



KNOWLEDGE IS POWER

How to identify cost
reduction opportunities





THE SHOW MUST GO ON

It's a tough world out there. When increases in the cost of doing business – from raw materials to finance costs – combine with falling demand, the result is pressure on the bottom line.

At times like these, it's crucial to renew your focus on operational effectiveness and efficiency. Typically companies that partner with OC&C achieve sustainable savings of 15-40% of the cost base reviewed, and they continue, quarter after quarter, after quarter. Can you really afford not to attack your costs?

THERE'S NO EXCUSE FOR NOT BEING GOOD AT MANAGING COSTS



Initiating your cost diagnostic

Cost reduction is a familiar concept but it is rarely handled as well as it might be. If it is not properly run, companies find that:

- Operational activities slow or even fail
- Management lose focus on day-to-day operations
- Time and effort is wasted on doing less important tasks
- Communication within the business is damaged
- Essential processes become fragmented and disrupted
- Critical knowledge within the business is lost.

Quite frankly, there's no excuse for not being good at managing costs. That begins with understanding your cost base and where opportunities for improvement i.e. a thorough cost diagnostic lie.

An effective diagnostic identifies real and sustainable reductions in cost, not just those which will deliver a short term profits boost (although a few 'quick wins' always drop out along the way). It's crucial that you cut costs in the right way. If you don't redesign a lower cost model, all you have is fewer staff doing the same things in the same way.

You end up destroying morale, ruining customer relationships and losing credibility all for a cost base that will be back where it started within two years.

The key is the appropriate levels and focus of analysis but still delivering savings early.

There are four 'buckets' into which costs can be divided:

1. Direct labour
2. Direct materials or costs of goods sold
3. Indirect (overhead) labour
4. Third party costs

Setting the context

Before beginning the diagnostic it is useful to be able to answer the following questions about your cost base:

- What is your total cash expenditure?
- How do the various costs move with revenue?
- How do the various cost lines move with headcount?
- What are the main drivers for cost lines that move without revenue or headcount?
- What are the trends in the major cost items?



STEP ONE, STEP TWO

To avoid the common pitfalls of cost reduction initiatives, there are two critical rules to follow:

1. Focus on the right areas of the business or spend
2. Take a strategic, sustainable approach to cutting these costs

In this guide we discuss how to go about following these two rules.

THE FIRST STEP: SELECTING THE RIGHT COST AREAS TO FOCUS ON

Prioritise, prioritise, prioritise

Most organisations are complex and have many opportunities to reduce cost. They also have many managers who think that other parts of the organisation should cut costs first. Given this context, how do you decide which areas to prioritise?

Be seen to be independent. Make the process as objective as possible. If necessary, bring in a partner who has no vested interest in the outcomes. Keep an open mind.

Which areas should I prioritise?

1. Substantial enough to make an impact and warrant the time and money involved to improve things: target areas where the benefit is at least five times the investment.
2. Savings need to be achievable within a clear time period. If that period is more than two months, measurable interim goals need setting.
3. Take into account industry trends. Savings must be controllable. For example, petrol prices may be a significant component of a haulage business' cost base and increasing, but there's very little that can be done to change the underlying commodity price. However, developing more efficient drop economics, changing to more fuel efficient vehicles and training drivers to get better fuel economy are all within management's sphere of influence.

Focus on the long term goal

Businesses must adopt a pragmatic and realistic approach to cost reduction. When thinking of achievability, we focus on identifying savings that are substantial within our control and shorter term in focus.

Clearly, savings with substantial external requirements or longer gestation periods for change can have very good results. Getting rapid results to hit the bottom line help build buy-in and organisational momentum for a longer term process.

When we think about large and controllable savings, we need to look behind the headline number. In a cost diagnostic, the crucial items to prioritise are the achievable cost savings. Too many businesses focus on the absolute cost lines, and not the controllable costs. Many programmes grind to a halt because teams become demoralised and just haven't grasped this fundamental point. Likewise, smaller areas of spend may be very fruitful if changes can be made easily and quickly.



