SECOND QUARTER 2014

Doing more with less: driving operational efficiencies during uncertain times

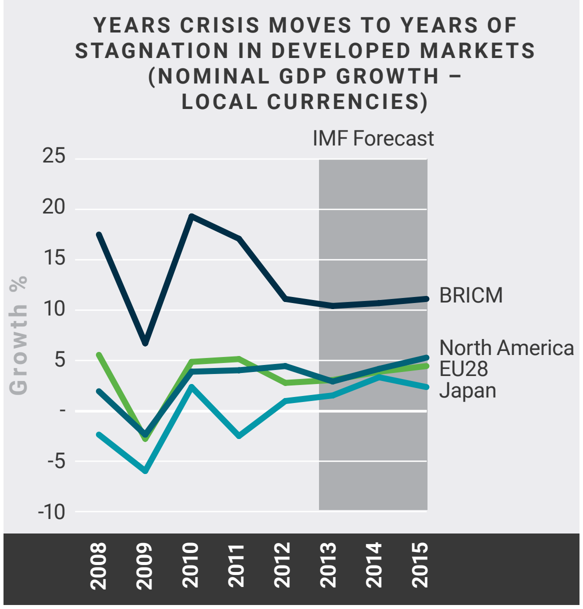
The macroeconomic environment in North America, Europe, and Japan, although recently improved, has grown more challenging and more unpredictable than ever before. Every day, companies are grappling with the continuing impact of sluggish gross-domestic-product (GDP) growth and government stimulus packages—to say nothing of weak consumer spending, persistent unemployment, stiffening competition from emerging economies, and a rash of business bankruptcies.

GDP-growth numbers alone speak volumes about the situation (figure 1). In North America, growth has remained positive since 2010. In Europe and Japan, growth plunged in 2009 and again in 2012, leveling off at 0% in 2013. Recent positive economic news aside, the International Monetary Fund forecasts those markets to remain flat going into 2015.

In such an environment, companies in developed economies can no longer rely on market and sales growth to safeguard their margins for earnings before interest, taxes, depreciation, and amortization (EBITDA), because top-line growth will remain hard to achieve in the face of the multiple forces buffeting those businesses today. To survive and thrive in this environment, enterprises must also craft and execute strategies for optimizing their sales, general, and administrative expenses (SG&A), or overhead costs.[1]

[1] Overhead consists of all personnel and nonpersonnel costs not directly allocated to a product, such as the costs of sales staff and administration staff as well as operating expenditures covering such items as information technology, insurance, and corporate policies covering, for example, travel and expenses, relocation costs, and recruitment costs.

FIGURE 1: SLUGGISH GDP GROWTH IN DEVELOPED MARKETS



Source: IMF, AlixPartners Analysis
Note: North America includes US and Canada

Overhead optimization can generate valuable benefits for companies, including the streamlining of operations, improved decision making, and setting the stage for growth. But it's more than a simple question of setting across-the-board cost reduction targets. To achieve meaningful success marked by rapid, transformational change, management should apply a more sophisticated approach that is tailored to the organization's specific structure and industry. By carefully and concurrently considering six key causes of cost, companies can achieve sustainable overhead reductions that can lead to the much-needed competitive advantage in today's unpredictable environment.

LIMITS OF TRADITIONAL OVERHEAD-COST MANAGEMENT

Traditionally, companies often take a relatively simple approach to managing SG&A costs—for example, by slashing, say, 10% of overhead across the board during periods of economic uncertainty and recession. Such a more reactive approach can boost margins in the short term, but it also comes with a number of painful trade-offs. Because that kind of cost reduction often ends up being only temporary, it is usually not sustainable; and as budget pressures ease, overhead costs tend to creep back in, often disproportionately.

Furthermore, because the cuts are typically made quickly and across the board, they can hurt the business in the mid to long term. For instance, an organization that contracts its workforce but doesn't simultaneously strengthen underlying business processes will almost surely see its selling efforts and client relationships suffer, which in turn will jeopardize revenues and thus EBITDA margins.

