FIT for GROWTH

A GUIDE TO STRATEGIC COST CUTTING, RESTRUCTURING AND RENEWAL

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What is currently inhibiting your company's ability to grow? Is it simply the global economic headwinds all companies are trying to navigate? Or is it rising consumer expectations? Digital technology disruption? Increased regulatory scrutiny? Competitive pressure on margins? Commodity volatility? Or has an activist investor just taken a substantial stake in your company and demanded immediate and drastic cost savings?

It doesn't matter. The effect is the same. Whether they're trying to jump-start flattening revenues or facing imminent bankruptcy, companies across industries and geographies are realizing that the only way to unleash growth—profitable growth—is to cut costs, often dramatically. In the globally interconnected, digitally disintermediated market in which all enterprises operate today, there is no safe harbor when it comes to the bottom line. To protect and bolster it, companies need to focus on managing costs as rigorously as they concentrate on growing revenues. In fact, as with any living organism, there is no profitable growth without equally robust pruning.

Welcome to the New Normal.

So, are you fit to weather this tough competitive environment and come out ahead? We've devoted 70 years of collective experience to helping dozens of companies answer this question affirmatively: Are *you* Fit for Growth?

To be *fit* in this way means to be prepared as a growth enterprise. This is not just a matter of innovation prowess, entry into new markets, or acquisition savvy. It means to have your resources, and thus your cost structure, aligned to your company's overall strategy—deployed toward the right businesses, initiatives, and capabilities to execute your growth agenda effectively. Fit for Growth companies have the right amount of resources they need to compete effectively—no more, no less—at the right places. As we noted in the Preface, companies become Fit for Growth by doing three things consistently and continuously:

1. They focus on a few differentiating *capabilities*.
2. They align their *cost structure* to these capabilities.
3. They *organize* for growth.

To focus on a few differentiating capabilities, you must build a clear identity for your company, based on the things you do better than any other company. These differentiating capabilities—the three to six combinations of processes, tools, knowledge, skill, and organization that enable your company to outperform—are at the heart of the Fit for Growth approach. When you know what your company does well and base your strategy on it, it gives you a "lighthouse": a clearly defined, focused goal that everyone in the company can see that directs them all to fulfill the same objectives. In such companies, employees know what drives the company's strategy; indeed, outsiders know, too.

But too many companies have *not* achieved this focus, and you can generally tell by the distractions endemic to working there. Too many initiatives clog people's calendars. Managers go to multiple meetings on unrelated topics every day. The best talent is tasked on so many high-priority programs that they are burning out. The distractions drain financial resources as well, so it's no wonder that these companies routinely underinvest in the activities unique to their enterprise, where they have begun to build a distinctive edge.

If a company's cost structure is *not* aligned to the company's strategy, its leaders will base their spending on other factors—generally to the company's detriment. We often see companies struggle this way. You can spot them because of symptoms like these:

- They use benchmarking as a way to make allocation decisions. Every function from marketing to HR to risk management is pursuing an excellence agenda, spending significant money to be "best in class"—better than other companies, whether or not those functions are strategically critical to the company.
- Legacy programs with little impact continue to get funded—becoming self-sustaining organizations in their own right—while priority growth initiatives cannot get off the ground.
- The budget process is basically "last year plus 3 percent," and staffing levels are out of sync—they might have twice as many finance people counting the money as sales people bringing it in, for example. Every couple of years, they go through a "fire drill" cost-cutting program to reduce overhead, and then watch the costs steadily creep back.

Last, if a company is *not* organized for growth, inefficiencies proliferate and decision making becomes uncertain. The internal bureaucracy is so cumbersome that it takes a week to get a sales quote approved; meanwhile your competition wins the business. Decisions made weeks ago still have not been executed and, worse, frequently come back for reconsideration. Information moves haltingly through the organization and is not readily available to the people who need it. People are afraid to take calculated risks for fear of failure and career derailment, which stifles innovation. Managers actually "manage" fewer than four staff on average and are overinvolved in their subordinates' work. Incentives don't motivate behaviors that drive the company's strategic priorities.

You get the picture. Too many organizations are not Fit for Growth, and their employees, leaders, and shareholders are living with the consequences. In fact, the majority of institutions—both private and public—display some or all of these symptoms.

