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FINANCE

Be Your Own Activist Investor

With these 10 principles for rethinking cost management, you can maximize value and avoid threats from Wall Street.

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Illustration by Federico Jordan

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A hedge fund just bought 5 percent of your company. The fund partners clearly see value in what you're doing, and, as a member of the management team, you

take heart in that assessment. But you also know life is about to get more difficult. The fund partners are well-known activists. They have already asked for board

seats. Now they're proposing some dramatic strategic and financial changes, confidently assuring you and your shareholders that these moves will drive the company's stock price higher. If you don't comply and boost margins in a timely fashion, they will quickly bring in a management team that will.

For many company leaders, this is not a scary hypothetical – it is reality. It may also be an opportunity. In any case, activist shareholder campaigns are proliferating. According to the journal *Activist Insight*, 300 companies around the world were publicly targeted by activist investors between January and June 2015, about 25 percent more than in the same months the previous year. Since 2013, hedge fund managers have demanded change at hundreds of companies. The most widely publicized have included Apple, DuPont, General Motors, Microsoft, PepsiCo, Sony, Sotheby's, and Yahoo.

One reason activism is growing is the rich rewards it earns for investors. On average, hedge funds with an activist approach have outperformed most other types of investment funds since 2010. The data analysis firm Hedge Fund Research reported recently that activist funds returned 12.5 percent a year between August 2012 and August 2015, while other funds, on average, earned returns in the single digits. No wonder investors increasingly demand activist funds in their portfolios, while the managers of those funds search diligently for new targets. No one can assume his or her company is immune.

Before hedge funds

Even if
you are

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not

threatened by activist investors, you can learn from the experience of those who have been. Before hedge funds start to circle your company, apply their best practices yourself. Take control of your cost base **-not** to cut back, but to build a more resilient and capable organization. You can even use your cost transformation initiative to create a positive, strategic vision of the future, one that inspires people and attracts their commitment.

With this potential in mind, we've distilled 10 principles for cost transformation that can help companies play the role of gadfly investor for themselves.

Adopting an Activist Agenda

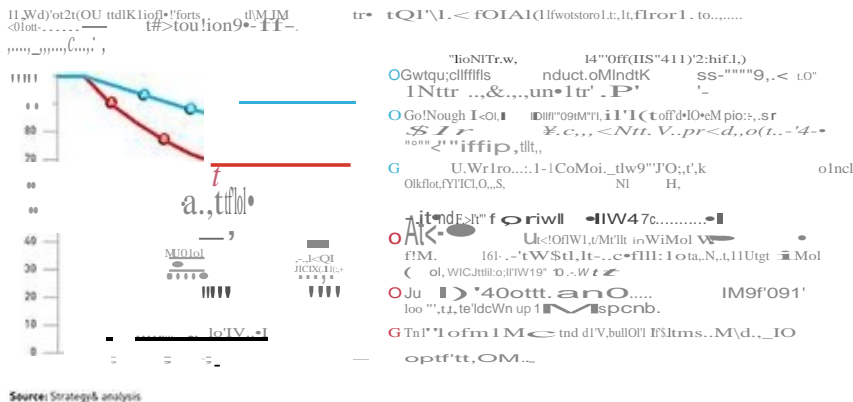
The first five principles in this list reflect the amped-up agenda of increasingly activist shareholders. By adopting them yourself, you can create immediate and substantial value.

1. Go big and go fast. Reducing costs by 10 percent, net of investments, over three years used to be a stretch target for many companies. No more. Activist investors routinely expect management teams to slash expenses by 20 percent or more, and to achieve half of that goal in the first 12 to 18 months. Moreover, senior

management attention inevitably wanders after a year or so. In general, management teams are looking at a finite window of 12 to 24 months to free up resources to fund future growth.

