Smart Cost-Cutting
Sustainable restructuring for small- and medium-sized companies
The current economic crisis, and the speed with which it gained a foothold, caught many companies by surprise. Even as long-term forecasts point to a reviving global economy within the next few years, many managers remain worried about their short- and mid-range prognoses. A sustainable restructuring plan can help reduce the uncertainty in the near future while preparing to take advantage of opportunities in the longer term. Using our approach, small- and medium-size companies can outline potential scenarios, improve cash flow quickly and implement a corporate fitness program.

The global downturn has hurt almost every sector, and the sudden drop in demand and sales has been especially menacing. As almost all companies focus on reducing costs, only a handful have done so systematically enough to make a lasting impact. Most firms are conserving capital and controlling expenses in the most obvious areas—cutting back on equipment investments, reducing marketing and IT spending, selling assets, drastically cutting inventory levels, freezing salaries, reducing administrative costs, and eliminating all unnecessary staff, travel and training.

No doubt, these are all necessary measures that clearly boost a company during a recession, but most are implemented too narrowly and will have little effect on growth or prosperity when the crisis is over. Successful change requires tackling the challenges of the current situation while creating future opportunities.

For small- and medium-sized companies to meet these challenges, we recommend a smart cost-cutting approach called sustainable restructuring. There are three pillars to this approach: know all possible scenarios, ensure a healthy cash flow, and shape corporate fitness for the crisis and beyond (see figure 1 on page 2).

No one can say exactly how long the crisis will last, or what dangers lurk in the future, but good managers prepare for all possibilities.

Know all Possible Scenarios
Scenario planning recognizes that the economic crisis will have a different impact on different companies, their value-chain partners and competitors. By involving all of a firm’s stakeholders in outlining possible scenarios, companies can prepare for the worst while avoiding surprises and roadblocks that can lead to hasty, unpopular decisions.
The following are steps we suggest to our clients when they engage in scenario planning. It usually takes about four weeks to complete.

**Develop the scenarios.** Many of our clients are struggling in this economic crisis as banks resist loaning money, investors demand no-risk business cases, suppliers delay orders and customers hesitate to order in advance. By developing scenarios, all stakeholders have a clear, documented vision of the future and the concrete steps necessary to get there. We typically use the following three scenarios when preparing for potential problems:

- **Staggering loss of sales.** This is characterized by a sales drop of 20 percent or more, often caused by a general decline in customer demand or a sales hit in a few markets or product segments. Lost sales mean less purchasing muscle and the need for temporary labor and cost reductions as companies struggle to break even.

- **Black eye.** In this case a recession hits all relevant markets and product segments. Sales tumble dangerously, by as much as 40 percent, led by the departure of main customers. As the balance sheet falls into the red, the knee-jerk reaction is often to stop all innovation projects, partially halt production lines, cut salaries and bring in temporary workers.

- **Business inferno.** Sales collapse by 60 percent or more, bottom-line losses are staggering, cash flow is problematic or nonexistent, and fixed costs can’t be covered. At this point, companies often call for government help or major cash infusions on equity and debt—the recent events surrounding the U.S. automakers are a good example. A business inferno is usually caused by a severe recession and a complete collapse of primary markets and customers. Facing such a crisis, companies are forced to sell assets and lay off large numbers of employees.

**Perform a segment analysis.** In all three scenarios, an analysis of market segments is used to evaluate the effect of the scenario on corporate strategy and market positioning. It serves as a stress test to help make the right choices. There are three steps to this analysis:

- **Assess market segments.** Re-evaluate the attractiveness of major market segments. Are you protected against potential competition? Do you expect regulatory changes that would change the face of competition?

- **Review positioning in relevant segments.** Examine the impact of the crisis on consumers, competition and the competitive landscape. How would a price change affect how customers see your company? Is consumer behavior shifting in some segments?

- **Test strengths and weaknesses.** Amid all these changes, strengths and weaknesses will be affected. Are your current strengths sustainable in light of
the crisis? Will it be necessary to develop new strengths to participate in new segments?

Gauge the impact. A primary goal of scenario planning is to understand the impact of each scenario on innovation, purchasing, production and logistics. Determine where the crisis is hitting the company hardest and which areas you should focus on to minimize risks and capture potential opportunities. Reduce costs in non-core areas but keep crucial capabilities intact.

Think beyond your company’s four walls. For each major cost area, assess risks in each of the three scenarios, weigh your ability to adapt, and determine the right actions to address the risks (see figure 2).