NEEDED: A MORE SOPHISTICATED AND TAILORED APPROACH

To succeed in a stagnating market and a business arena marked by intensifying competition, developed-market companies need a more sophisticated approach to overhead-cost management. Forward-thinking companies will tailor their overhead-management strategies to their unique situations, including their industries and histories. To illustrate, when it comes to industry, earnings before interest and tax (EBIT) and SG&A as a percentage of revenues vary markedly across sectors (figure 2).

Some industries are characterized by low profitability at the outset or have inherently high overhead costs, whereas others are more profitable even in their early stages or have become leaner in terms of SG&A over time. Still others have reduced overhead costs but also have seen their revenues shrink, which means they're running to stand still in terms of profitability. And some businesses have unusually high overheads because of their legacies of growth through mergers and acquisitions or lack of budget focus that caused SG&A costs to spike.

Moreover, depending on where companies stand in terms of their SG&A costs and EBIT as percentages of revenue, their opportunities for optimizing overhead costs vary significantly across industries (figure 3). For example, in general, businesses in industries that have both low overhead costs and low EBIT-to-revenue ratios—such as automotive, healthcare services, and aviation—have relatively less room available for further reducing SG&A costs. By contrast, those in industries with high overhead costs and high EBIT-to-revenue ratios—such as consumer products, apparel, and media—are relatively successful but could benefit from trimming some fat.

SIX LEVERS FOR OPTIMIZING OVERHEAD COSTS

To optimize overhead costs effectively, companies can pull one or more of six levers (figure 4). The challenge is to select the right combination of levers relevant to (1) the company's specific situation—based on its performance, industry, geography, and history—and (2) its ability to deliver benefits over the short, medium, and long terms (figure 5).

TAILORING OVERHEAD-OPTIMIZATION STRATEGIES: TWO CASE SUMMARIES

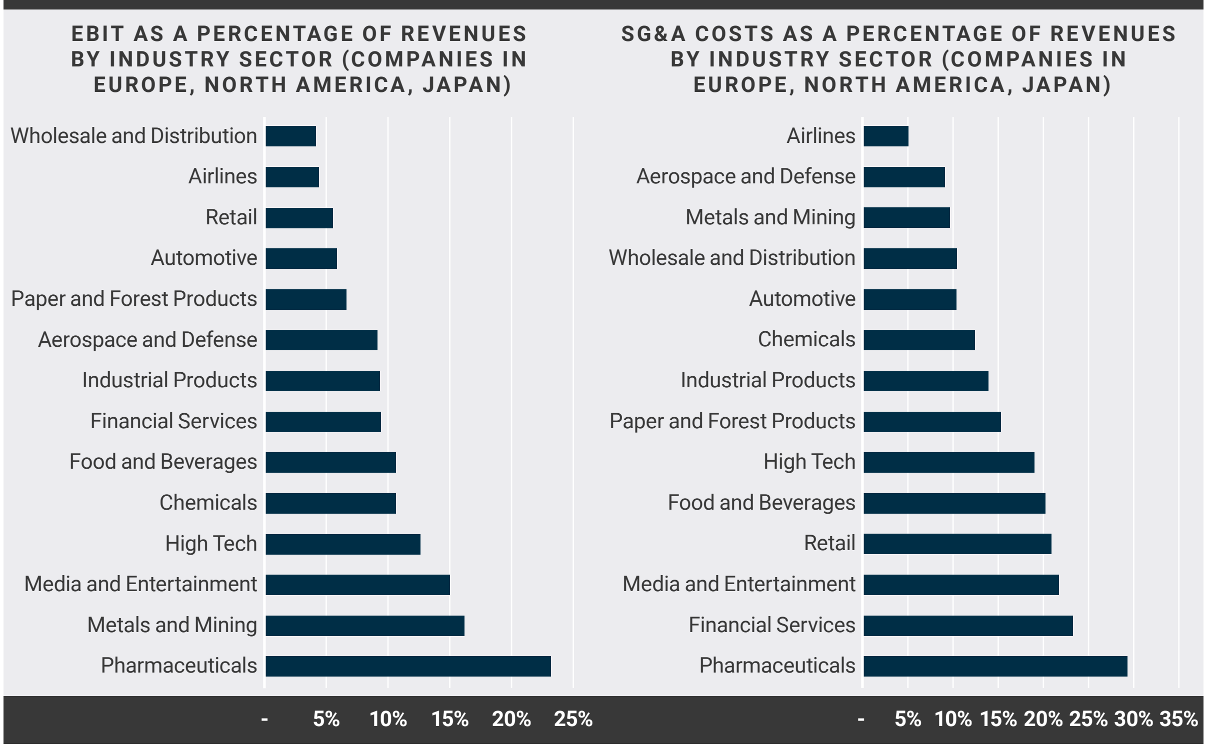
To determine which of the six levers to pull in order to optimize overhead costs, companies must assess the challenges and opportunities they face and then identify areas of spend that offer the best SG&A savings opportunities. The following case studies shed light on how two companies approached that assessment and identification process.

