



# Reducing Costs, Strengthening Potentials

## Strategic Process Optimization for Sustainable Value Enhancement

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### Management Summary

Traditional reaction mechanisms seem to work less and less as an answer to high costs: Large scale projects for the introduction of activity-based costing for example often take years or get bogged down in details. Cost reduction programs according to the “lawn mover principle” work at the expense of quality. Cost advantages are often overestimated while at the same time the controlling expenses are underestimated in the cases of outsourcing and off-shoring.

This much is clear: One of the main causes of high costs often lies in the squandering of resources through processes and structures that are no longer appropriate. However, instead of first analyzing this problem strategically, many companies directly bank on the apparent solution: Reducing process costs. If they are too high, the processes have to be simplified. If others can do it better, then outsourcing is the solution. If production costs are lower abroad, the solution is Off-shoring. Those types of cost reductions are only successful, if the right activities are outsourced or off-shored to the right degree. Companies should first obtain an overview of their core processes to do that. They place their processes in a process portfolio according to their strategic importance and relative efficiency, in order to determine specific measures on that basis. That way they avoid the loss of value potentials through cost reduction, while at the same time sharpen the distinction between internal (improvement) and external (outsourcing) solutions.

Should companies want to improve their process efficiency, the next trap will already be waiting: It is easy for them to lose sight of the big picture because a very detailed understanding of the processes is necessary. In addition to this, it is often the case that only the processes themselves are changed. Companies should counter this by expanding their field of vision by prioritizing the processes through a strategic filter. Last but not least, the products and services themselves are the drivers of the process costs, especially because of their complexity. The resources utilized can also provide indicators for reducing costs. Thus the reduction of uncommitted and committed idle capacities, the utilization of the effects of scale and changing resources structurally can constitute long-term cost reduction potentials. Instead of losing future value potentials, the company is liberated from inefficiencies that would impede growth.



## Cost pressure and no way out?

Recent studies on various industries from the automobile industry to the retail trade and the construction industry as well as the banking sector have often enough empirically proven the cost problem of numerous companies. The fact that protective barriers that currently still exist will fall in the wake of the EU expansion will make the situation even more difficult. Furthermore, traditional recipes for cost reduction seem to work less and less effectively in today's world: Uniform top-down cost reduction targets, increased off-shoring, i.e. relocation of corporate activities to foreign countries, and outsourcing, i.e. relocation of activities to third parties, or activity-based costing with subsequent efficiency improvements – the concepts of the eighties and nineties are reaching their limits in an increasingly complex world.

Traditional cost reduction concepts are reaching their limits

## Setting top-down cost reduction targets for middle management – that may easily result in less quality

In the past the thinking often prevailed that the reduction of costs is not a question of analyzing potentials, but above all that of proper implementation. The company would become paralyzed through discussions of (in)justice, rather than tackling the problems by applying differentiated cost reduction measures according to divisions. Clear, top-down formulated targets, combined with the free choice of means through the middle management do not, after all, only correspond to a "modern" management by delegation, they also come close to widely-held ideas of leadership. And yet, in an increasingly networked world such approaches that are too simple can lead to partial optimizations. And even the cause-and-effect chain cannot always be reconstructed as clearly as in the following example from the automotive industry:

The German plant of an international car manufacturer was confronted with a clear message from the headquarters of the group of companies: Unit costs had to be reduced to achieve the planned profitability. Related to that goal was the statement that only the performance would count and that the German management was, after all, paid for implementing the targets – no matter how. Furthermore the fashionable motto was followed that implementation was of primary importance in the case of cost reductions. Therefore an easily communicated, uniform cost target was chosen for all divisions: "10% is always possible".

The result was as expected: In order not to miss the ambitious cost-savings target, costs were cut in the material quality and refinement steps of various models. Only a few years later those models started rusting badly. The manufacturer's image was severely damaged.

