unnecessary oversight. But an initial analysis found that managerial spans and layers were within acceptable ranges. So the company probed deeper. It found that more than 70 percent of employees in the top five layers were staff, many of them analysts, with no direct reports. Partly as a result, people were spending as much as 30 percent of their time on low-value activities, such as validating one another's numbers and kicking back change requests for more work, rather than making decisions on them. Thanks to the discovery, the company was able to identify more than $100 million in savings through streamlining decision roles and redesigning processes. Needless to say, these changes also resulted in a faster change order process.

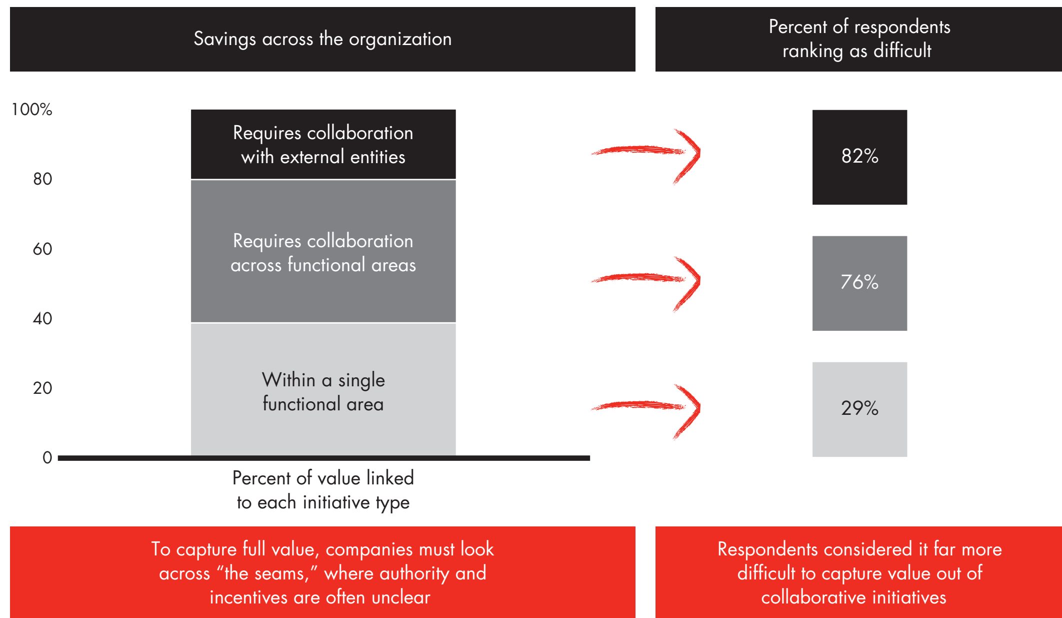
Focus on the organizational seams

Complexity arises from all the points at which organizational units bump up against one another. Costs also build up in these seams of the organization with no clear accountability, and that can yield big cost savings opportunities. Our experience suggests—and survey respondents confirmed—that at least 60 percent of the value in cost-reduction efforts depends on initiatives requiring coordination among different parts of the organization or with external parties such as vendors (see Figure 4).

Leading companies make a point of examining the seams closely. A global engineering services company that experienced significant growth through acquisitions took steps to reduce costs in functions like HR, IT and finance as it moved to a centralized service delivery model. As the market slowed, the company needed to take out even more costs in order to fund essential business development and marketing activities. After analyzing all support costs across every department budget, the company found it was spending more money on administrative support than on other support functions like HR and marketing. Office administration, project administration and management support costs all sat in separate budgets and were not managed as a single department. By using ratios of administrators to total staff and adjusting for office size, the company was able to reduce its administrative costs—hidden in the seams—by 35 percent, investing the savings to grow the business.