A recent Strategy & analysis of 29 cost reduction efforts shows the leverage that comes from going big and fast. Twenty-two of these efforts followed a traditional trajectory: They streamlined processes, consolidated footprints, rationalized product lineups, reduced discretionary spending, and developed better outsourcing and shared services practices. Their total cost base went down less than 20 percent over five years. The other seven efforts, by contrast, were rapid and decisive. In addition to the measures adopted by the first 22 companies, they embraced the principles in this article – for example, following the “parking lot” exercise described in principle 3. These companies reduced costs by 32 percent over just three years, freeing up significant cash for reinvestment (see exhibit).

Exhibit: Conventional versus “Big and Fast” Cost Reduction



To reach a similar target yourself without eviscerating your company's strengths, you have to look at cost reduction as a strategic lever. Don't default to across-the-board spending cuts; instead, ask larger-order questions. Which customers should you serve? With

which products and services? Supported by which capabilities? If an expense isn't justifiable in the answers to these questions, stop funding it.

The leaders of one software company took this path after a group of activist investors acquired a significant stake in their company. The investors informed the top management team that the company's operating margins weren't up to industry standards -one competitor had almost twice the margins. If the management team didn't change its business model, the investors would install a team of their own choosing.

The management team listened, evaluated its business and strategy, and embarked on an ambitious plan to increase its earnings margins by more than 50 percent in two and a half years. To accomplish this, the company changed its operations footprint, shed low-margin customers and products, applied stricter thresholds for discounts, reshaped its sales force, and eliminated low-value internal support services. The activists had demanded even more drastic moves, but these changes -designed to fit the priorities of the management team -were sufficient, in part because they were delivered on time. And the actions set the business on a much more solid footing for years to come.

Activists recently pushed another enterprise, a large retailer, for similarly dramatic changes. Here, too, the company's leaders decided to go big and go fast. They spun off some businesses that weren't core to the enterprise, stopped investing in non-differentiating capabilities, cut IT project spending in half,

streamlined the hierarchy, increased management spans of control (the number of people reporting to each executive), and reduced non-people-related spending -all within 12 months. Because the company rallied so rapidly and completely, it met its targets and has continued to be highly successful.

In both cases, company leaders were surprised to see that big, rapid change was easier to absorb and implement than the smaller, slower cost reductions of the past. The "death by a thousand cuts" approach is excruciating, tedious, and ultimately unrewarding. Instead of laboring over dozens of incremental changes that will, in sum, get you only halfway to your goal, focus on a far smaller number of major actions that will move the needle to 80 percent. Don't overplan and wait for every process to be perfect; act quickly and assuredly.

2. Start with head count. The old-school style of cost transformation was sequential: Take the work out first, then the people. In each part of the business, an expense reduction team would assess the way work was done, adjust processes and organizational factors to gain productivity, and reduce head count accordingly. Then it would go on to the next division. Although this approach seemed to be a good way to avoid disruption, it was a prolonged undertaking that involved careful coordination across many units, often over several years.

Companies no longer have the luxury of this time-consuming, meticulously orchestrated approach. Debunk the myth that new processes and systems have

to be up and running before positions are eliminated. To achieve stretch goals in a far shorter time frame, you have to start reducing head count right away, taking out layers of upper and middle management and perhaps a part of your frontline workforce -all in advance of process and system changes. Do this through levers such as enhanced severance, voluntary separation, and performance management programs.

Lowering head count first creates a vacuum, and nature abhors a vacuum -if not in physics, then certainly in business. The remaining workers must fill that vacuum, rising to the occasion to keep their part of the business running. They must prioritize and manage workloads more effectively and efficiently. With your support, they will be glad to focus on "critical path" items, and to cast aside make-work or "nice but not necessary" projects they no longer have the resources to execute. As one company leader noted while planning a cost reduction effort, "We have some smart managers, and they figure out ways to stay busy and add value. But are they doing the work we need or we can afford?"

By removing head count first, you create a vacuum. The residual organization must rise to the occasion.