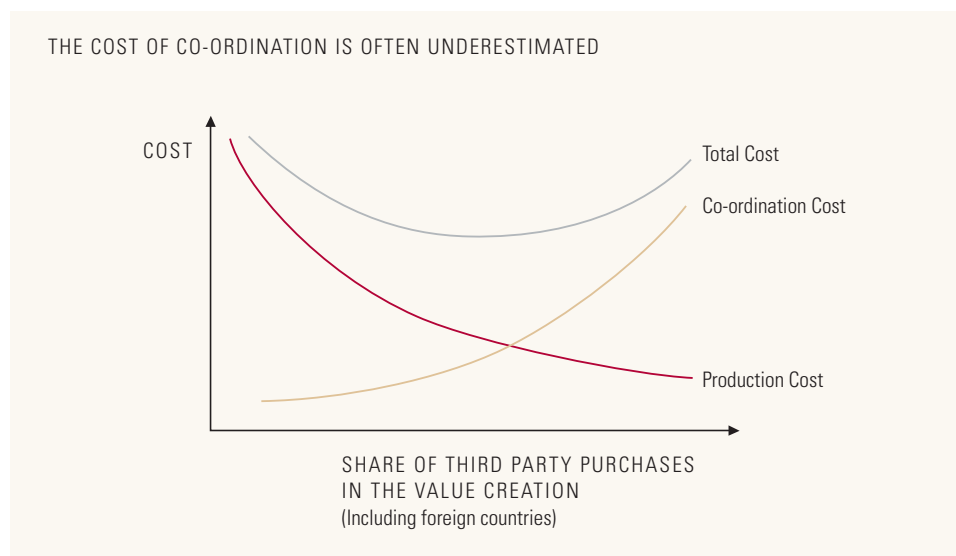
This example shows in a drastic manner that cutting costs according to the "lawn mower method" can easily create losses of future potentials.

## Off-shoring and Outsourcing – One out of three projects does not lead to success

Outsourcing and off-shoring often miss their mark because the wrong activities are relocated and the cost of coordination is neglected.

Another way of reducing costs that is being widely discussed at present is the relocation of parts of the company to foreign countries (off-shoring) or to third parties (outsourcing). The goal of these activities is to make the production factor "labor" more flexible and to reduce its cost. However, all too often people make the mistake of underestimating the cost of the co-ordination and control of the outsourcing partner. In addition, they try to push problematic divisions away instead of optimizing clearly defined processes. Current studies show the result: One third of all outsourcing / off-shoring projects are unsuccessful. On the one hand, a company's core competence is endangered by an inadequate performance by the third party: For example, Dell recently moved its business customer support back from India, where it had been relocated, after complaints about processing times and quality started increasing.

On the other hand, higher "general and administrative expenses" go hand in hand with the increasing complexity of the organization. The integration of many outside companies leads to numerous dependencies and networks that are difficult to control and direct. The cost advantages resulting from the division of labor are getting increasingly smaller, while the cost of co-ordination explodes in spite of utilizing of modern information and communication technologies.



Entire management levels spend a large amount of their time in meetings to reach agreements on coordinating measures and controlling results. In addition, risks are not viewed across the entire company. An example of this is the Swedish-Swiss engineering and construction company ABB, which was almost ruined through co-ordination requirements and an uncontrolled accumulation of risks. With its 10,000 independently operating units, it was long considered a textbook example of a successfully operating networked company.

Particularly in outsourcing, the most serious source of mistakes lies in the contracts. Many projects fail, because it is impossible to regulate everything with the service provider. Thus one has to either accept less flexibility on the part of the service provider or the subsequent amendment of the contracts has to be paid for dearly.

### **Activity-based costing and process improvement – first results after years, but is that better?**

Capturing all processes within the scope of introducing activity-based costing is a gruesome process and often ties up many resources. However, with activity-based costing reliable analyses can only be carried out, if it is clear that all inputs (resources), outputs (products and services) and processing procedures (processes) have been identified, modeled and evaluated. As optimization approaches for processes have to be available at a very detailed level, in order to be realizable (e.g. combination of the welding and soldering process in the production level III of manufacturing turbine parts), a high degree of detail is essential in the analysis. As textbook product companies do not exist in real life, already the analysis phase is complex and thus expensive.

Process cost projects are often lost in the details and therefore don't progress beyond the analysis phase

Therefore simplifications are used, in order to keep the amount of work controllable in spite of the necessity of a high degree of detail. However, those may have the effect that one process is optimized, while the interface with other processes remains unclear. And thus the overall cost could stay the same or even rise! Additionally, the interdependencies with suppliers are often ignored for reasons of simplification.