Identifying savings opportunities

When considering areas of spend where substantial savings may reside, it is critical to look behind the top line figure to get a feel for the realisable levels of savings.

There are different potential diagnostic approaches for different areas of spend and different levels of rigour. For example, top down benchmarks help focus the targets but are not exact (not like-for-like) and do not suggest how to access the opportunity. Bottom up assessments provide better foundation but take longer. Ultimately one hour of good planning often saves ten hours later.

For example, with third party costs, indicators that particular areas may present substantial savings opportunities include:

- Benchmarks versus industry norms which suggest an inappropriate cost base
- Increasing spend levels despite a flat underlying business
- Spend on similar items fragmented into many small cost buckets
- A long tail of small suppliers
- Long timeframes since the last supplier's renegotiation or tender
- Inconsistent supply prices cross supplier
- Incentives not aligned between suppliers and clients
- Complacent cultural attitude to cost management
- Lack of clear cost-focused financial controls such as purchase order control, expenses control and missing supplier contracts.

In people costs, the indicators are different:

- Low span of control, i.e. too many managers
- Productivity variability across similar functions
- Activities not valued by customers
- Too high or too low churn rates in staff
- Duplication of activity and lack of clear responsibilities
- Different and numerous pay scales for the same job functions.

There are always plenty of signs that the cost base is out of control. You just need to be aware of them.

Applicability of cost diagnostic techniques

	Primary top down			Primary bottom up		
	Benchmarking	Brainstorm workshops	Best practice comparison	Contract and sourcing diagnostic	Input/Output/Factor assessment	Market test/RFI
Direct labour						
Direct materials/COGS						
Overhead labour						
Other third party costs						

Highly applicable
 Less valuable

THE SECOND STEP: TAKING A STRATEGIC APPROACH TO COST REDUCTION

Don't be narrow minded

Once the diagnostic phase is complete, you have a great foundation for delivering large and sustainable benefits.

Having selected the areas of spend for investigation, the most common approach is to focus work on too narrow a series of levers. Such levers include:

“Can we cut staff headcount by x?”

“Can someone provide this cheaper than I'm paying today?”

“Are there any unnecessary steps that we can cut out of the process?”

“Can we cut the supplier's profit margin by y?”

“How can we cut expenses by z?”

This is not to say we should not grasp quick wins, but this type of operational cost reduction is effective at identifying 5 to 10% savings. However to realise more substantial savings, it is critical to ask a broader set of questions:

“How can I avoid or improve the process?”

“How can I alter the scope of the process and the operating model?”

“How can I alter the underlying demand that this process satisfies?”

“How can I alter the SLAs and outputs required?”

“Can I help reduce a supplier's cost base and hence their price?”

Be strategic

Why are these questions more effective than the typical questions on cost reduction? The reason is straightforward.

The further you move the discussion from 'unit costs' be they salaries or products/ services, towards more strategic process, operating model, demand and output discussions, the greater the savings available. Against savings of 5 to 10% from cost per unit discussions, we tend to see savings of 10 to 15% for process changes, up to 30% for operating model discussions and up to 100% for 'do we need this' type discussions.

What you achieve by broadening the question is increasing the scope of the costs that you can attack. Instead of limiting savings to those at the margin, the basis of the gains becomes the entirety of the process.

You should consider the inputs, outputs and process that go together to generate each cost line. This allows you to attack so much more than the price of the unit of resource employed. You can consider whether the demand that generates that cost line is being appropriately met or would a cheaper specification be sufficient? Is it really necessary at all and do customers value it?

The additional benefit to taking this approach is that it is far less likely that you do something that damages the revenue potential of the business.

There is also a culture skills and capabilities issue. The whole process of cost reduction requires skills and capabilities that are not always required in line management roles. There's little doubt that an extensive cost reduction programme requires significant analytical and programme management skills, but those required in monitoring and measuring are often overlooked. Of course, if you measure the wrong thing then you won't deliver the benefits that you want.

