Cost restructuring vs. business portfolio restructuring

by

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An important point about crises is that they compel decision-makers to do their job. What are the key decisions that will give successful companies an edge over their competitors by 2012?

Cost restructuring

Companies naturally treat a crisis with three remedies: slash costs, lower break-even points and select more drastically investment projects. Such reactions allow companies to generate positive cash flows, to maintain room for manoeuvre - in a word: to survive.

When there is an economic slowdown, such decisions are easy to implement. However, in times of recession, they are impossible. Costs of a well-run business cannot be slashed by 20% to 25% *on average* without fundamentally unravelling the business model of the company, its business and geographical portfolio, its client and product mix, and its rebound potential when growth resumes sooner or later. Fundamental arbitrations must be performed, which suppose to *individualize* the necessary restructuring according to strategic priorities.

This means that such priorities should be clarified.

At any point in time, a large part of costs are linked to developments or renewals that may or may not be pursued. These costs or CAPEX (commercial spending, new capacity outlets, R&D, advertising…) underpin future growth but anticipate the turnover they are supposed to generate. In times of crisis, it is unsure whether one should hedge one's bets or focus resources only on the most promising ways forward.

Such costs may also be renewal/adaptation costs (equipment, technologies, product range…) merely aimed at staying in the race. Times of crisis may lead to ceasing historical businesses that no-one had the nerve to restructure in the past. If such costs are correctly identified and there is a clear vision of where the strategic priorities are, these expenditures may be stopped, slashed or deferred. A stringently differentiated restructuring has a major impact on financials.

One may wonder whether the priority should be (a) to stop spending on capacity renewal, R&D and marketing, and to maximize short-to-medium-term cash flows (potentially jeopardizing the future) or (b) to simply slash costs in marginal and stagnating segments where the group will never be competitive nor profitable. Whether (c) to optimize costs, prices, CAPEX and discretionary spending in 'cash cows' or (d) to defend structural positions against competitors. Whether (e) there are critical sizes under which not to drop. Whether (f) there is a strong value to size in all the relevant segments. Whether (g) there are client, product, or geographical segments that can be 'milked' without danger. Whether (h) the quality and value of products / services provided should be adjusted to prices or not.

Conversely, why should commercial, industrial, technological… costs / investments in new, high-growth businesses where the company is competitive be reduced if therein lies the group's future?

Classical cost restructuring (slashing overheads, optimizing procurement, improving industrial productivity, reducing indirect costs…) is a normal response to a normal crisis. When facing a recession, such restructuring is nonsense as it rapidly reaches its limits. The true answer is the restructuring of business and geographical portfolios. It is the only solution that leads to strong and differentiated cost and margin adjustments, paving the way for future, competitive growth.

Business portfolio restructuring

The point is to profoundly restructure the business and geographical portfolio beyond an extreme differentiation in cost reductions, authorized investments, compulsory cash flow generation and necessary disposals – always difficult and poorly valued in times of crisis.

Traditionally companies consolidate their industries through the cheap purchase of struggling competitors; it enables them to increase their market share in some fields or merely achieve critical mass in others. The issue is whether this should be done to improve positions in mature markets or to keep on growing and improving competitiveness in new, growth markets.

The answer is clear. If long-term profitability is similar, one euro of investment means two or three times more if it is invested in a high-growth business or country (10-20% per annum) than if it is spent in a low-growth business or geography (3% per annum).

In times of crisis, as in normal times, investment and competitiveness enhancement should be targeted at high-growth activities only. Investing to mend the effects of past vagaries or to strengthen further in stagnating activities is meaningless. In mature industries, value creation and cost synergies are ultimately largely transferred back to customers.

Managers are naturally inclined towards building leadership positions in the businesses they have joined at the beginning of their careers. It is a strategic mistake. What shareholders want is leadership in the businesses of the future, not those of the past.

What crisis exit?

The upcoming, 2009-2010 recession is not going to bring dramatic changes. Leading emerging countries will keep on growing at 8 to 12% per annum, and are going to represent an ever larger share of world markets.

Western economies will rebound at no more than 3% a year – on average and at best. Should economic growth be limited to 0 to 1% (or worse) in 2009 and 0 to 2% in 2010, Western economies will turn out to have grown at 2.6% a year(1) during the 2002-2007 period, but at only less than 2% a year over the complete 2002-10 cycle, i.e. they will clearly lose out to large emerging countries.

Among these Western markets, old and mature businesses, products and services will suffer even more from competition and price and margin drops. On the contrary, some businesses or niches will grow at 10 or 20% a year over substantial periods of time, with attractive margins.

The true growth of large Western groups will be measured throughout the whole 2002-10 cycle. For a number of them, such growth is going to turn out to be extremely low, entailing dramatic strategic overhauls. Why not start such revisions right now?

With few exceptions, 70% to 80% of large Western groups' turnover occurs in low-growth (2% to 3% per annum)(1) businesses and countries. Only 20% to 30% of that turnover is derived from high-growth (10% to 20% a year) businesses or geographies. The resulting average growth thus rarely exceeds 5% to 6% per annum – which equals the average growth of the world economy.

The current crisis will see some groups manage to rectify that breakdown. Others will consolidate their industries in mature markets, increasing the relative weight of stagnating activities in their portfolio, with a poor effect on their valuation.

The issue at stake should not be under-estimated. Long-term value cannot be created for shareholders if the company does not grow at a greater rate than the average of the economy. Cost reductions are indispensable but insufficient. They can permit the financing of the

(1) in real terms
(1) Estin & Co estimate.

company’s growth but do not help in increasing such growth. In any case, such reductions will be limited if the business portfolio isn’t profoundly modified.

The defense or improvement of competitiveness is also key. It can only result from cost reductions. And it is two to three times more valuable in growing businesses than in stagnating ones.

The only issue at stake throughout the crisis is growth and its financing. The winners will be companies that will significantly and competitively reposition themselves in high-growth businesses and/or geographies over the long run.

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Estin & Co is an international consultancy in strategy based in Paris, London, Geneva and Shanghai. The firm assists the boards of major European and North American Groups in their growth strategies, as well as private equity funds in the analysis and value improvement of their investments.