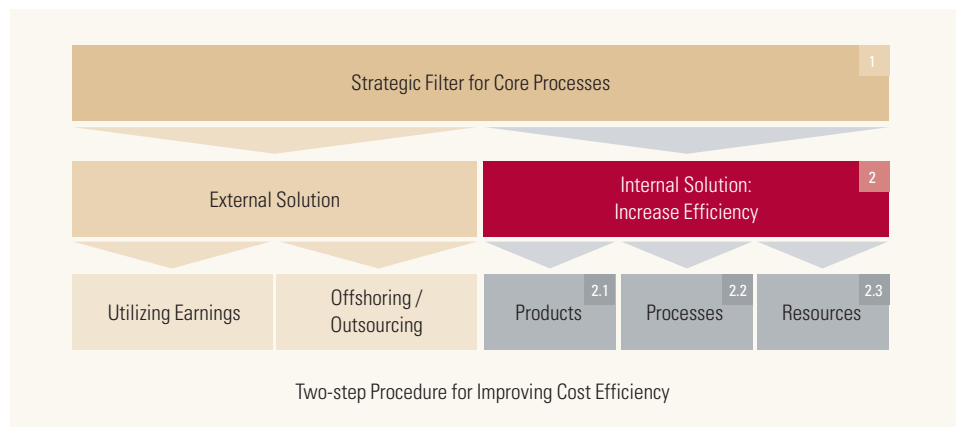
After the analysis phase the company knows which processes have to be improved, how they can be improved and which resources are not utilized. However, the entire expensive and complex analysis is useless, if major reorganizations have taken place in the meantime. It is also of little help in addressing the two largest cost drivers: The efficient utilization of resources (input) as well as the complexity of the products and services (output). Those determine the processes to a great degree and thus the resulting costs. According to a study by the Technical University of Munich, each

doubling of the number of models in an industrial company causes cost increases from 20 to 30 percent.<sup>1</sup> And the resulting cost disadvantages can also be proven for financial service providers. Direct insurance companies with a slim product portfolio and a tight organization only have a quarter of the administration costs of a provider with a full range of products and a bloated administration structure. And this does not even include the competitive advantage of the direct insurance companies' more efficient sales structures.

## Learning from successful companies: Improvement with a strategic view towards processes

Gaining an overview quickly through a process-based perspective on the highest level and concentrating on trouble spots

So, how can companies reduce the costs that result from outdated structures and processes and at the same time set the course for future growth? A process view provides new insights compared to the traditional cost accounting that are decisive for achieving higher long-term performance through cost reduction measures. However, the problem should be approached on a strategic level first, in order to counter the previously described problems of activity-based accounting. Successful companies are able to limit the work and expenses and to sharpen the distinction between processes worthy of being outsourced and those where the strategic control would make outsourcing inefficient.

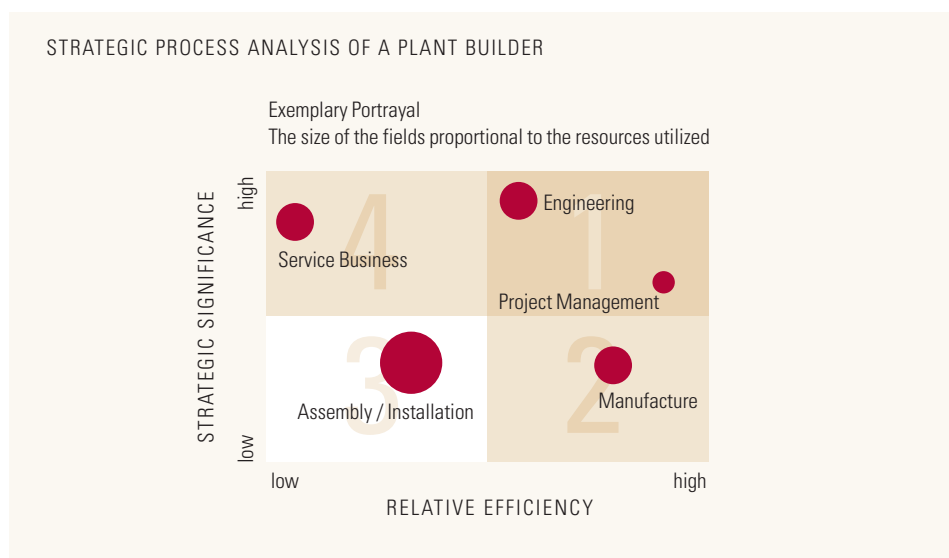


### First Step: Applying strategic filters on the core processes level

Successful companies view their cost structures from a process-based perspective, as they can better identify approaches to cost reductions that way. The use and consolidation of already existing process models and data can markedly accelerate the analysis phase. Interfaces to external

entities (e.g. suppliers, service providers) are also taken into account, in order to not only shift the costs but to actually improve them in terms of their structure and amount. A complete assessment of the lowest level processes can thus be dealt with. Prioritizing measures according to potential and time invested to realize the potential are necessary to utilize scarce management resources in the most efficient way possible.