To be sure, the

transition will probably be wrenching, remembered as

a time of tough choices and forced retirements. But when that is over, a surprisingly liberated and rejuvenated workforce will remain. Functions will be streamlined and focused on results. With fewer people, managers will concentrate on getting things done. They will redesign processes accordingly, with the resources on hand. With little help available, they must innovate; there will be fewer overseers to micromanage them or turn down proposals, so they will have more opportunities to act. This new way of doing things will percolate rapidly through the hierarchy.

You experience this kind of rejuvenation only after you eliminate positions. It may seem harsh, but it usually turns out much better for the residual organization.

3. Justify what to keep, not what to kill. All spending is investment. Every cost is a choice. The secret to unlocking growth through cost reduction is to make deliberate choices: not about what to cut from your budget, but about where to invest. In our view, the right choices are those that close the gap between strategy and execution.

Rethink your spending from scratch. Imagine every cost in your company as a parcel that you can take out of the building and place in a virtual parking lot. Then for each item, ask whether your business needs it to compete over the next three to five years. One by one, ask: What kind of expense is this? Should we let it back into the building? Does it earn its way? Assign each cost into one of four categories, considering its relationship to your company's value proposition.

- *Distinctive capabilities* are the choices that pay off.

These investments consistently deliver value for you in a way that sets your company apart from others. You compete on the basis of your distinctive capabilities. Well-known enterprises that invest deeply in distinctive capabilities while being frugal elsewhere include IKEA and Starbucks, which have learned to provide a strong central brand identity in highly varied retail locations around the world; Procter & Gamble and GE, which have strong innovation capabilities tailored to the lines of products they launch; and Southwest Airlines, which boasts energetic customer service and asset utilization, giving it the rapid airplane turnaround time at the gate for which it is famous. These capabilities are complicated and expensive enough to require most of your time, money, and attention. But without them, you are just like every other company. (For more examples of the value of distinctive capabilities, see "[Grow from Your Strengths](#)," by Gerald Adolph and Kim David Greenwood, *s+b*, Autumn 2015.)

- *Table stakes* are the costs necessary to stay viable in your industry. In consumer packaged goods, these might include packaging and distribution costs. Resist the temptation to overspend on table stakes. You should spend just enough to stay in the game.

- *Lights-on expenses* are required simply to operate — to keep the lights on. As with table stakes, these costs should receive just enough cash to function (which will typically be less than competitors spend).

- *Not required* is the final cost category. These costs might include a layer of management that was important once; the private jet that is seldom used; the

old IT system that was mostly, but not entirely, replaced, and kept on "just in case"; and the extra money expended trying to be best in class in ways that don't really help your strategy. These costs should be eliminated. They are the hidden enemies of growth.

Now that you have divided your costs into categories, you can evaluate their potential accordingly. The highest priority should be the first category: distinctive capabilities. Those are the first activities you bring back from the parking lot, and the activities on which you keep investment strong. Concentrate expense reduction efforts in the other three categories. In other words, instead of cutting everywhere across the board, openly play favorites. Support the investments you need by cutting the costs you don't.

This exercise and the discipline it requires may seem difficult at first. It might also remind you of zero-based budgeting – in which you question every dollar spent each quarter, for the sake of eliminating expenses. The parking lot exercise, by contrast, accentuates the positive. By focusing on the costs you want to keep, you build an expense structure from the ground up that is fit for purpose and that differentiates you competitively.

It may take time to evaluate some expenses. We recommend assessing them on a net present value basis, just like other investments. For each cost, calculate the anticipated impact on market share, earnings, and customer retention based on its expected contribution to your strategy. If the contribution is high enough, you can confidently make the decision to keep it. The value you create this way will be worth the

trouble of thinking it through.

4. Appeal to hope, not fear. Any major change initiative has winners and losers. When you designate some capabilities or businesses as nonstrategic, you threaten established fiefdoms with entrenched supporters. Bring these controversial decisions and thorny issues to light in an inclusive, constructive way, by focusing on your company's strategic aspirations — what you hope and expect to accomplish — rather than on threats or the tough times ahead.