In the current business and economic context, company leaders cannot afford to let their organizations get or stay out of shape—not if their goals involve profitable growth. They need to focus on what they do best, align the cost structure, and organize to support the strategy. They need to accept the facts: they need to cut to grow.

And that is hard. It requires difficult choices and wrenching trade-offs. Not everything you do is a differentiating capability, which means that you are probably overinvesting in the rest of your processes, systems, and organization if you haven't made conscious choices on how to allocate costs. This is particularly true of large, mature companies that have settled into a complacent, comfortable rhythm. The lean structure and laser focus of their early years has dissipated, and it becomes increasingly difficult to get back in shape.

Consider the cautionary tale of consumer electronics retailer Circuit City.

Circuit City: The Ostrich Approach

Circuit City's precipitous fall from grace vividly illustrates what not to do in the quest to be Fit for Growth. Forced out of business in early 2009, the once thriving big-box chain careened from solvency to bankruptcy to liquidation in less than six months.

Why? Because management did not adhere to the Fit for Growth formula. They lost sight of their differentiating capabilities system, which was centered on the hand-holding, advisory relationship they had developed with middle-class consumers looking to buy big-ticket electronics devices. Therefore, when it came time to cut costs, they cut into this productive muscle—undermining the customer experience—instead of shedding other nonessential costs. Last, they did not make the changes to their organization necessary to protect and promote what they did best.

Serial entrepreneur Sam Wurtzel was onto something big in 1949 when he opened a television shop in the front half of a tire store in Richmond, Virginia. He foresaw the American public's fascination with the fledgling medium and helped put a TV set within lower-income families' reach by offering installment payment plans and free overnight in-home demonstrations.[1]

In the flush postwar 1950s, Wurtzel sensed the growing demand for refrigerators, washing machines, and electric stoves and capitalized on that wave by offering appliances in his stores. He spotted the trend toward big-box discounting and was one of the first retailers to build superstores. Over the decades, under continued astute management, Circuit City expanded its offerings from TVs to appliances and personal computers. By 2000, it was the dominant electronics retailer in the country with 60,000 employees at nearly 700 locations and annual sales of more than $12 billion. Circuit City was ranked in the top 200 of the Fortune 500 and was featured in management expert Jim Collins's bestseller *Good to Great.*[2]

Circuit City flourished for decades with a commissioned sales force trained to hand-sell expensive and complicated home entertainment systems and appliances, along with extended service plans. These salesmen in sports jackets were the cornerstone of the company's business model, and they felt a sense of pride and loyalty in the company. They were experts in their field, educating buyers and participating in the rewards. Circuit City built its value proposition around the customer experience this veteran sales force delivered.

But as the company advanced toward the end of the century, it lost sight of this differentiating capabilities system and did not evolve it to meet changing customer needs. Circuit City did not adjust its product assortment or store formatting to keep up with retail trends or the times, and failed to play to its strength in customer experience enabled by expert advice. It also strayed from its premium-customer-experience value proposition when it signed cheap real estate leases for "B"- and "C"-grade sites inconvenient to customers.[3]

You have only to look as far as Best Buy—which experienced steady growth as Circuit City's sales declined—to understand what Circuit City could have done differently.

It could have sought opportunities to keep its trust-based premium advisory capabilities front and center. It could have invested in locations more convenient to customers and attracted traffic by offering the full line of home theater systems, accessories, peripherals, and gaming software. It could have streamlined the shopping experience for busy customers and been earlier and bolder in capitalizing on the promise of the Internet, especially in the services arena, where it had a natural advantage. In fact, high-end advisory services—such as home entertainment system consulting and installation—were a natural market opportunity for Circuit City's expert sales staff.

Having already lost significant ground to Best Buy and Amazon, Circuit City was on its heels when it came to terms with the magnitude of its financial distress in the early 2000s—and then it made mistake after mistake. Instead of engaging in a proactive and strategic process to redirect resources to its differentiating capabilities, it reacted haphazardly with a series of ill-considered tactical moves.