A classification and evaluation according to strategic significance and relative efficiency takes place through the process portfolio. The criteria of value potentials, key process position in regard to the competitive advantages and the customer awareness flow into the classification. In evaluating the relative efficiency, the three factors cost, time and quality are taken into consideration with regard to the external comparison. The cost factor in this case may be decisive, but not by itself, as cost, time and quality cannot be controlled independently of each other.



The sample company is a leader in the processes shown in Field 1. This is where the largest value contributions for the present and the future are based. The short-term cost-saving potential in these processes is rather slim, but they should be monitored over the medium- to long-term, in order to continue securing its outstanding position.

Cost reduction in fields 1 + 2 can lead to a reduction of one's own value potential

In Field 2, the sample company is well-positioned in comparison to the competition. The company is being provided with the opportunity to capitalize on its processes in the marketplace. It can thus expand its strategic position in the medium- to long-term. Lufthansa, for example, has offered its expertise in maintaining airplanes to other airlines, so now more than half of the sales from the maintenance business are made with external customers. Another example is Volkswagen, which offers to build manufacturing machines for other automobile producers.

Non-competitive processes with low strategic significance should be outsourced.

The processes in Field 3 are not competitive. In addition, their strategic significance to the company is low-level, so that any great effort to improve these processes would not make sense. On the contrary, in this case an external solution would be best, e.g. outsourcing, as only little strategic control is required. However, even a long-term successful outsourcing policy needs several prerequisites:

- The cost advantage must be sufficiently large: Building up successful outsourcing partnerships needs time and commitment from management. After outsourcing, increased coordination and control costs must be expected – even in the case of strategically insignificant processes.
- The cost of the outsourcing partner’s “self-realization” of the proposed solution should be known, in order to enter into negotiations having a benchmark.
- Effects on flexibility and dependency have to remain within limits and not lead to sustained loss in quality or time problems in other processes
- The remaining contract risk may not have a detrimental effect on strategically relevant processes, as otherwise the costs will subsequently increase or the ability to create value diminishes.

A successfully implemented outsourcing project not only leads to significantly better competitiveness through an improved cost position. Management capacities are no longer tied up in strategically insignificant processes dealing with operative cost reduction programs and can dedicate themselves more vigorously to the core competences in future.

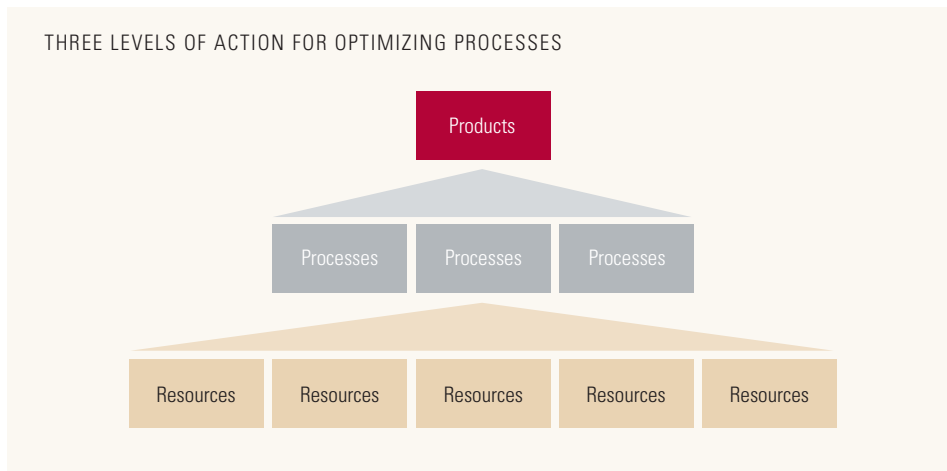
The emphasis of all cost reduction measures should lie with the processes located in Field 4

The processes in Field 4 are extremely critical to the company’s existence, as they are strategically significant, but the competitive position is weak. In the case of outsourcing, enormous efforts would have to be made to gain strategic control and not risk long-term competitiveness. These processes must therefore be kept within the company, but only at significantly lower cost. The most important measures of all cost reduction measures that lead to more efficient and more effective processes in the company are located in Field 4.

