HighPoint INSIGHTS

CAN YOU KEEP OVERHEAD CUT?

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INTRODUCTION

It's a classic command from top management. Need to reduce overhead? Just cut 10 percent.

Like most top-down edicts, it never works. You think you made the cuts but you haven't. It doesn't last. The costs always come back. Why? Because you failed to make the underlying changes in work, output, activity or priorities. Without real productivity improvement, the costs quickly come back. Worse yet, this across-the-board approach to cost cutting inevitably eliminates costs that should have been kept; in essence, "Throwing the baby out with the bath water."

How can a company successfully reduce costs and overhead, and keep it cut? Look no further than a process developed almost four decades ago: the AVA.

The White Knight to Cost-Cutting

In 1975, John Neuman, a Partner with McKinsey & Company in New York, invented a process called Overhead Value Analysis (OVA), introducing it in a *Harvard Business Review* article entitled "Make Overhead Cuts That Last."

John's idea was simple yet compelling. It offered a solution to what executives worldwide already knew: Across-the-board cost cutting doesn't work. Simply stated:

> *Don't focus on the costs. Examine the activities that drive costs. Look at all the reports and "services" the overhead departments provide to their "clients" (typically inside the company). Examine how useful these end products really are. Look for ways to reduce, eliminate or streamline the end products, or the activities that generate them. Challenge the organization to get creative. Give them a stretch target. Tell them that every idea matters, even the small and insignificant ones. Then, add up all the ideas deemed a "go" (typically several thousand) and restructure the overhead around what's left.*[1]

[1] "Make Overhead Cuts That Last," by John L. Neuman, *Harvard Business Review*, May 1975.

He laid out a process solution, a McKinsey project, and clients bought it in droves. Finally executives had the means to cut overhead and actually keep it down. Not only did the process reduce the amount of underlying work, it gave management the tools to manage expenditures and requests for new initiatives at a level of granularity never before possible.

McKinsey went on to do thousands of OVAs (later renamed AVA for "Activity Value Analysis"). Other consulting firms copied it, modifying it slightly so as to call it their own. New firms sprang up specializing in the process. Decades later, several firms have evolved highly specialized versions, including HighPoint Associates, which conducts AVAs in partnership with Vici Capital Partners, combining HighPoint's general management skills with Vici's specialists and web-based analytic tools.

Despite the overwhelming success of the AVA process for almost 40 years, many companies still don't use it. Many have never even heard of it. And while an AVA is certainly not a simple two-step process, it is and has proven these many years to be the most effective method a company and its leadership can utilize to reduce overhead and keep it down.

AVA: A Compelling Solution to Cost Cutting

The primary impetus for conducting an AVA is cost-cutting. A successfully conducted AVA will deliver reductions of 10 to 25 percent of a company's studied cost base. When the decision is made by management to reduce costs identified through the AVA, the costs don't come back. Furthermore, the AVA provides tools that let top management explicitly authorize "add backs" or "new activities." In essence, the AVA puts top management in actual control of the company's cost structure. Some companies have extended the process beyond cost cutting to include revenue growth and even pricing. But it remains primarily an efficiency tool.

When a company finds and implements savings near the upper end of the range, the results can be transformative with almost tectonic shifts in cost structure. Companies can leap from the middle of the pack to lead their peer group in terms of SG&A expense ratios, or move up from the back of the pack to the middle. And while these exceptional results are not always realized, when they are they can actually change a company's competitive position.

Overhead Cuts and So Much More

In addition to revising a company's cost structure, AVA delivers top management with an equally compelling understanding of how things really work within their organization. Imagine having a blueprint of what each department in the company actually does and how that work benefits others in the company? AVA delivers a level of insight not achieved in any other way.

Moreover, AVA often creates a new culture of accountability in the company. Buying into the process fully, a company can become 'AVA-driven' with fact-based proposals, detailed work plans, no double counting, no generalities that cannot be measured. AVA becomes more than just a discipline. It is a mentality; a cultural shift.

Going forward, companies also keep these sophisticated tools to manage by, creating a marked improvement in the annual budgeting process and far superior cost-control mechanisms than existed before (think of it as "Zero-Based Budgeting on Steroids").

It is important to note, however, the one downside you can expect after an AVA: organizational fatigue. It's like running a marathon: you feel great that you did it, but you finish exhausted.

Companies should always allow for a breathing period after an AVA. If you can accept the temporary fatigue as the price to achieve the benefits, the AVA process can in fact have a transformative effect.

An AVA in Action

Take for instance the AVA conducted by "HealthCo", a HighPoint client and $1-2 billion in revenue consumer goods company.