In 2001, it exited the appliance business overnight—the company didn't even inform its suppliers before it announced the move. It scrapped a store remodeling initiative targeted to roll out a more consumer-friendly format. And most alarmingly, in 2003, it summarily fired thousands of its most tenured and knowledgeable commissioned sales staff and replaced them with inexperienced hourly employees. Circuit City projected at the time that the disruptive impact on morale and customer satisfaction would be over in one month. They could not have been more wrong.[4]

By late 2008, when the recession and credit crisis struck, Circuit City's stock price had plummeted 90 percent to 10 cents a share (versus Best Buy's $25),[5] prompting the NYSE to threaten delisting.[6] Vendors were refusing to supply the stores, given the backlog of inventory the retailer had failed to unload and vendors' doubts that Circuit City would be around to pay off its debts. And store employees were so disheartened by rounds of mis-handled layoffs—while headquarters executives remained secure and well compensated—that there was no reservoir of goodwill to draw on to shore up sales. And no cash—the company had engaged in a lavish $1 billion stock buyback program between 2003 and 2007, leaving it without necessary reserves.[7]

This domino effect of bad decisions left Circuit City tragically unfit to survive the perfect storm of the Great Recession. It declared bankruptcy on November 10, 2008, and was forced into liquidation by its creditors within months. The last Circuit City store closed its doors on March 8, 2009.[8]

It's easy to play Monday morning quarterback, but when you are a senior manager in the midst of stalled growth and declining results, it is anything but easy to clear a way up and out. It's not hard to be Fit for Growth, in theory. But in practice, for many companies it's next to impossible.

For those companies that align their costs and organization with their distinctive and differentiating capabilities, however, the results are impressive and enduring.

IKEA: Elevating Cost Optimization to an Art Form

Here's the story of another big-box retailer, founded in the post–World War II era by an enterprising leader with a clear vision of how middle-class consumers wanted to live in their homes. Same context, different outcome.

Swedish home furnishings superstore IKEA has set a great example when it comes to focusing on what it does best and aligning its costs and organization, not only for itself, but also—quite explicitly—for the consumers that the IKEA Group and its franchisees serve in 386 stores in 48 countries worldwide (as of 2016). IKEA is globally known for its simple and elegant product design, its huge but inviting retail stores, and its almost impossibly low prices (which drop another 1.5 percent to 2 percent at the start of each fiscal year per company mandate).

Few brands have achieved such an iconic status, and fewer still command the devout customer loyalty that IKEA has earned, which is all the more remarkable when you consider the relative burden IKEA places on its customers to pick, carry, and assemble its flat-packed furniture themselves. But customers do it willingly, because they understand that IKEA passes the savings on to them, prizing consumer value and affordability above all else.[9]

IKEA embodies the Fit for Growth formula: It is laser-focused on its strategy and differentiating capabilities; it has firmly aligned its cost structure to reinforce those capabilities; and it is organized to enable profitable growth.

Founder Ingvar Kamprad's original vision—"to create a better everyday life for the many people"—is a lighthouse visible to every IKEA employee worldwide and guides every decision, however big or small. As Ian Worling, IKEA's former director of business navigation, explains it, "That means we offer home furnishings at such low prices that as many people as possible can afford to buy them. That colors everything we do."[10]

IKEA employees are relentless in searching for cost savings opportunities in everything but the quality of their merchandise, the customer experience in their stores, and the efficiency of their operations. These comprise IKEA's key capabilities and they safeguard them—in fact, its leaders plow savings they generate elsewhere back into them.

To enhance the customer experience in their stores, for example, IKEA's management has invested heavily in understanding how their customers live at home in various markets. They do home visits and even install cameras in the homes of volunteers to gain insight on what sort of issues their customers encounter, so they can design home furnishings to solve them. Ingvar Kamprad has been known to walk through stores asking customers, "What could we have done better today?"[11]

IKEA integrates customer engagement, supply chain efficiency, and pricing considerations into the design process itself, enabling it to offer price-conscious and stylish product design while increasing its margins. Designers not only create new products, they work on packaging to economize materials and space to fit more pieces into a container. This congruence between strategy and execution is rare in product design. Designers are generally not responsible for managing expenses. The designs are costed out by a separate group in the finance or supply-chain function, and the retail price is set by a third group in marketing, resulting in a series of trade-offs between competing interests . . . with no one truly representing the customer or the bottom line.

At IKEA, design, cost, and price are all considered together in the product innovation phase; there are relatively few trade-offs because everyone is seeking the same goals.