Typically, there is no single owner for what happens at the seams and thus no accountability for costs. When we were asked to perform a cost diagnostic at a major energy company, we found that a startling 40 percent of overhead costs were in such areas. Much of the corporate IT budget, for instance, went toward providing services to the business units. But those services

Figure 4: Collaboration across boundaries is both necessary and difficult in cost-reduction programs



Note: "Difficult" = a ranking of 3 or higher on a scale of 1 (not difficult) to 5 (extremely difficult)
Source: Bain/EIU SCT Survey, September 2011

were charged back to the units below the profit line, and business-unit managers were not held responsible for their IT costs. Year after year, the recipients of the IT services demanded better, faster support, and, year after year, costs rose. The IT people thought they were doing a good job prioritizing requests and were, in fact, eliminating up to 50 percent of them. But at the end of the day, they could not second-guess the requests coming from the businesses. So costs rose, and no one had real accountability. Finally the company created an internal market, developing an effective chargeback system and setting up boards of business-unit leaders to ensure that IT charges were competitive. This initiative was one of many that contributed to more than $2 billion in cost savings.

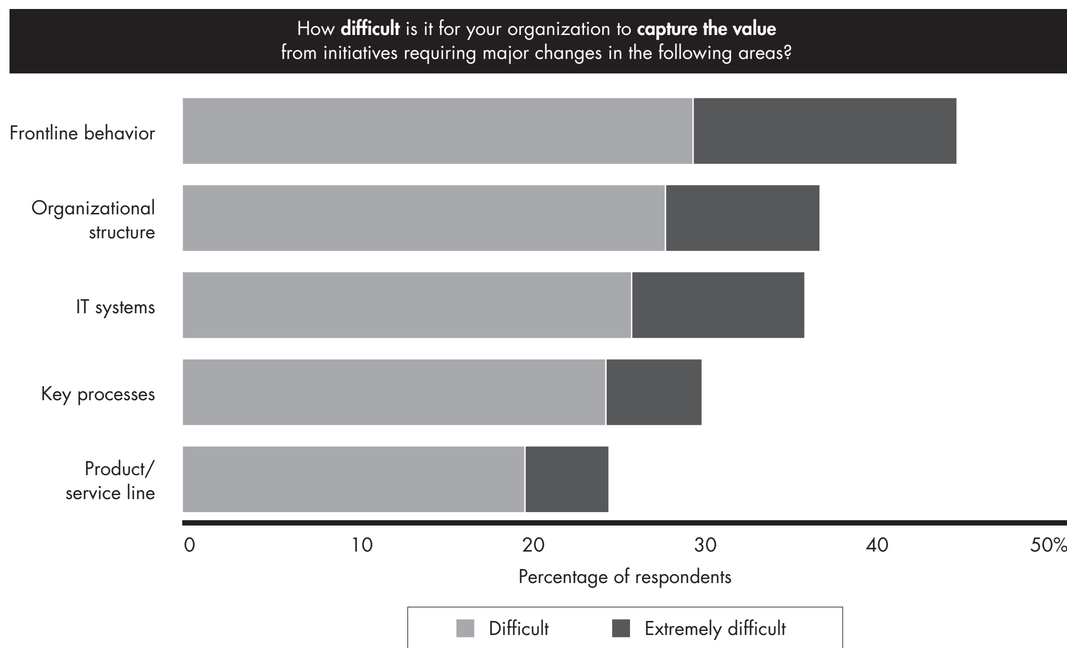
Develop the capabilities that make change stick

Careful tracking of cost metrics over time is an essential element of any sustained cost transformation—the table stakes, so to speak. But the real engine of sustainability is the hearts and minds of frontline managers and employees. If the people at the front line don't begin to think and act differently, the initial cost savings won't last. Survey respondents identified frontline behavior as the single biggest obstacle to capturing lasting value from cost-reduction efforts (see Figure 5).

