Want to grow the top line? Manage costs better
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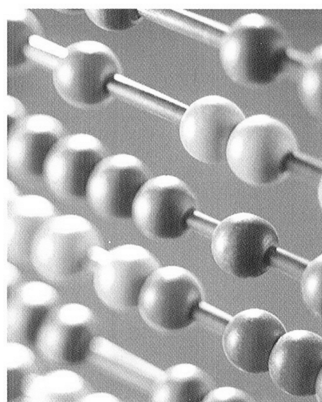
limmed down and operating more efficiently after the recent recession, many companies are looking for ways to boost sales and grow their way to higher profits. While news of this renewed focus on growth is encouraging, the reduced emphasis on cost management as part of the corporate agenda is alarming. The only thing certain about planning economic expansion is the most efficient way to fund that growth. Companies that want to grow and grow profitably must be relentless in finding ways to free up costs and capital and must reinvest those funds in their most promising growth opportunities.

One of the best examples of this mindset and approach is Wrigley, the chewing gum maker. Since the mid-1990s, Wrigley has significantly improved gross margins and overall operating efficiency. Some of the savings created have gone straight to the bottom line, but a large proportion has been redirected to increased marketing, trade spend and innovation to drive growth. As a result, Wrigley has been able to "outinvest" – and outperform – competitors. Over a six year period (1996 to 2002), the company returned 13.6 percent to shareholders (annualized) versus 5.2 percent for the global food and beverages industry.

In this article, we argue that cost management should be closely aligned with, and made an explicit part of, corporate growth strategies, for the challenge is not only to lower costs but also to ensure competitors are "out-invested" on growth (see Figure 1). We then suggest four principles for achieving this alignment. Our approach involves the use of ambitious sales and earnings growth targets, tailored cost-reduction targets, selective cost cutting and improved organizational capabilities.



Since the 1980s, cost-cutting programs have become an integral part of corporate life in the search for increased profits. Such programs have been responsible for creating heroes and villains (depending on your perspective) in equal measure. While cost cutting does lead to temporary gains in efficiency and can help companies meet earnings targets, it rarely leads to sustained improvement in competitive position. There are three reasons for this:

(1) Cost-cutting initiatives are an excellent way to enhance profits in the near term, but can undermine efforts at more durable competitive improvements. The motivation for cost reduction programs has typically been around either belt-tightening in hard times or as part of a turnaround. In either case, the primary driver has been increasing or protecting the bottom line. While this should continue to be important, cost-reduction programs in isolation are by definition a one-dimensional, short-term approach to creating competitive

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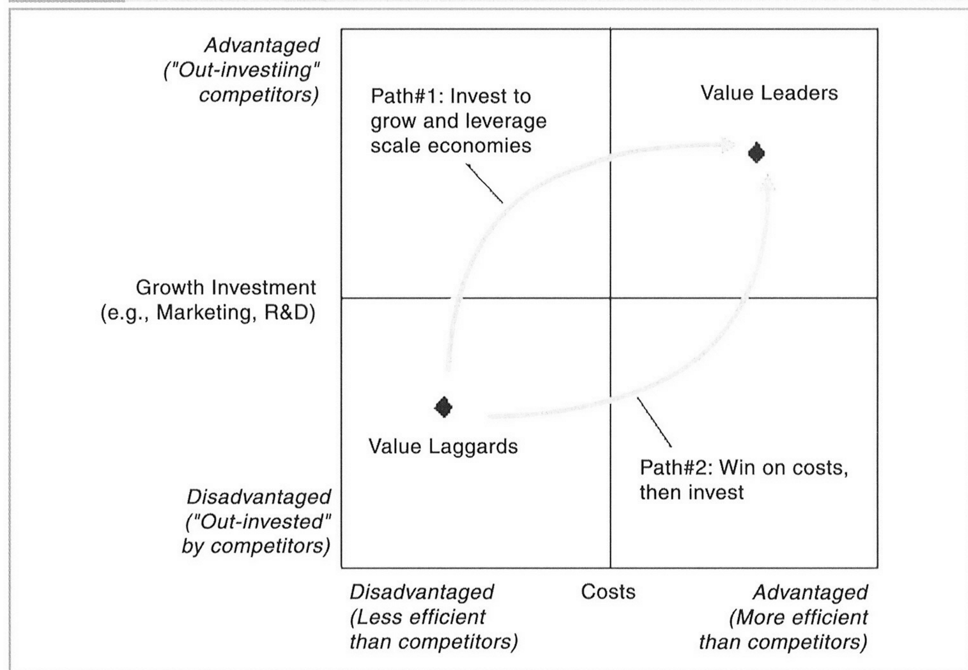
Figure 1 Aligning cost management with corporate growth strategies



advantage. They rarely fortify or improve the company's product and service offerings, as benefits go straight to the bottom line or are extracted by customers and consumers in the form of lower prices.

(2) Most cost-cutting programs are ''cookie-cutter'', taking a single target and applying cost-cutting measures across all of the different businesses in the company, without regard for the particularities of each business. When it comes to cost management, one of the most common problems is throwing the baby out with the bathwater. In an attempt to reduce costs and become more competitive, critical capabilities are lost, resulting in reduced competitiveness. The challenge is to differentiate between ''good costs'' – those that contribute to a profitable advantage – and ''bad costs'' – those that can be eliminated without reducing profitable advantage. ''Bad costs'' are likely to vary in nature and level across businesses, depending on the strategy.

(3) Cost-reduction programs are treated as finite projects rather than continuous processes. Even after successful cost-cutting campaigns, many companies eventually find that either competitors have caught up with them or costs have crept back up again, albeit often in different areas. Any competitive advantage that may have been temporarily gained has eroded, leaving the company back at square one and facing the prospect of another painful round of downsizing (to relieve the relentless pressure from customers and consumers to extract ever greater value). Embedding improved and continuous cost management into the organization is therefore just as important as implementing aggressive cost cutting. The organizational advantage derived from the former is more permanent and ultimately limits the need for repeated, large-scale efficiency initiatives.