Start by granting amnesty for the past. There is nothing to be gained from looking backward at "how we got here," and blaming past administrations or decisions. Explicitly withdraw censure and sanctions for old excesses or mistakes. It's a new day. Granting amnesty also sends a message that traditional excuses ("We've always done it that way") no longer apply. Managers must reconsider priorities and trade-offs that were previously inconceivable. If employees (especially leaders) persist in resisting or undermining the journey ahead, they should be invited to disembark.

In most companies, only the CEO can grant amnesty. Without his or her explicit blessing, the move will lack the legitimacy it needs and people will not feel protected. One technology company learned this the hard way. After talking with activist investors who had targeted the company, the CFO made the case at a senior management meeting that it was time for massive, wholesale changes. Unintentionally, in recounting some of the "stupid things" the company had done over the previous 10 years, he put some other

top managers on the defensive. Before long, debates over past mistakes, and whether they had truly been errors, spread through the rest of the company. The more time people spent justifying past practices, the more threatened they felt by change.

Fortunately, the CEO stepped in. He issued a company-wide statement saying that although leaders would indeed change the way they did things, they should stop blaming one another for the past, and instead look ahead. Only then did a critical mass of managers embrace the changes.

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everything you do, avoid putting people on the defensive. If your mandate appears to be simply reducing head count, the only emotion you will stimulate is fear. People will hunker down and defend their turf. This is why a positive view of the post-transformation future is so important. Indeed, many renowned business leaders, including Jack Welch and Steve Jobs, have built growing enterprises from a beginning of cost transformation. Every vested interest that is cut should be linked to an opportunity for doing something better with that funding in the future.

People will sign on when they understand that they will end up working in a less bureaucratic workplace and in a company poised for growth.

5. Shake up the executive ranks decisively. The source of your cost or other transformation problems may well be embedded in the executive team and others in the top three levels of the organization. The more revolutionary the changes in cost management, the more likely it is that some members of your incumbent management team will resist them. You need to find effective ways to shake up your senior leaders, giving them an appetite for change and the incentives and support they need to think in a fresh way and act with urgency. If that doesn't lead to rapid and decisive change, you may need to overhaul your leadership roster.

A few years ago, a large company went through a major strategic restructuring. In the final meeting before launching the new organization, the CEO questioned every executive committee member directly: "Do you believe in this direction? Will you take this step forward with me?" All but one person said yes. The one dissenting executive, a linchpin in the old organization, declared that he believed the direction was not right and if the CEO wanted to move forward, he could not be part of the future. He resigned shortly after the meeting. As painful as it was to lose such a capable and highly motivated executive, his departure enabled the rest of the executive team and the company to move forward more assertively.

In this case the executive was candid with his views and left voluntarily. Sometimes a CEO must make the

assessment of who is truly committed versus who needs to get out of the way. By expediting these tough but necessary changes, you ensure you have the right executive team for the future. This will accelerate the journey to your destination and help your corporate culture and organization evolve.

Classic Moves of Cost Transformation

The first five principles we discussed reflected the activist shareholder agenda. The next five principles concern strategic cost reduction and reallocation, the central tenets around which you should structure any program. These steps are de rigueur for any company looking to operate efficiently in a world of global competition, market share erosion, and margin compression -**and** even more important for those building a defense strategy.

6. Reconsider everything, even your sacred cows. Don't be afraid to put everything out into the parking lot for evaluation. This includes even supposedly untouchable expenses: the business or function the CEO used to run, the new business the CEO acquired three years ago, the executive dining room, corporate giving, employee benefits. If the CEO's favored organization or pet project is on the chopping block, it sends a powerful signal to the organization that "we're all in this together." The urgency of change becomes clear, and managers will be more reluctant to buttonhole their sponsor on the executive committee to apply for special exemption status.

