



Worth Noting

Volume III, Issue XVIII, 20th August 2003

Worth Noting is the fortnightly management journal of research and conferences company L21. It is focused on management strategy issues of relevance to senior executives.

A growing number of analysts have expressed concern with continual rounds of cost cutting and reductions in corporate Australia. Comments have ranged from “there are no real winners in cost cutting programs” to “the only people who gain are cost cutting consultants” while phrases such as “slash and burn”, “bleeding dry”, “corporate anorexia” and “squeezing the pips” have all been used to characterise cost cutting programs.

There is no doubt that many ASX 100 listed companies that have done well in share price over the past 18 months have undertaken swift cost reduction measures. Woolworths and the major banks are prime examples.

There is also no doubt that several companies that have done well in terms of reducing costs have NOT done so well in terms of their share price. Telstra would be the best example.

So is cost cutting merely temporarily hiding bad corporate performance or is it the fabled tonic for companies during downturns?

Some put the current ‘obsession’ with cost cutting as a result of the growing influence of business economists who are obsessed with economic efficiency. They have, as it were, stolen the stage from those economists more interested in economic growth.

This, according to some, places management in a seductive and ultimately dangerous trap: Having been seduced by the 'efficiency' economists' and their dogma, management teams exacerbate the pressure to engage in a seemingly endless cycle of more cost reduction that further reduces the company's capacity for future economic growth.

The assumption is that shareholders in the medium to long term reward sustained *wealth creation* by companies by supporting the price of the company's share at higher and higher prices. The obvious concerns then are two fold. First, current solid results from the main companies have largely been the result of cost cutting rather than revenue growth. And second, the emphasis on cost cutting potentially reduces the company's capacity to achieve revenue growth in the future. In other words, the drivers of wealth creation have been stymied.

Let's flesh these arguments out a little more.

The key is wealth creation. Simply put, the investor's objective is to get a return on the investment. This is nominally through an increase in the share price (if it is a listed company) but for private companies and for listed companies in the medium to long term, the key is an increase in earnings and net profits.

The argument against cost cutting strategies then becomes clear.

Cost cutting delivers an instant hit for the bottom line. We might be producing the same, selling the same and so on, but our costs are lower ... hence immediate net profits are higher.

However, critics will argue that this is not sustained wealth creation because cost reductions cannot continue forever. Without real revenue growth, costs must be significantly cut every year to maintain performance. At best, we hold the wolves at bay for another year. But at worse, according to critics of cost cutting programs, it could be very bad...

It seems that one time zealots of cost reduction programs are coming out of the woodwork to confess their recent sins. One such person is Stephen Roach, Morgan Stanley's chief economist who was recently one of the strongest proponents of downsizing and cost reduction initiatives in the U.S. Where not so long ago, cost cutting was a top defensive move, now, according to Roach, open-ended downsizing is a recipe for corporate extinction. This is, according to the argument, the case for several reasons.

1. Cost cutting often focuses on lowering the numbers of staff employed. In the short term to medium term, this leads to low morale and overworked staff, a culture of wariness towards management, high employee turnovers and resulting costs in training new staff. In the medium to longer

- term, we lose many of our assets essential for future growth in terms of expertise and manpower.
2. Cost cutting might lead to reductions in the service we offer to our customers and clients, leading to losses in company reputation and brand.
 3. R&D and executive training budgets are often the first areas to be cut. Countless studies in the U.S. and in Australia (e.g., American Management Association; Profit Impact of Market Strategy (PIMS); Workplace Change NSW) have shown that innovation and R&D are key drivers in long term revenue growth of major companies.

Cost cutting has led to some winners while the initiative has also led to others seriously damaging their capacity to survive and grow long term.

In our view, the question is not whether to cut costs or not to cut costs. It is more a matter of 'why' we are cutting costs, which in turns determines the 'what' to cut. Any company can cut costs but that doesn't mean it gives them a competitive edge. Similarly, to say that 'cost cutting' is not the solution during downturns also lacks rigour as to be practically meaningless.

Take Telstra as an example. Since 1999, the company has been undertaking an ambitious cost cutting regime. About a billion dollars of costs have been cut in a couple of years and its workforce has almost halved. Yet, Telstra's share price has fallen during this period to historical lows. Why haven't shareholders and analysts responded to the tangible savings made by Telstra?

The problem seems to be that there is no strategic or overarching framework directing the cost reduction programs. Terms such as 'slash and burn' to 'bleeding dry' have been used to describe the Telstra policy. Analysts have instead called for restructuring of Telstra's business units into more manageable parts etc., rather than just indiscriminate cuts.

In contrast, take the major banks in Australia. Banking is an increasingly mature industry and it is difficult to achieve growth without cutting costs and rationalising. Over the past few years, all major banks have closed branches, retrenched staff and outsourced part or all of their IT divisions – most of it to acclaim by shareholders and analysts. The result have been a general upwards trend in their share price.

As we mention, the key is 'why' cost cutting has occurred in these companies. With respect to Telstra, the perception was that an increasingly inefficient company where spending had blown out felt the need to drastically cut costs in order to rescue the immediate bottom line. Hence, the easy targets were sacrificed - mainly staff. The perceived problem is that this reduces Telstra's capacity to take advantage of future developments in the fast moving telcos industry due to a dramatic loss of expertise and manpower.

In the case of the major banks, and companies like Woolworths, cutting costs was not merely about making ad hoc savings here and there without regard for the future. *It was about improving margins and leveraging off improved margins as a source of future competitive advantage.*

Hence, Woolworths 'Project Refresh' – the streamlining of its supply and distribution chain – was not just about achieving immediate cost savings. It was about using innovation and technology to become the most efficient retailer which in turn positions the company for future expansion. Similarly, the major banks were focused on identifying areas of strong and weak margins and cutting expenditure in the latter – not simply saving money in any way possible. It is true that the banks, in particular, cannot rely forever on their present mode of cost cutting – branch closures, retrenchments etc – but this is a different argument from saying that cost savings from these initiatives have up to now been ill advised. It may be that banks can reach the point where further substantial cuts in these areas would actually damage its framework for growth but that is another issue.

What is worth noting is that cost cutting should not be seen as the last resort of increasingly desperate companies but as a strategic tool to gain present and future competitive advantage. Moreover, viewed in this way, cost cutting is not a move that is opposed to future revenue growth but an initiative that can support future revenue growth and wealth creation.

In this sense, we believe that critics have been too indiscriminate in criticising the 'obsession' with cost cutting in corporate Australia. There is never a bad time for cost cutting – there is never a bad time to improve margins or get rid of poorly performing staff. There are only bad ways in which management choose to cut costs.

Indeed, companies that only start to think about cutting costs when times are tough are generally close the gates only after the horse has bolted. By then, cost cutting becomes not so much a strategic but a desperate measure.

Not surprisingly, more enlightened executives and analysts are increasingly speaking the language of cost cutting within a framework for future growth, for example:

- "Cost cutting through a return to the core"
- "Restructuring the drivers of costs"
- "Merging cost control with growth strategies"
- "Using efficient cost structures to drive profits"
- "Maintaining cost discipline in complex operations"

The point is that for successful companies, the question is never about ***whether*** to cut costs or not; it is ***why*** we cut costs.

Once we have a framework within which sensible cost cutting should occur, we can then look at the nuts and bolts of how and where we should extract cost savings.