The hidden cost of doing business

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If strategy is the art of gaining a competitive edge, what's the secret of sustaining it? Consider Nestlé, Toyota, Philips, BT and Porsche, all notably well-managed companies, all examples of enduring competitive excellence. Each operates in an industry where innovations can be quickly copied by competitors. All are strategically nimble. But where they really shine is in execution. Their competitive edge is consistent operational effectiveness through effective complexity management.

Environmental issues often lead to dynamic challenges which are inherently difficult to resolve (Table I). Nestlé, Toyota, Philips, BT, Porsche and many others build reinforcing global growth engines while simultaneously managing or removing the "frictional forces" (bottlenecks within business processes) that restrict profitable global growth. Through this approach, they literally add more "fuel to the fire". Managing or removing complexity is essential to prevent a global growth engine from stalling.

Even today, many global companies dream of coming up with a brilliant new strategy that will lift them permanently above the dreary grind of head-to-head competition. Some pursue this dream like alchemists in search of the Philosopher's Stone. Yet in most global industries, new strategies are easy to emulate, if not for competitors, then for share hungry new entrants. Operational effectiveness via complexity reduction, not fancy strategic footwork, will decide who wins.

The 80/20 rule, a core concept in strategy, tells us that one-fifth of almost anything typically accounts for four-fifths of the value or cost. The message: focus on the big-ticket items and forget the chickenfeed. However, this is fatal for executives in today's complexity-driven global businesses. It is just those companies that excel in that last 20 percent that consistently make out in difficult times. The world's best companies share a single distinguishing characteristic: close and consistent attention to complexity management (i.e. "the last 20 percent"). Managers of global companies need to be skilful "putters" as well as strong "drivers".

Complexity pays?

Not so long ago, markets admired the company that could stretch its brand across everything. One of the consequences of all this activity has been an enormous increase in the complexity of their businesses which tends to increase the fixed costs of conducting their business. This complexity manifests itself in many forms affecting everything from the day-to-day operations of the business to senior management's strategic plans. Economies of scale, scope and skills appear to be wiped out by "economies of complexity".

According to a recent research study by Universiteit Nyenrode among 65 chief executives, senior managers and other corporate managers around the world, many global companies have expressed serious concerns about their capability to successfully manage complexity and, for example, have striven to simplify their business, retrenching to a stable portfolio of

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Table I From "uniformity" to "complexity" era

"Uniformity era"	*Major changes*	*"Complexity era"*
Simple business model	Fragmenting customer preferences	Increasing diversity in customer needs/wants
Limited information	Information explosion	Information overload
One-product/one-approach	New distribution channels (e.g. internet)	Multi-channel approach
Efficiency/low-costs key	New competitors (e.g. China, India)	Productivity is key
Sales-driven firm behavior	"Added" value becomes center of gravity in business policy	Stakeholder orientation
Market "available"	Cut-throat global competition	Market "searching"
Unsophisticated buying procedures	"Educated" customer/supplier	Sophisticated buying procedures

core products and processes (Box 1). Depth, rather than breadth is what many markets and shareholders crave.

For companies like Philips, single-mindedness seems to be the key to success. They prefer simple monomaniacal business models. However, others like UBS have attempted to manage complexity through information systems, advanced management structures, operational procedures, and decentralized group decision making. Only a few have come to grips with the challenge: they have learned to manage a complex business. It's a public secret that for many chief executives break-ups and de-mergers are a relief, a final chapter in a complexity reduction race.

Take Siemens. Even Siemens' managers were surprised, when they looked into how complex its global operations had become. Around the world, for example, for reasons of local regulation, Siemens was offering not one medical device (e.g. an MRI scan) but numerous versions of it. To handle all this, Siemens' back-office needed 11 different computer systems. Siemens has since launched an ambitious project to reduce its complexity by 60 percent, and to cut the number of computer systems to one or two. The goal is to save approximately $450 million a year. Global companies like Siemens have a tremendous opportunity in making quantum leaps in complexity reduction.