Global consumer goods company

The central division of a global consumer goods company took action when sales volume growth began shrinking in Europe during the recent financial crisis and analysts began predicting sluggish volume growth over the next three or four years[2]. The company was a major global player, thanks to an aggressive series of mergers and acquisitions (M&A). But that same M&A drive had also created a complex organizational structure and manufacturing footprint, leaving a legacy of several—and diverse—local brands that required managerial attention, as well as a number of acquired businesses that were still being managed as stand-alone entities, never having gotten fully integrated into the business. All of this raised overhead costs, spawned fragmentation and duplication, and eroded the company's flexibility and agility. What's more, the combination of rising overhead and a steady decline in revenues was pressuring profit margins intensely.

To reverse the situation, the company decided to focus its overhead-optimization efforts on a reconfiguration of its organizational structure. Given the company's history of M&A, company executives determined that simplifying its organizational structure, delayering its organization, and initiating immediate austerity measures would achieve indirect procurement savings and drive process efficiencies. The executives determined that such efforts would offer the greatest opportunities to make the organization more responsive and more agile and would increase the speed of decision making while at the same time target significant SG&A savings opportunities. Additionally, the benefits would be realized over the short to medium term.

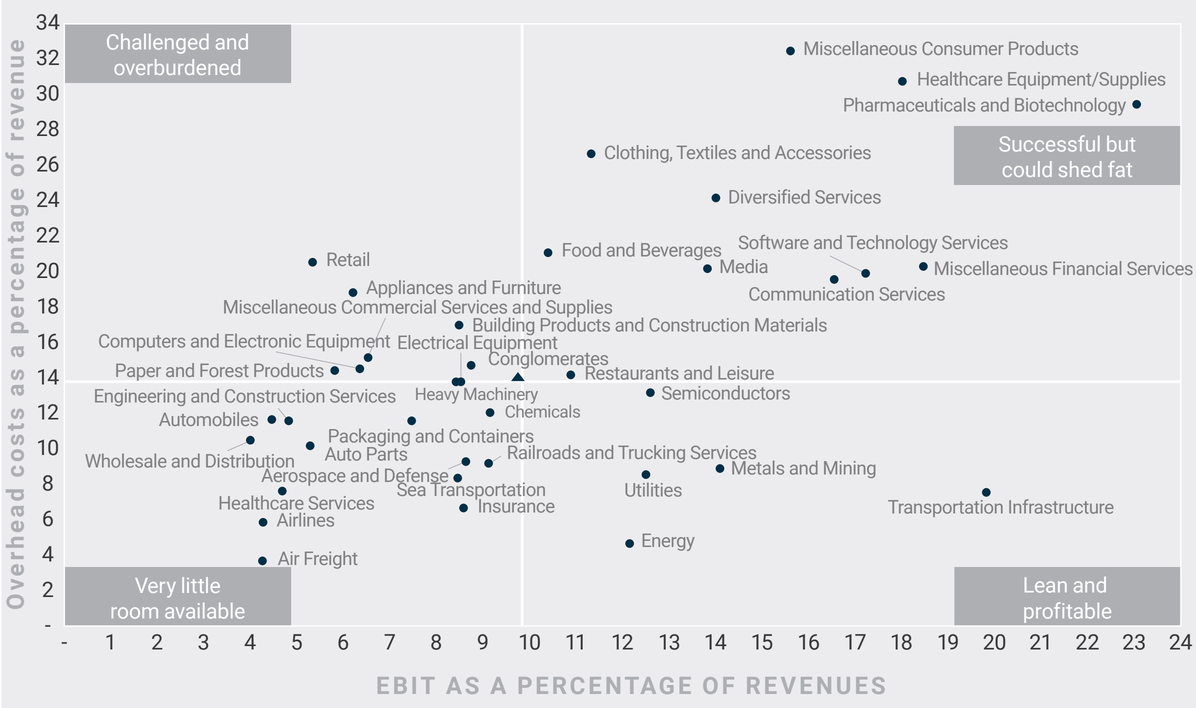
FIGURE 2: EBIT AND SG&A AS PERCENTAGES OF REVENUES VARY SIGNIFICANTLY ACROSS SECTORS



Note: The ratios outlined in this figure cover average ratios for a number of sectors and cover a large number of companies with varying individual performance.
Source: Capital IQ, AlixPartners Analysis

[2] AlixPartners experience.

FIGURE 3: OVERHEAD-OPTIMIZATION OPPORTUNITIES VARY ACROSS SECTORS



Note: The ratios outlined in this figure cover average ratios for a number of sectors and cover a large number of companies with varying individual performance.
Source: Capital IQ, AlixPartners Analysis