Nobody expects the people on the front line to change their behavior on their own. Yet many companies seem to think that a blizzard of town hall meetings, one-time communications and exhortations from managers will do the trick. It rarely does. Change generally makes people anxious. A company that hopes to encourage new attitudes and actions has to address that anxiety directly and find ways to mitigate it. It must also involve the front line in creating and maintaining the change.

How to go about it? Companies that we work with often rely on tools, such as the following,

Figure 5: Changing frontline behavior poses the biggest obstacle to capturing value



Source: Bain/EIU SCT Survey, September 2011

to ensure that change becomes embedded deep within the organization:

- **Risk assessment.** Every cost-cutting initiative has its own risk profile, which occurs in predictable patterns. A risk assessment allows a company to understand its risk profile and identify the four or five risks that pose the biggest threats to lasting savings.

- **An organizational "heat map."** In its simplest version, this is just a 2x2 chart showing all the groups in the organization on two dimensions: their importance in achieving the cost-cutting goals and the degree of disruption they are likely to experience. A heat map helps management support the people most important to the success of the initiative.

- **High-velocity learning loops℠.** One telecom company improved service technician productivity by 70 percent over a two-year period, significantly reducing costs. A key to this improvement: Technicians learned every morning how they had done the day before and how they could fix whatever issues might have arisen. Their managers challenged them to get a little bit better every month and every quarter.

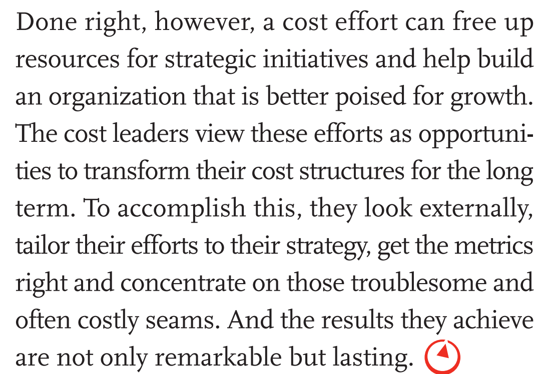
Ultimately, of course, the goal is to create an organization and a culture in which everyone understands the importance of low costs and finds ways to realize savings throughout the organization. This is essentially what happened at one leading global bank. In 2008, following a merger with a large regional bank, the CEO and his team developed a new strategy and vision for the combined companies. But funding the new strategy would require nearly $1 billion in cost savings through operational improvements. Focusing on its functions, the bank identified potential savings of $120 million in G&A expenses, $80 million in purchasing, $30

million in cost centers and $300 million in IT. Examining its organizational seams, it looked for simplification and cost-saving opportunities in end-to-end processes, regardless of which function or business unit housed a particular set of activities. This exercise turned up an additional $350 million in savings.

The bank found, for example, that its own cost for a mortgage application was nearly double what it cost at the newly acquired bank. It also found that its branch staff spent only one-third of its time devoted to customer-facing activities. Furthermore, its support functions were between 20 percent and 30 percent higher than benchmarks, and one-third of its consumer-lending products contributed only 5 percent of its revenue. The bank also uncovered "orphan costs," such as training specified by an organization, that were not accounted for in the budget. Standardizing, simplifying and rationalizing all such activities not only produced close to $1 billion in cost savings, but it also imbued everyone at the bank with a cost-saving mentality. That, people came to realize, was the key to competitive success and eventual growth.

Transform your cost structure for the long term

Sustained cost transformations are difficult, and too many such efforts fail to deliver their targets. Even when they seem successful, executives are leery: A majority of survey respondents expect to retain less than 75 percent of the savings generated in their recent cost initiatives over the next three years.



Done right, however, a cost effort can free up resources for strategic initiatives and help build an organization that is better poised for growth. The cost leaders view these efforts as opportunities to transform their cost structures for the long term. To accomplish this, they look externally, tailor their efforts to their strategy, get the metrics right and concentrate on those troublesome and often costly seams. And the results they achieve are not only remarkable but lasting.

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