IKEA clearly focuses on its differentiating capabilities, aligns its cost structure to advance these capabilities, and enables all of this and its profitable growth through its organization. Its organization and culture are in lockstep when it comes to supporting and reinforcing what it does best. "We work hard to ensure that as new people come in, they understand who we are and what we're trying to do," says Worling. "The people who work here genuinely want to be here and share IKEA's core values of cost consciousness and humility." As Kamprad himself put it more bluntly: "Wasting resources is a mortal sin at IKEA. . . . Expensive solutions to any kind of problem are usually the work of mediocrity."[12]

People at every level recognize when someone is behaving counter to the company's values. If an employee visibly wastes resources or reprimands a subordinate for suggesting an idea, he or she will hear about it immediately, not just from higher-ups, but from everyone around that person. People know that their continued attention to each other's behavior makes the entire system work.

This rigorous and continuous focus on what they do best when it comes to allocating costs is what distinguishes IKEA from Circuit City. Nowhere is the contrast more striking than in how they both confronted the need to sharply reduce costs in the global recession of 2008, which hit both retailers' core markets (new homeowners and middle-class consumers) hard.

While Circuit City summarily exited core businesses and executed waves of demoralizing layoffs, IKEA returned to its guiding vision and simply amplified the cost fitness measures it already had in place. "We didn't focus on cutting costs, because that's the easiest thing to do in retail. You just lay people off, and cut back some of your capital expenditure, and it reduces your variable costs," says Worling. "But it also weakens you."[13]

Instead, the chain's leaders continued investing in the capabilities that differentiated IKEA—for example, its custom-designed stores with distinctive room settings, supervised children's playrooms, and convenient self-serve eateries—all designed to make customers feel at home. IKEA not only built new stores, it extended and expanded existing ones.

"To make up the difference, we had to become very good at four things: Lowering operational costs . . . increasing volume . . . developing an even better-functioning supply chain . . . and empowering our coworkers. We asked ourselves what we could do during this period to lower our costs and, instead of increasing the bottom line, turn every Euro back to lower prices for our customers," recalls Worling. (At other companies, even 25 percent reinvestment is considered remarkable).

With that goal in mind, IKEA sought further cost-savings opportunities in places customers didn't see. Its product designers collaborated with its factory engineers and suppliers even more intensively to uncover additional efficiencies. They worked even more diligently on reducing packaging. "Even a few millimeters can make a big difference in fitting more pieces into a container. We hate transporting air," says Worling. "In general, we always ask ourselves, 'Would our customers want to pay for that particular item themselves?' If the answer is no, then we try to find a way to do without it or to do it in a cheaper way."

And this is why IKEA is emblematic of the Fit for Growth philosophy and approach. It makes deliberate choices around a crystal clear value proposition that prioritizes its key capabilities. It's also why the IKEA Group has achieved the seemingly impossible: about 10 percent annual top-line growth since 2001, surpassing €30 billion in revenues in 2015, and stable margins despite the ongoing price reductions and economic pressure of the past several years.

Fit for Growth companies are lean and deliberate in spending money—every day. They manage their costs for both efficiency and effectiveness. In all their investments, they seek long-term value. This means continually pursuing the lowest-cost way to run their operations and organization, taking full advantage of economies of scale and scope. In our experience, companies that become Fit for Growth do not see cost optimization as a single, "big bang"–style event. Instead, they make it a continuous process, embedded in the daily fabric of business.

By choosing to cut costs proactively and continuously, IKEA has been able to operate from a position of strength, even in times of market stress. As a result, it has avoided the panic and aggression that overtook Circuit City's senior executives in its final days—and the fate of all too many other companies in recent years.

To adhere to the Fit for Growth formula, companies have to make tough decisions. Senior executives may decide to exit an entire business or product line that doesn't leverage the company's differentiating capabilities. They may decide to outsource a number of support functions that do not have to be world class to enable the strategy. They may realign compensation and incentives to drive performance in one area to the detriment of another. These decisions have real consequences for real people—it is the rare senior manager who finds making and executing these trade-offs comfortable or easy.

But the sense of purpose and energy that this sort of strategic clarity and coherence delivers to an organization cannot be overstated. It is those companies that stick to this guiding philosophy that demonstrate market-leading returns year after year.

The Fit for Growth Index

To demonstrate the truth of that statement, we developed the Fit for Growth[14] Index, a quantitative metric that measures companies' adherence to the three elements of the Fit for Growth framework: focus on a few differentiating capabilities, align cost structure, reorganize for growth.[15] Having seen these three elements create value in the market, we wanted to determine how important they are—collectively and separately—in driving results. So we correlated the index scores of about 200 companies

FIT FOR GROWTH COMPANIES GENERATE HIGHER RETURNS

This diagram shows the comparative placement of 197 sample companies on scales showing performance (two-year normalized total shareholder return on the y-axis) and readiness for growth (the Fit for Growth Index score on the x-axis).