A media company in London eliminated **all** executive frills, starting with the corporate headquarters

building, which had been a crown jewel, located in a separate part of town from the rest of the offices.

Moving the senior executives into the same building with everyone else made a strong statement to shareholders and the public. The move was a visible sign of the company's new resolve –**but** it was just a start. The company went on to recast its expenses and reinvent its corporate culture to make the savings stick over the long term. Some of the changes might have been merely symbolic; executives shed their suits and everyone began coming to work in jeans and T-shirts with the company logo, for example. But those changes accompanied other, more substantive management shifts, including a more egalitarian structure that included an open seating plan and perks that were more evenly distributed through the company.

For those items you have chosen to cut, set aggressive targets. You rarely get more than you ask for from a cost reduction initiative, so ask for more than you need. Remember that stretch targets stimulate new ideas and help high-potential managers reach beyond comfortable limits to create breakthrough solutions. The figure for each cut should be credible but significant. Your goal is to yield enough funds to reinvest in growth and build a cushion for savings erosion.

Nothing commits the organization to a credible cost transformation program more emphatically than communicating it to the outside world, particularly to shareholders. Publicly estimating the financial impact of this effort –**for** example, in analyst calls — reinforces its strategic importance and serves as a powerful deterrent to backsliding.

7. Set up a parallel organization to change the business. Cost transformation is not business as usual, and yet you need to run your business as usual while you design and enact the necessary changes. It's like changing the tires on a bus while it is traveling at 55 miles per hour.

The most ambitious efforts address this by putting a separate transformation management office (TMO) in place. Led by a senior executive, this is a cross-functional team of the company's most creative and talented managers, which is dedicated to the transformation for a defined period of time and is charged with achieving its goals and working with the P&L owners to deliver results. Its central task is to orchestrate the complex, often disruptive change process, and to coordinate the many cross-functional working teams that will drive the transformation. A TMO tracks progress with frequent reviews (perhaps every three weeks) tied to the bottom line. Senior management assesses that progress, makes decisions, and reports results regularly.

At one high-tech company, the lead TMO officer was a well-respected senior vice president. He was handpicked by the CEO, appointed to the senior leadership team, and given broad authority to sequence and set priorities. He recruited a diverse team of other senior executives who devoted 80 percent of their time to identifying big-ticket cross-functional opportunities and implementing the transformation effort. The TMO structure provided rigorous program management, highlighting initiatives that were exceeding or falling short of their targets. This gave management a clear view of overall performance and flagged situations that

required interventions. As a result, the company delivered on the ambitious earnings target set by the CEO. The TMO also helped business units adopt a continuous-improvement approach that kept capturing gains after the formal transformation program ended.

8, Challenge the way you do things. Given the nature and magnitude of the change you are seeking, you must go beyond simply addressing unjustifiable costs. You also need to consider the factors underlying them. So take another look at the businesses and capabilities that you have brought back in from the parking lot, with an eye toward fundamental improvement. This might include a critical look at your operations and administration, the way you line up the products and services you deliver, the segmentation of your customers and markets, the way you build and maintain capabilities, and your make-versus-buy footprint. All of these affect your cost structure.

The top team and program management office may not recognize all the opportunities for improvement by themselves. Involve people throughout the company in assessing your cost structure dispassionately, while looking toward the future. Encourage them to suggest ideas to the executive committee, and give them the cover and support they need to speak openly, without fearing reprisal.

Continue to protect the value of your most critical capabilities -don't weaken them with indiscriminate cuts. But you will find many opportunities to improve your table-stakes and lights-on activities. Look for fundamental changes that improve productivity

everywhere: a new approach to cloud computing and cyber-security, for example. Outsource or jettison the businesses and products that don't produce sufficient margins or fit with your distinctive capabilities, and relinquish the associated customers. Reorganize your operations to run more effectively at a lower cost.