Origin of complexity

Complexity is a by-product of managers' daily decisions – decisions which are influenced by many factors rooted in a company's internal and external environment. But although additional fixed costs – of which complexity costs are a part – may not matter during fast growth phases, they are unacceptable in slow growing markets. Fixed costs do not decline along with sales. And the share of costs concerned here is substantial: in the course of various studies, we have found that around 25 to 35 percent of costs are complexity-driven.

Box 1 Research study

If our discussions with senior managers are any guide, there is growing conviction that superior execution skills are at last as important a source of long term competitive advantage as superior strategy. Indeed, you have to be a world class operator just to survive. There is a strong consensus across our interviewees that "complexity management" is required.

This article presents the findings of a project to study the complexity management activities and strategies of 20 global companies: Siemens (Germany), Porsche (Germany), Volkswagen (Germany), Ford (USA), IBM (USA), l'Oréal (France), BP (UK), BT (UK), ING (Netherlands), Royal Dutch Shell (Netherlands), Philips (Netherlands), Sony (Japan), Canon (Japan), Toyota (Japan), Banco Santander (Spain), Zara (Spain), Fiat (Italy), Nokia (Finland), Nestlé (Switzerland) and UBS (Switzerland).

This article is based on a survey of 65 managers of the aforementioned global companies, executed by the Center for International Business of the Universiteit Nyenrode, the Netherlands. Interviews with senior management were combined with the study of public and company files. The managers interviewed included a.o. (Executive) Vice-Presidents, Country Managers, General Managers, Managing Directors, COOs, and CEOs.

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Therefore, managing complexity is vital. The challenge for management is to effectively capitalize on complexity management.

Managerial decisions generate complexity in terms of the number of ''challenges'' that a company has to handle. Each of these can relate to either physical materials or bits of information. All of these challenges are generated by the multitude of decisions managers make every day about the company's activities.

It is often difficult for (large) global companies to make complexity cost/benefit trade-offs because their decentralized and empowered decision-making is split between many managers in different divisions or groups, business units, teams and departments. Each manager or group of managers does its best with the challenges it receives, and throws its own decisions ''over the wall'' for the next manager or group of managers to cope with. In the end, decisions are made which add complexity without creating offsetting customer, supplier or competitive benefits. It is the exponentially expanding interaction of all these strategic, tactical and operational challenges and decisions that constitutes complexity and leads to severe reductions in a company's competitiveness. Therefore, complexity management cannot be enacted by the stroke of a manager's pen. It takes persistence and perspiration on the part of everyone, all the time.

A few years ago, Boston Consulting Group (BCG) has calculated that, while market concentration in Britain, as measured by the market share of the top five banks and insurers, has risen from 22 percent in 1990 to 39 percent in 2004, banks' and insurers' expenses as a proportion of premiums have gone up from 29 percent to 36 percent. In the Netherlands, France, and Switzerland, due to a diverse array of local alliances, mergers and acquisitions, the top five controls (in 2004) a bigger slice of the market, compared to 1990, but their expense ratios, too, have risen. For banks and insurers, complexity management is an important agenda item for the years to come. Banks and insurers that can successfully manage complexity will gain a competitive edge.

The BCG results are both interesting and important for managers: the well-known experience curve phenomena (more volume leads to more experience, and, therefore, lower unit costs) could be derailed by increasing complexity. The experience curve phenomena is self limiting, i.e. because productivity growth depends on an exponential increase in volume. Sooner or later volume fails to keep up with historical productivity growth. As a consequence, productivity growth slows.

Furthermore, as the search for volume continues into ever smaller niches of the market, complexity costs rise. According to our study, complexity costs already has reversed the experience curve trend in some industries (for example in banking and the automotive sector). Some believe that the continuing evolution of technology can overcome the inherent slow down in the experience curve, but according to the research, this does not appear to be uniformly the case (see Box 2).

However, while some companies (e.g. Ford) in mature industries have suffered slower productivity growth, or even productivity decline as a consequence of increasing complexity, others such as Porsche seem to manage dramatic improvements in productivity and profitability.