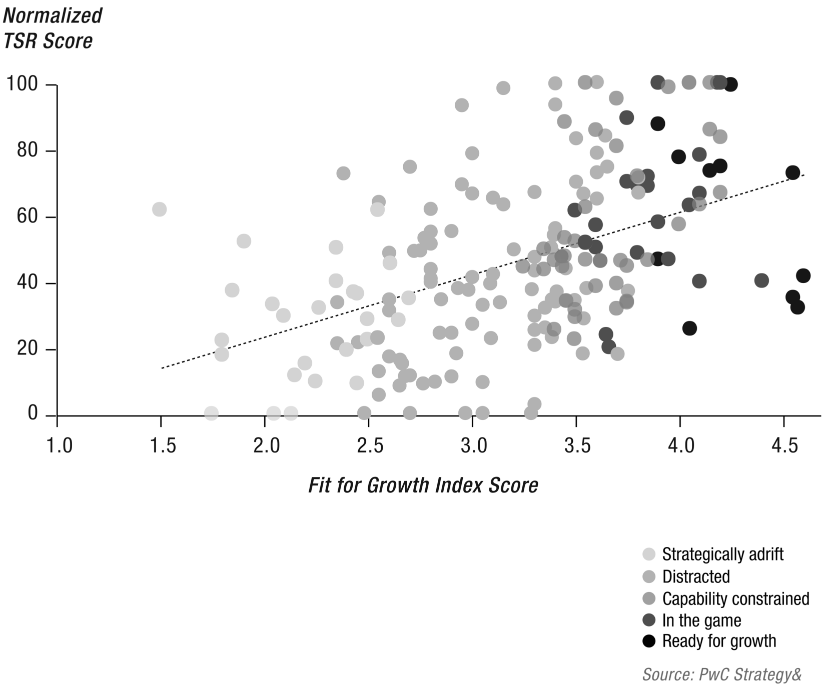

Figure 1.1

across various sectors with their financial performance, namely total shareholder return (TSR) adjusted for industry-specific factors.[16]

As Figure 1.1 illustrates, there is a clear correlation between how fit a company is for growth according to our index and its total shareholder returns. Almost three-quarters (73 percent) of companies with high index scores had high or medium-high TSR scores, and the reverse also proved true—those with low index scores generated lower returns. (See Figure 1.2.)

Having established the link between Fit for Growth Index scores and market returns, the next logical step was to isolate those specific attributes in

DISTRIBUTION OF NORMALIZED TSR SCORES BY FIT FOR GROWTH INDEX SCORE

Companies with higher index scores (at right) have better TSR profiles. The width of each column reflects the number of companies falling into that index score category.

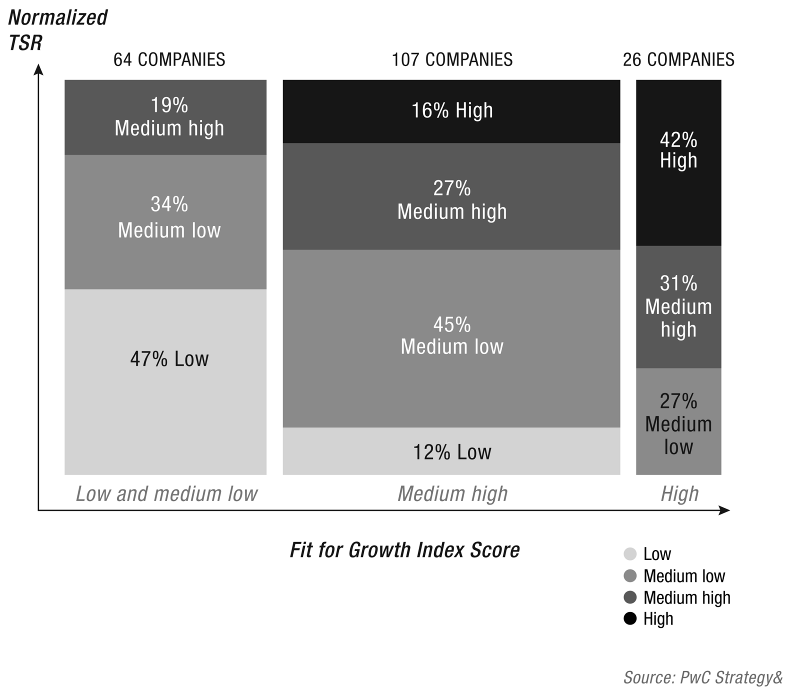

Figure 1.2

the index framework that best explained strong performance. (See "Calculating the Fit for Growth Index.") Our analysis highlighted the following six attributes across all three index dimensions: coherent strategy, strong capabilities, systematic investments, aligned initiatives, speed and decisiveness, and strong leadership.