Identify new opportunities. Evaluating risk is important, but you also want to identify new opportunities that will emerge. By doing this you can escape the general downward trend that comes from decreasing demand, overcapacity, falling prices and profits. There is no better time to identify and push promising new ideas and activities than when your competitors have stopped doing any of that. With select investments, companies can establish an advantage in terms of know-how and time-to-market relative to their competitors, with the goal of capitalizing on the opportunities when the crisis passes. For example, you may consider pursuing an innovative process at the same time competitors are
freezing their innovation budgets. Furthermore, if partners in innovation are under pressure brought on by the crisis, it is a good time to re-negotiate cooperation contracts with new terms and new partners.

This thinking also applies to labor-intense segments where the crisis can present an opportunity to get a more flexible workforce. In production, for example, a crisis is an opportunity to establish new standards, improve the logistics footprint and consolidate facilities. All procedures that fall into the “we’ve-always-done-it-this-way” category are now subject to change.

Ensure a Healthy Cash Flow

The second pillar of our sustainable restructuring approach focuses on capturing immediate savings and cash flow opportunities by reducing operating costs and net working capital and restructuring liabilities. Figure 3 shows the links between these areas and the economic earnings of a company based on a value creation model.

There are seven steps to securing cash flow, a process that takes about eight weeks:

- **Reduce net working capital.** Inventory management, decreasing accounts receivables and increasing accounts payable are proven steps toward reducing working capital. A best-practice benchmarking initiative will indicate the potential advantages of increasing working capital.

- **Reassess planned investments.** Map investments according to their strategic and financial justification and, depending on the scenario, adapt, postpone or cut individual investments.

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**Figure 3**

To improve cash flow quickly, reduce operating costs and net working capital

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Source: A.T. Kearney analysis
Audit cost center budget. This audit is conducted in three steps: reviewing underlying business and scenario planning, analyzing cost positions and recalibrating budgets.

Find quick wins in purchasing. Assessing sourcing will help identify costs and uncover savings potential such as reducing the cost of materials and complexity.

Reduce flex workers and freeze hiring. Beyond simple workforce reductions there are other tools to reduce surplus, such as redeploying workers to other areas and reducing work hours.

Examine IT development. When improving IT costs, the focus is on: technology architecture and lifecycle analysis, service and application processes, total infrastructure costs, and overall operations and strategic IT sourcing.

Restructure debt. In restructuring debt, the challenge lies in finding the right balance between financial engineering and obtaining

Companies have several options for debt restructuring, differing in liquidity impact and money requirements (see figure).
1. Debt buyback. Purchase debt at a discount to reduce cash drain by cutting interest charges and repayments. A German media company did this successfully, buying back a significant amount of its senior debt in the past several years.

2. Recapitalization and refinancing. Develop a new capital structure based on assessing the company’s business plan. This should take into account debt capacity and conditions, and cash flow profile. A leading Brazilian telecommunication firm completed a $500 million debt recapitalization in 2006 that provided the company with greater flexibility to deal with future economic changes.


4. Debt conversion. Recalibrate capital structure with debt-to-equity swaps. This is often done in the case of fundamental deleveraging due to underperformance. A Spanish real estate company sold a 55 percent stake to a consortium in exchange for canceling almost $3 billion in debt.

5. Deleveraging M&A. Dispose of or divest non-core assets, depending on the transaction type. For example, in 2006 a global automaker began the divesture of its financial service business. The company is expected to make similar reductions due to the current crisis.

Figure: Options for restructuring debt
a quick impact that can lead to recovery. Short-term wins are likely to be realized by resetting covenants, exercising equity cure rights, or simply taking advantage of the existing headroom in loan documentation.

To succeed in the long term, however, it is essential to think in terms of the bigger picture. Financial modeling, for example, is crucial to understanding the company’s future cash flow profile and its potential financing needs. There are several options for restructuring debt depending on the company’s current financial situation (see sidebar: Restructuring Debt for Long-Term Success). All of these debt measures have one thing in common: The challenge is in the execution. Creditors have to be convinced to agree on new conditions and equity owners have to reinvest in the company. That can be a hard thing to communicate in shaky conditions.

**Shape Corporate Fitness for the Crisis and Beyond**

Incremental improvements will not carry a company through a crisis. Planning for the worst and saving cash offer meaningful hints of what must happen over the medium term to survive the crisis. However, sustainable, ongoing change requires high-impact actions that maximize the benefits and build momentum for change. A corporate fitness program does just that, helping you reach sustainable cost competitiveness by taking out unnecessary costs while strengthening key value-adding activities. A corporate fitness program consists of the following steps, which can take eight weeks to perform:

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**In a Hurry to Capture Tangible Results?**

Considering the magnitude of the current financial crisis, companies are often in a hurry to capture tangible results. As such, the focus should be on deploying resources and optimizing current assets and investments, while also examining the overriding corporate strategy. All short-term measures are tailored to this strategy (see figure).