Don't try to be world class at everything -that's a recipe for unnecessary expense. If a function, process, or activity will not differentiate you in the market, settle for being good enough. Apply this fresh lens to your entire business and look for step-change shifts in costs, even if it means drastically reducing head count, IT investment, or whole processes.

9. Look horizontally, across the organization.

Resist the temptation to impose percentage cuts on each department or function. Instead, look for expenses hidden in the seams and buried in cross-functional processes.

Take, for example, an end-to-end practice such as order to cash (OTC, the receipt and processing of customer sales). It cuts across multiple functions. The sales division typically handles customer engagement, managing the receipt and entry of the customer order, while the finance division manages credit, billing, and receivables. Managers in these functional silos understandably try to optimize the parts of OTC under their direct control, running them as efficiently as possible. However, improvements within one function can generate extra workload for everyone else, hindering the efficiency and effectiveness of the whole process.

When one business services company encountered this problem, it stepped back from the parts and considered the whole. The product management team, with urging from sales, had developed a large portfolio of customized products. The team assumed that the quote and contract development processes had to be designed separately for each customer. This was complex and time consuming. A small army of billing and receivables specialists were needed to navigate these custom contracts. The problem was solved only when the company created a single team with people from each function to look at the process from end to end. The team simplified product bundles and pricing packages, rewrote contract terms, and specified just a few areas where the sales team could tailor contracts to the clients. Finally, the company upgraded its systems to automate a simplified process. This multifaceted change led to a significant improvement in customer experience. It also freed up the sales team to spend time with customers, and it reduced the billing and receivables workload by two-thirds.

10. Showcase quick wins. To build confidence and accelerate momentum, identify and showcase quick wins early in the transformation process. These are cuts that generate significant savings rapidly with relatively minor transition costs. These early "trophies" communicate that the company is serious about tackling nonessential, nonstrategic costs to throw off funds for more productive and far-reaching initiatives.

These quick wins encompass more than the low-hanging fruit captured in any standard round of cost cutting. They can be found in three principal areas.

- *Discretionary spending*: Tighten your belt by doubling down on the "not-required" expenses from principle 3. Fully enforce your spending policies, lower expense approval thresholds, and eliminate perks for those who go "above and beyond" on matters unrelated to your strategy. Dial down support services. You might, for example, reduce the number of custom reports or analyses that the communications staff is required to produce, adopting self-service or standard reports instead. Or you might redesign travel policies with tighter approvals for long-distance trips.

- *External spending*: Aggressively negotiate prices with suppliers. Seek outright concessions in certain categories while negotiating contracts with more favorable pricing (in return for higher volume or longer terms) in others.

- *Management hierarchy*: Examine your middle and senior manager ranks and assess their spans of control. Seek opportunities to consolidate manager positions or increase their spans. Challenge the seniority and salary-grade creep of your middle management, and consider a one-time re-leveling of salary bands. This organizational flattening process requires discipline, the willingness to confront sacred cows, and a fast and fair approach. But done correctly, it can reduce bloated middle management layers by as much as 15 percent within a year.

Expenses as a Strategic Lever

True and lasting cost transformation gives you a chance to reformulate your company's overall direction. As we've said, this may seem wrenching at first. It may

lead you to divest long-standing businesses, even profitable ones, if they don't fit with your strategy or your most distinctive capabilities. Veteran and highly regarded executives may well leave the company, and hardworking employees will lose their jobs.

But the benefits to the company of streamlining the organization and focusing it on what it does best will more than compensate for the dislocations.

Comprehensive and forward-looking strategic cost transformation will position your business for success well into the future. And if activist investors do come knocking at your door, you can present a cost transformation plan already under way. More than likely, they will be willing to give it a chance and back off from making loud public demands or trying to stage a boardroom proxy battle. You might even make your company more attractive to the kind of long-term shareholders who will help you lead it to sustained success.

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