Our research highlighted a number of other noteworthy findings:

High-performing companies tightly link their growth and cost agendas. They clearly understand what capabilities are truly critical to winning with their strategy, and they funnel the bulk of their resources to those differentiating capabilities.

Companies need to combine all three elements to unlock outstanding results. Those that integrate and align differentiating capabilities, cost structure, and organization generate the highest Fit for Growth Index scores and the highest financial returns. You cannot excel in only one of these elements and hope for the same result. For example, a company that does the hard work of identifying its few differentiating capabilities and aligning its cost structure will see costs creep back after a few years if it fails to adjust its organization to support the new regime. In our experience and research, companies stumble on the second imperative—they identify the right differentiating capabilities, but they don't have the heart or discipline to actually redirect resources to them from everyday activities.

Few companies are Fit for Growth. Although the formula for success is clear and its positive impact obvious, less than one-fifth of the companies we assessed seemed well-prepared for growth. Very few—only 6 percent—demonstrated strength in all three elements.

Calculating the Fit for Growth Index

The index assesses companies in three key areas: strategic clarity reinforced by an aligned system of capabilities, an aligned resource base and cost structure, and a supportive organization. Each company received a composite score from 1 to 5 based on its "fitness" in each of these areas (5 = the most fit). In calculating the scores, we weighted the three factors as follows: strategic clarity and coherence at 50 percent, resource alignment at 30 percent, and supportive organization at 20 percent. The second and third factors together constitute a company's execution capability. Thus, a company's index score is derived in equal parts from its strategy and its executional fitness. These weightings reflect our belief that strategy and execution are equally important in determining performance.

The three factors were in turn made up of several components, each with its own weighting:

- Focus on a few differentiating capabilities: coherent strategy (15 percent), strong capabilities (10 percent), strong/coherent product portfolio (10 percent), and presence in critical markets (15 percent)
- Align the cost structure: systematic investments in differentiating capabilities (10 percent), thoughtful cost reduction (15 percent), and improvement initiatives aligned with strategy (5 percent)

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- Organize for growth: speed and decisiveness (10 percent), strong leadership (5 percent), and supportive culture (5 percent)

Our survey sample comprised 197 companies in 17 industries. Companies were chosen to yield a balanced sample including high, medium, and low financial performers in each industry, based on their total shareholder return over a two-year period. To supplement our knowledge of the companies, we examined information from research databases, analysts' reports, earnings call transcripts, and business periodicals.

So we know that companies that are Fit for Growth outperform. Their strategies are clear, differentiated, and well articulated. They have demonstrated resilience to market and environmental changes. Their most important capabilities are highly advanced and lead their industries; their resources are systematically directed to initiatives and opportunities with the highest strategic and financial returns; their organizational structures support key capabilities, with efficient decision making and talent in the right places; and their culture of cost management extends to the front line.

But we also know that most companies are *not* Fit for Growth. In the next two chapters, we will break down the journey to becoming Fit for Growth into its three basic steps—focus on a few differentiating capabilities, align the cost structure, and reorganize for growth—and provide an overview on how to achieve excellence in each. Part II provides a manager's guide on how to cut costs and grow stronger that presents in detail nine specific levers you can pull to reduce costs in a smart, strategic way—everything from automation to zero-basing. In Part III, we offer insight on how to actually manage a cost transformation from the top to the trenches—and then how to sustain the gains by aligning your organization and culture behind its new growth priorities.

We will show how companies like IKEA have not only restructured without wreckage but have actually enlisted their employees in the cost transformation process. Cost reduction does not have to conjure up images of mayhem and destruction—it can be a constructive, even uplifting exercise if managed adeptly and sensitively. Most important, it can make your company more competitive, more profitable, and better prepared to grow.