In the face of growing cost problems, more and more global companies are now taking steps to identify, understand and reduce complexity costs. The good news is that excessive complexity costs can be reversed and prevented. Armed with a thorough understanding of complexity costs and with a knowledge of the critical benefits valued by customers and other stakeholders, managers have to rethink decisions in all areas of a company's value chain.

Basic approaches

There are basically two approaches to managing business complexity costs: simplification and reconfiguration. The interviewed executives and managers argue that simplification is preferable to reconfiguration but add that a combination of the two is often more effective.

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Box 2 Quotes from the executive suite

Many experts call for a broadening of businesses's strategic perspective. There is often a tendency to focus on far strategic horizons while overlooking immediate operational complexity related pitfalls (Mr M. Lafforgue, Executive Vice-President Production and Technology L'Oréal (France)).

We have to eliminate complexity as much as possible. In practice, this means that we need not too much structure and hierarchy. Too much structure and hierarchy hinders effective decision-making (Mr Dr W. Wiedeking, CEO Porsche (Germany)).

We are convinced that when business grows more and more complex, structure becomes progressively less effective as a device for unifying our global organization or insuring smooth teamwork (Mr B. Verwaayen, CEO British Telecom (UK)).

We report and continue to report on complexity. We take it very seriously. It has been given a permanent place on our management agenda (Mr C. Espinosa de los Monteros, Director Zara (Spain)).

Our management considers complexity management one of their main duties to be personally [*sic*] involved. They feel that a focus on complexity reduction contributes positively to better financial performance. It is beneficial to the bottom line of our company (Mr T. Uchida, COO Canon (Japan)).

Complexity can be reduced by discontinuing products, services and/or processes whose complexity costs are higher than the profit contribution they generate, or operationally by, for instance, increasing standardization (i.e. simplification). Zara, a global fashion retailer, headquartered in Spain, successfully standardizes most of its products (and sales, communication, and distribution strategies), except for their color, which is added at the last minute in response to the latest tastes. Focus variety on a few features seems to be the name of the game at Zara (its main European competitor, Swedish Hennis & Mauritz, follows a similar competitive strategy).

Simplification of support functions like HRM, ICT, Corporate Marketing, Legal Affairs, and Procurement can be realized through a disciplined analysis of the value of such support activities. Typically, according to our study about 20-25 percent of support costs can be saved by eliminating low-value activities. The key factor for success, however, is to ensure that new products or services (and/or business processes) are optimized *before* they are launched.

Complexity stems from fundamental causes that cannot always be eliminated. The hard reality is that the global business world in which we must work is often beyond our comprehension. However, "reconfiguration" may provide a means to seize the opportunities of complexity – opportunity to deliver greater value to trade and consumer by finer, more targeted segmentation.

In other words, we accept that some increasing complexity is inevitable in an era of disaggregation of needs and wants and we reconfigure the value chain to better handle it. According to the interviewees, to manage increased complexity through reconfiguration requires at least one or more of the following strategies: managing assets more flexibly, developing new information systems, developing people with adaptable skills, and decentralizing decision-making.

Approaches like these can substantially reduce the costs of complexity and make the revenue contributions for product and promotion variations more attractive to go for.

Simplicity is complex

Complexity is popping up on the radar screens of companies all around the world. It is a hidden cost of doing business which in many cases has created a many-headed monster for management. Mergers, alliances, acquisitions, the internet, the rise of "hot spots" like China and India and globalization in general adds to the complexity.

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Excessive complexity typically grows over many years and fossilizes into structures, cultures, systems, and personnel that are not easily altered but over time the impact on the way the company does its business can be profound. Simplification or reconfiguration to reduce complexity can have a major impact on global competitiveness by simultaneously lowering costs, improving customer benefits and cutting response times.

Coping with complexity requires continuous efforts to identify and eliminate complications that add no value. Management has to analyze the company and its environment to flush out the hidden linkages between costs, activities, and the decisions that generated them. Ideally, this complexity analysis should be extended to include major suppliers and important customers. By involving these stakeholders, the management team will not only gain a better understanding of the total industry costs of complexity, but will also win the stakeholders' commitment to, for instance, complexity reduction. ''Complexity value analysis'' has to be the name of the ''complexity management game''. The road not taken can be very expensive.

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