Culturally, it is difficult to challenge the status quo – rewarding positive behaviours can make change happen.

Finally the savings need to hit budgets and be delivered. This sounds simple but costs often just move around the organisation without appropriate monitoring and control. This will not naturally be delivered by the ERP system.



Setting the scene

When thinking about costs we find the following strategic framework useful:



**THE FURTHER YOU MOVE FROM
OPERATIONAL COSTS TOWARDS
A MORE STRATEGIC PROCESS, THE
GREATER THE SAVINGS AVAILABLE**

**EVERY BUSINESS IS DIFFERENT –
A ONE SIZE FITS ALL APPROACH RARELY
DELIVERS THE BENEFITS SUGGESTED**

A TAILORED APPROACH

The key to cost reduction programmes is delivering the benefits. Every business is different – a one size fits all approach rarely delivers the maximum benefits. The most effective way of creating success is an analytical approach, tailored to the business needs and combined with practical hands-on experience.

It's easy to maintain momentum in the early stages of a project given the excitement of the opportunities ahead. After that initial enthusiasm has worn off it's possible to slip back into the old ways. When we work with a client we create a sustainable lower cost base which ensures that the benefits of the programme stay with the business, and that the business has a platform to improve costs further going forwards.

There's no time to waste. Now is a good time to make a sustainable reduction in your cost base. It will generate benefits not just this financial year but each and every following year.

Activities to consider undertaking should not just identify the new world but should help deliver it in practice and transfer the knowledge and skills to ensure sustainability.

Multi-skill, joint teaming is critical.

An organisation, process and technology solution that delivers sustainable benefits is the necessary legacy.

THE PROOF OF THE PUDDING

OC&C have worked on cost diagnostic and reduction projects with clients across our international network. Projects include:

Leading global telecommunications player

Our client was a leading global player experiencing considerable cost pressure as the result of severe price deflation in multiple market segments.

OC&C was tasked to identify substantial revenue growth opportunities over the following three years at the same time as achieving substantial cost reductions.

We conducted a short diagnostic to identify those internal and controllable issues which could be quickly and effectively addressed. These ranged from highly business-specific costs and goods sold such as international bandwidth, through to third party maintenance contractors. There was considerable opportunity both to reduce costs and to reinvigorate sales as a result of not fully integrated acquisitions and the lack of management focus on the key drivers.

Within a month, working alongside our client, we identified 125% of the cost opportunities with which we had been targeted. Within the next month we had developed the detailed implementation programme to deliver these benefits. Over the following four months we helped our client reduce headcount by a third throughout their business units. OC&C managed the entire implementation process and ensured that savings were on track and sustainable.

Global systems operator

A worldwide leader in IT systems for the travel industry employed OC&C to cut costs as a result of a structural market change. The business had until then experienced rapid historical growth and needed a strategic review of all the major business units. This included sales and marketing, product development, operations and the corporate centre. Due to the sudden nature of the need, OC&C had to move quickly to identify major cost reduction opportunities.

Within a matter of weeks the OC&C team in conjunction with the client had identified over 100 million Euros in savings. Furthermore, we had designed an aggressive but realistic implementation plan to get the sustainable savings delivered in as short a timescale as possible. Overall we delivered a headcount reduction of 1,000 FTEs within the space of a year which accounted for a substantial amount of the cost savings. In addition, we delivered further benefits such as outsourcing of customer helpdesks and a significant range of strategic sourcing initiatives.

Leading leisure group

This major UK plc took the decision to right-size the corporate centre. OC&C conducted an in-depth diagnostic.

In the course of the work, a new organisation structure was designed involving the outsourcing of a number of functions including HR and Finance. Existing third party contracts were reviewed and, where appropriate, renegotiated. The rationale for local sales personnel and the value of loyalty schemes was challenged.

Finally, a detailed programme was developed which would result in a £25m reduction in central spend.

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