Over the last 10 years, HealthCo saw rapid growth, solidifying a leadership position in its industry. The company's rapid growth, however, required many investments to develop new product lines and to support a larger company. The corresponding increases in staffing and infrastructure costs, and a marked increase in the complexity of the company, were masked by its rapid growth and high profitability.

As new competitors flocked to the space (given HealthCo's visible success), the company's growth inevitably slowed and its operating margins declined. Then came the financial crisis. Although HealthCo had remained profitable between 2008 and 2012, they experienced something new. As revenues declined (for the first time in the company's history), costs didn't go down proportionately. Management's attempts throughout the budgeting process to pare costs down in line with revenues were met with resistance. Virtually all parts of the organization claimed they were already stretched thin and needed more resources, not less. Even as revenues recovered from the effects of the financial crisis and began to grow again, there were requests for yet more resources.

HealthCo's senior management asked HighPoint for help, and the recommendation was an AVA. The CEO bought into the process completely – critical to the success of any AVA. At the kick-off meeting with the top 50 managers in the company, he announced that he was turning the company over to them for the next four months. He challenged them to turn over every rock, one at a time, and to let no sacred cows escape scrutiny. He told them that heroes would emerge from unexpected places. He encouraged them to be champions.

At critical stages of the AVA process, and a few instances when things were not going well, the CEO stepped in. At one point he quelled resistance from part of the organization that didn't think it really needed to contribute to the process. In another instance, the HighPoint team was having its own challenges keeping up with the company's process, requiring both consultant and CEO to shore things up.

In the end, HealthCo identified and implemented about 2,000 "ideas" that resulted in an overall savings of close to 20 percent of the company's total indirect cost base. On a run rate basis, this reduction doubled the company's profitability.

Equally important to the cost savings was the cultural shift that HealthCo made as a result of doing an AVA. For the first time in the company's history, there was personal accountability at the level of every front-line manager. Persuasion gave way to facts and analytics. Proposals without solid analysis were sent back to the drawing board. Business initiatives were looked at from a company perspective, rather than from that of a function or department.

For the most part, the 50 or so managers and executives who run HealthCo on a day-to-day basis like the change. In a way, the AVA process helped the company 'grow up' and transition from adolescence to adulthood. Ultimately, it's the rigor and discipline of the AVA process – carried out by the company, not the consultants – that made this possible.

Secrets to Success

The success of HealthCo's AVA process, however, was not just driven by mastery of the AVA mechanics. There are a number of secrets to success – what we call "the secret sauce" and what a seasoned consulting firm can bring to the process.

When the "science" of an AVA's excruciatingly detailed project process is combined with the "art" of the secret sauce, AVAs almost never fail. Like a force of nature, a properly conducted AVA just can't be stopped.

Aspects of the secret sauce include:

- **Use of stretch targets.** "Big idea" targets are used to stretch the organization's thinking. These targets are not savings to be realized but rather force creativity and challenge sacred cows. These typically range from 30 to 40 percent of the cost base being studied (one top-five bank used a 50 percent target).

- **A specific approach to messaging.** A carefully crafted PR campaign is waged within the company, from the opening announcement to the victory celebration.

- **Training.** Front-line managers must undergo extensive training on the AVA frameworks, tools and processes. This methodology has been tested over decades and shouldn't be made up "on the fly."
- **Strategies to combat resistance or a lack of full engagement.** These are proven lessons on how to deal with the inevitable testing of management's resolve. Like a parent with young children, there is an art to saying "no" without overreacting.
- **The degree of rigidity and flexibility around each aspect of the process.** Experience has taught us where the process can be customized and where it cannot. The client often has ideas about doing things a little differently to fit its culture and style. Knowing which aspects of an AVA can be modified without risking the results, and which cannot, is critical.
- **The degree and nature of CEO involvement and resolve.** Every consultant wants the CEO involved in a project; this one actually requires it. Give the CEO a role on center stage and the AVA becomes his or her project. When the organization sees this, an AVA is almost guaranteed to succeed.
- **The making of heroes, and thereby advancing careers.** This is about celebrating big and small victories, and giving the front-line managers credit for the result – even when they were helped behind the scenes. They need to trust that their hard work, creativity and initiative will be rewarded.
- **Managing the consequences of non-cooperation or failure at the unit level.** The opposite side of success must also be clear to the organization. During and after the project, the accountability culture an AVA can create depends on there actually being accountability.

HOW AN AVA WORKS

An AVA involves a massive amount of work. It is precise and tightly choreographed. Unlike many consulting projects where a consultant brings in small team to work with an equally small client team to "study" something, AVA is a management process led by the top and carried out by the front line. It involves expert leadership and the efforts and determination of dozens of people.