## The Second Step: Utilize all Available Levers to Improve Identified Vulnerabilities

Processes are not an end in themselves. That’s why efficiency increases start with products and resources

The explicit inclusion of products and resources in the optimization is a crucial performance factor in regard to significant and sustainable cost reduction measures.



Successful companies re-evaluate their products during a course of process and structure re-modeling. Frequently, the product range has grown historically and individual value contributions are generally not known. It is often only the variety of models that cause high complexity costs. Loss-creating products need to be identified and eliminated when portfolios are streamlined – however the life cycle phases as well as bundling effects need to be taken into account at the same time. For example, a car manufacturer was able to offer competitive prices for better product quality by reducing the product range from 45 to 12 battery types and to realize cost advantages by diminishing the number of suppliers (from 5 to 2). The technique practiced by world-renowned orchestras takes the same approach. With each new composition that is taken up into the repertoire, an old one is eliminated and no longer performed. These orchestras usually command only a few compositions, but they do so masterfully.

Products and services as drivers of process complexity

An optimization of processes takes place in order to increase performance. By applying “thinking-out-of-the-box”, preceding and following value chain steps are considered, thereby avoiding partial optimizations at the expense of the overall process. For example, the package sizes of a retailing group were modified in such a way that the packages could be placed directly into the shelves. Prior to that, the process had only been optimized according to the forwarder’s perspective, i.e. the delivery sizes were aligned to efficiency in regard to the transport (euro-pallet). The retailing group’s savings realized through fewer process steps in handling the goods outweighed the additional expense caused by the forwarder many times over and led to savings in the millions.

Optimization of processes from an overall perspective instead of partial optimizations

Companies that achieved successes by optimizing at the resource level started with the cost structure, based on the type and number of relevant production factors. A variety of cost reduction measures emerge from that, depending on the product/service portfolio:

Resources are the largest cost factor in the process input

Optimization by reduction of  
uncommitted and committed  
idle capacity

- Reduction of uncommitted idle capacity because of cuts in personnel, plant closings, etc.
- Reduction of committed idle capacity because of a decrease in volatility
  - Daily fluctuations: In many companies customer service is based on the “follow the sun” principle. Call centers in Europe, America and Asia guarantee that the customers can be served around the world at any time
  - Seasonal fluctuations: In another example, the number of underwriters in a re-insurance company were significantly reduced and the workload of the remaining ones increased, once the conclusion of the contracts were performed in a centralized, globe-spanning underwriting office. Prior to that the experts were only working at full capacity for a few months at different times of the year.

Optimization with  
Shared Services by utilizing  
economies of scale

- More efficient use of capacity by increasing lot sizes and the number of cycles
  - Internal merging of crucial tasks (Shared Services). Classic examples are personnel and research departments of different subsidiaries
  - External merging of resources through joint ventures and acquisitions. Example: At SonyEricsson, Sony and Ericsson joined their development, production and marketing resources in the mobile phone segment, in order to distribute the high fixed costs over larger quantities and more products

Increase in efficiency  
through differently  
structured resources

- Rearranging the structure of the resources used
  - The increasing cost of the production factor “labor” as opposed to capital makes an adjustment of resources through automation necessary. In a reference project at a pharmaceuticals wholesale operation, the increase in the degree of automation in order picking from 8 to 60% reduced the personnel costs by 40%.

## The efficiency increase is the source of future growth opportunities!

The most important insight gained from all implemented cost projects to date is the following: The procedure described here doesn't prevent growth, just the opposite: it promotes it! Companies can switch from the “cost reduction mode” into the growth mode without any major difficulty, if they follow this approach. Firstly they know from the strategic filter exactly what their competitive advantages are, so that they can build up strategies for growth. Furthermore companies are freed of processes that were keeping them busy, but were not contributing any value. And last but not least, a majority of the freed-up resources can be applied to strengthen growth in the activities promising high value potentials. Most importantly: While there are significant successes in cost reduction – the essence of the company is not being damaged!

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