In our work with a number of companies on cost management issues, four principles have emerged for aligning cost management with strategies for top-line growth. Using a global consumer goods client as an example, we can examine how one company successfully acted on these principles.

Principle 1. Use ambitious sales and earnings growth targets to motivate the need for, and commitment to, growth-oriented cost management.

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Most companies do not see cost management as linked to corporate strategy, much less a platform for growth. This was the case at a consumer products company. While historical earnings growth at the company had been solid, sales growth had been modest at best, and a step change in performance was required in both areas. So senior management announced extremely challenging top- and bottom-line targets to impress upon the company the need to take a different approach to cost reduction. The businesses would only be able to achieve earnings growth of the desired magnitude by cutting costs and increasing sales, thus forcing the need to make a connection between the two.

As it happened, a close examination of an important business unit showed that a high overhead cost base was limiting the amount of funds that could be invested in growth. Competitors with more efficient cost bases were able to achieve similar or higher levels of profitability while out-investing the company in areas such as trade spend, marketing and innovation. A similar picture emerged across the company – consistent underinvestment in growth compared to competitors and significantly higher overhead and SG&A costs. While on the surface the bottom line was holding up, the way it was being earned was limiting top-line growth and would erode the business position over time.

To some extent, the understanding that the business was cost-disadvantaged in such areas as manufacturing overhead and SG&A was not new. However, the urgency and consensus for addressing the situation did not come until high sales and earnings targets had been set. Management quickly realized that to meet these targets, it would also have to address its growth investment disadvantage; some costs would have to increase, funded by savings elsewhere. The end result was the creation of a global cost-reduction program applied across the group and championed by the senior leadership team.

Principle 2. Tailor cost-reduction targets to the existing cost position and strategy of each business.

It is one thing to set ambitious earnings growth targets to motivate line managers to cut costs for growth, but it's another to decide what percentage of those earnings will come from cost cutting and what percentage will come from top-line growth across different businesses.

In addition to "top-down" earnings growth targets set by senior management, three other factors should be taken into consideration when setting cost-reduction targets for any business. These factors should be balanced, and no single factor should take precedence over another:

- How do the cost levels compare to cost levels for other businesses within the company?
- How do cost levels compare with those for competitors?
- What level of costs will be necessary to support projected growth rates and ensure that the business is not "out-invested" on growth by competitors?

At the consumer products company, management wanted to reduce overhead costs by 10 percent but could not issue an across-the-board cut. The variation in business models across the group meant that the baseline costs were very different. And the proposed growth paths for the different businesses also meant that the target cost levels would be quite different over time. As a result, tailored goals were developed for each major business (see Table I). While different for each business, these goals were equally difficult given each business' current position.

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Table I Tailored cost targets

	Business unit 1	*Business unit 2*
Current SG&A costs ($)	100	100
Current SG&A costs (% of sales)	25	35
Year 4 sales growth target (%)	10	5
Year 4 SG&A cost target ($)*	100	85

Note: * including impact of inflation

Principle 3. Differentiate between "good" and "bad" costs.

The most important part of our approach to growth-oriented cost management begins once earnings and cost-reduction targets have been set. The challenge then becomes how to reduce costs in such a way that critical capabilities are not lost, resulting in reduced competitiveness. Differentiating between costs that are currently contributing to profitable advantage, or will in the future, and those that can be shifted from unproductive areas to growing, profitable areas of the business is key.

At our consumer goods client, where the focus was on SG&A expenses, management did just that. Executives asked themselves, which components of SG&A were critical to existing competitive positions? Which were not? Could expenses related to supporting the sales force be reduced? The finance and accounting function? Human resources? Central staff? What would the impact be on the current earnings stream, and what benefit may be realized from reinvestment? This ensured a far more strategic approach to identifying cost-reduction opportunities. It resulted in a wide-ranging set of cost-cutting initiatives coordinated within a single multi-year plan. Together, these initiatives trimmed overhead by more than 10 percent and moved the business costs in line with peers while creating significant funds for reinvestment in growth. The ideas and detailed plans were driven primarily "bottom up" from the businesses, ensuring ownership from those who would ultimately have to produce the savings. This also built confidence at the center that the plans would be delivered.

Principle 4. Create the right conditions for ongoing cost management.

Making changes to management processes, organization and capabilities is often a prerequisite for continuous cost management. At our client, this was achieved in a number of different ways. First, the company created a more granular financial reporting system that provided detail on specific cost areas within each business. Second, management introduced new metrics for monitoring both overall cost performance and specific initiatives in order to prevent "squeezing the balloon" – that is, driving costs out in one area only to have them reappear in another. Third, it created a central "cost group" under senior leadership to complement executive ownership within the businesses. This group had representation from both central functions and the major businesses. Its mandate: to manage delivery, challenge individual businesses to identify further savings on an ongoing basis and facilitate the sharing of best practice across the company.

In the end, managing costs for increased growth means finding the right balance between top-down directives and bottom-up initiatives. Senior management provides a focus and a rallying cry – in the case of some companies it's higher earnings or higher economic profit. But line management provides the "scalpel" and is able to wade through the details of the business, differentiate between good and bad costs and weigh the trade-offs between different cost reduction options. Ultimately, however, the most essential element in getting cost management to be effective and stick within an organization is the link to growth, giving cost reduction a clear and agreed role on the growth agenda so that it drives both top- and bottom-line performance.

Keywords:
Costs, Cost reduction, Capital growth, Corporate strategy

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