Our approach examines various measures, from hands-on to complex, that can improve liquidity and profitability, and reset and strengthen the company’s strategy. These measures are classified based on their main focus and on their time-to-impact, and then categorized to either improve liquidity, profitability or strategy.

**Figure: Improvement measures range from hands-on to complex**

<table>
<thead>
<tr>
<th>Main focus</th>
<th>Strategy and sales</th>
<th>Liquidity and efficiency</th>
<th>Time to impact</th>
</tr>
</thead>
<tbody>
<tr>
<td>Immediate sales push</td>
<td>Dual impact pricing</td>
<td>Products and services: refocus and new products</td>
<td>Growth program</td>
</tr>
<tr>
<td>Customer retention</td>
<td>Reduce overhead</td>
<td>Improve business processes</td>
<td>M&amp;A and alliances</td>
</tr>
<tr>
<td>Capacity adjustments</td>
<td>Supplier de-risking and collaboration</td>
<td>Supply chain optimization</td>
<td>IT management</td>
</tr>
<tr>
<td>Securitization of financing</td>
<td>Reassessment of investments</td>
<td>Fast-track material cost reductions</td>
<td>Complexity reduction</td>
</tr>
<tr>
<td>Stabilize liquidity</td>
<td>Reduce net working capital</td>
<td>Fixed assets: focus and divest</td>
<td>Efficient (lean) production</td>
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<tr>
<td></td>
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<td></td>
<td>Shared services and outsourcing</td>
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**Measures aimed at improving:** Liquidity □ Profitability □ Strategy □ Source: A.T. Kearney analysis
**Set targets.** Establish a baseline view of the company’s situation by identifying and analyzing the main cost drivers. We use a benchmark database that comprises data about more than 32,000 companies, combined with hands-on experience to set targets, develop hypotheses and identify improvement opportunities.

**Assess opportunities.** Workshops and interviews with key managers will help validate the hypotheses and identify gaps. After the managers have come to a consensus, workshops can be broadened to include other stakeholders such as department heads, experts and employees who can help outline ways to close the gaps and determine necessary actions. Hierarchy is not relevant in these workshops as everyone is encouraged to question old beliefs and make decisions based on facts and logic. The goal is to identify and prioritize potential actions and set out short-term plans to realize them (see sidebar: In a Hurry to Capture Tangible Results?).

**Prepare for implementation.** Delineate the business case for each improvement opportunity and prioritize rollouts to capture quick wins and realize the full cost-reduction potential. To secure commitment and ownership, agree on implementation plans with all responsible line managers and budget holders. All project and line managers should be clear on targets, remodeling actions within units, efficiency improvement areas and precise responsibilities. Process champions, project drivers and line managers are all responsible for implementing the measures, realizing the potential and keeping executives and the workforce up to date on their progress. Tangible results can be used as a basis for communications with vital stakeholders within and outside the company.

**Implement the plan.** Implementing a corporate fitness plan should take into account the financial impact and ease of each action, tracking mechanisms and monitoring tools. Appointing program managers can steer the transformation and ensure that agreed upon milestones are met and savings are captured.

A corporate fitness program is compelling because it is based on a broad master plan, designed for fact-based discussions about setting priorities and allocating resources. In this way, internal political fights and disagreements can be kept to a minimum.

One major success factor is involving all relevant managers and internal experts to perform a quick top-down assessment to identify the main performance gaps and roadblocks. Don’t waste time explaining the company’s unique situation—in comparing your company to peers and best-practice firms, there are indisputable places to improve. There must be agreement among top and middle management about which gaps to close and how quickly to close them.

In the end, the corporate fitness program mobilizes a company for improvement. The single master plan reduces unnecessary costs and processes, assesses and prioritizes opportunities, and creates an implementation roadmap for a strong return on investment.

**Building for the Future**

The current crisis caught a lot of companies off guard, but the opportunity to preserve the business today and become stronger for the future has not passed. With a sustainable restructuring plan, it is possible to counteract the risks of the current crisis while preparing to exploit new opportunities when the recession ends. As the crisis “normalizes” the value of companies, there is an opportunity to strengthen business segments poised for growth, and acquire attractive targets with the funds released through smart cost-cutting.
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