The company, like many others, had multiple potential axes of organization: product, geography, or brand. The company had recently transitioned to an organizational structure defined by the customer-facing brands. Profit-and-loss (P&L) accountability was concentrated at a brand level. However, that caused complications due to a wide range of local legacy brands that spanned differing product groupings and geographies. After a careful review, the executives decided to reconfigure the company's existing structure into one that would be defined by product and country groupings. In the new configuration, P&L accountability would center on a product basis.

The new organizational structure aimed at delivering overhead-cost savings of roughly €100 million annualized, derived from such gains as a significantly simplified and flatter organization with reduced complexity and redundancy and with significant process efficiencies. In addition, it promised improvements in decision making, process agility, and capabilities. For instance, managers could more quickly make decisions about operations and identify supply risks and opportunities during sales and operations planning. To improve process agility, the company could establish a uniform approach to sales force performance management as well as harmonize information technology systems and its processes for back-office activities. And in the area of capabilities, the new structure would position the company (1) to create shared capabilities at the country-cluster level and more-consistent customer touch points and (2) to increase cross-selling to retailers. As of 2013, with revenues still flat, the company had achieved its SG&A savings targets and as a result had achieved a much leaner business that was scalable and sustainable in the midterm.

Global high-tech company

A global high-tech company reevaluated its approach to overhead-cost optimization after the advent of competitive technology solutions had eroded demand for its products and put its prices under intense downward pressure[3]. Margins were suffering. The company had major offices across three regions globally, as well as a number of offices located near major customers and suppliers. To combat the macroeconomic forces affecting its business, the company defined a competitive strategy centered

[3] AlixPartners experience.

FIGURE 4: SIX KEY LEVERS TO MANAGE OVERHEAD COSTS (DEPENDING UPON APPROACH, SIGNIFICANT OVERLAPS BETWEEN AREAS EXIST)

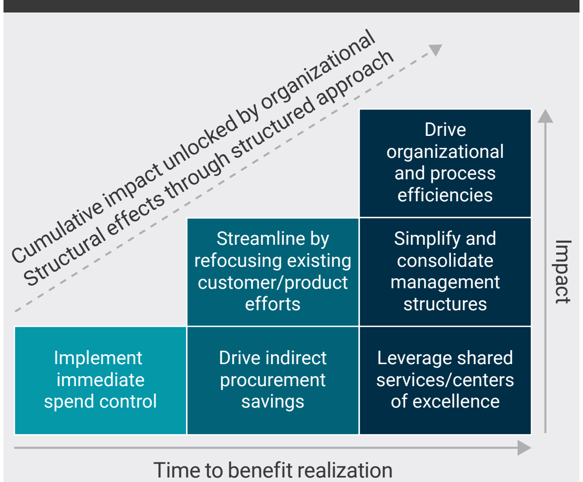
Lever	Examples of actions needed	Typical benefits range (of relevant cost category)
Immediate austerity measures	• Empower senior leadership team to review and authorize spending • Freeze hiring • Tighten travel policies • Strictly control marketing expenses	0%–5% (onetime effect)
Indirect procurement savings	• Renegotiate better pricing and payment terms with suppliers • Consolidate top suppliers across geographies • Designate one person or group to manage indirect spend • Review and challenge indirect spend across key categories	5%–15%
Refocused customer/ product efforts	• Review ongoing profitability of customers, products, markets, and channels to ensure they're covering general overhead plus incremental overhead for specific countries, accounts, and products • Terminate loss-making segments	5%–10%
Organizational restructuring	• Cluster countries with in-country operations • Consolidate multiple business areas into a few product lines or customer verticals	10%–15%
Process effectiveness	• Ensure that the right tasks (sales, R&D) are being done by the right people and in the right way • Review top- and middle-management skills, and strengthen as needed	10%–15%
Shared services	• Consolidate transactional activities into shared-service centers • Remove redundant activities and resources in such functions as finance, supply chain management, quality, engineering, and R&D	5%–10%

Source: AlixPartners benchmarks and analysis

on (1) building on its position as a leading hardware company within its segment; (2) widening its scope to include software, services, and integrated solutions; and (3) improving efficiencies in its core business.

With those aims in mind, the company crafted and executed an overhead-optimization strategy that included reducing SG&A in a number of its country operations by completing a number of complex postmerger integration activities that had never been completed, thereby aiming to achieve synergies and economies of scale, simplify and delayer organizational structure in its operations, and achieve significant cost take-out with its top suppliers while also identifying low-cost manufacturing locations globally. Additionally, a number of complex process efficiency improvement efforts were undertaken.

FIGURE 5: CUMULATIVE BENEFITS OF OVERHEAD OPTIMIZATION



Source: AlixPartners Analysis

The efforts unfolded over 2011 and 2012. By end 2012, the company had achieved SG&A savings of more than $100 million in annualized personnel costs and more than $20 million in nonpersonnel operational costs. In addition, the company is now able to report—and forecast—continued revenues and earnings increases from the end of fiscal year 2012, and its stock has more than quadrupled in value since 2011.

CONCLUSION

The macroeconomic situation in developed economies appears unlikely to improve dramatically in the near- to medium-term future. To safeguard their margins, all businesses operating in those economies need to augment their revenue-enhancing efforts by means of a sophisticated optimization of overhead costs.

Across-the-board cuts simply won't work in this environment. To weather the sustained uncertainty and volatility, companies must take a more sophisticated approach to overhead-cost management—one that examines all areas of spend and identifies where the best savings opportunities lie. The challenge is to develop the right plan: one that is relevant to the company's specific situation based on its performance, industry, geography, and history. Overhead-optimization strategies that are customized for an enterprise's unique circumstances will deliver the most valuable—and most sustainable—competitive advantages over the short and long terms. **A**

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