The AVA process is divided into a planning period and three pre-implementation phases and takes about six months before the results begin rolling out.

Phase 0: Project Planning – 1 month
Phase 1: Idea Generation – 1 month
Phase 2: Idea Evaluation – 3 months
Phase 3: Implementation Planning – 1 month

Phase 0: Project Planning

Several things have to happen during this pre-project phase. First, there is a financial analysis, recommendations by the consultants and decisions by management to set the cost base to be included.

AVAs used to include only true overhead in the scope of the project: corporate staffs, administrative departments within groups and divisions, etc. In recent years they have become more inclusive. They now can include call centers, sales forces, operations functions, purchasing, pricing, and even growth. Management must decide whether it wants to go "all in" (include everything) or limit the effort to the more traditional G & A areas. Both approaches work.

In addition to this fundamental decision, the accounting data is recast to get the "AVA base budget." This typically includes adding back some capitalized costs to departmental budgets, removing depreciation charges, and sending allocated costs back to the source. The AVA base budget ends up looking a lot like cash accounting; and all the costs are where they actually occur. This is a non-trivial exercise.

Another important aspect of getting ready is getting organized. AVA "units" and "groups" are defined and unit and group managers are assigned. This typically follows the organization of the company, with units being departments or portions of departments with 10 to 50 people and managed by a single person. Corporate

Accounting or Finance might be the units in a mid-sized company. In a giant company, the units might be Cost Accounting or FP&A.

In addition to the unit structure, "challenge managers" are assigned. These are higher-level managers or executives who will devote themselves to "helping, coaching and encouraging" the unit managers. The company also assigns an "AVA Project Leader" and a handful of analytic types to work with the HighPoint consultants in managing the day-to-day activities under the direction of the project leader. A Steering Committee is also assigned, which typically includes the CEO and his or her key direct reports.

Late in this phase, the project is announced and key milestone meetings are set (in concrete). The CEO makes the all-hands announcement and invitations go out to participants to attend the kick-off meeting.

Phase 1: Idea Generation

After an all-day training session to launch the effort, the first phase consists of two basic tasks. First, each AVA unit manager must recast his or her AVA base budget around activities and end products. Departmental budgets are typically organized by type of cost. Now managers are asked to describe what tasks (activities) are performed and what outputs (end-products) are produced. In addition, the users (customers) of the end products are identified. These are typically other internal groups. Most work inside a company is done for the benefit of some other group inside the company.

The other part of Phase 1 is to start generating ideas. The goal is to generate too many ideas – many of them will survive scrutiny and a lot more won't. This is every manager's chance to get out all the ideas he or she has on how to do things better. Each idea is categorized as eliminate, reduce, streamline, automate, combine, etc. and given a preliminary value. For example, if the daily flash report from Finance takes one FTE and the idea is to make it bi-weekly, the savings estimate might be half an FTE.

In a mid-sized company like HealthCo, thousands of ideas were generated in the first month. The success of the AVA is grounded on the realization that many small and seemingly uninspiring improvements lead to a huge leap forward in the company's overall productivity. The ideas need to come early and often.

Phase 2: Idea Evaluation

During this major phase, ideas are refined, added to, culled out, evaluated, valued and recommended. Ideas are risk-rated by the end users. They are made specific. The savings and any one-time implementation costs are identified. Each surviving idea has its own spreadsheet and owner.

In addition to the thousands of "bottom-up" ideas, there are always bigger ones that are not limited to a single department or area. These "Cross-Company Ideas" are identified and taken offline to be assigned to an executive or a team for in-depth study. A Cross-Company Idea might be: "Subject all proposals for new expenditures or staffing in excess of $100,000 per year to the Company's capital budgeting Green Light Process." It's a good idea; but fleshing out the practical ramifications and estimating the savings requires analysis and thought.

The final step in this phase is to decide on the ideas that will be implemented. There are typically a limited number of important ideas that just couldn't be evaluated during the project. These are designated as "Further Study."

Phase 3: Implementation Planning

This last, non-trivial phase involves three steps. First, the Unit Managers develop an implementation plan for each idea. What steps need to be accomplished? When will the savings occur? Who does what to whom to get the change made? How can it be monitored? Every implementation plan has an owner. The owner must commit to the CEO that he or she will actually deliver the promised result.

The second implementation planning step is to translate all the savings back into the regular budgeting format of the company, and to layer in the savings (from the base budget) on a quarterly basis. Remember that each idea has its own spreadsheet. These need to be rolled up to reflect the aggregate one-time implementation costs and recurring cost reductions for the entire company. And those special adjustments, like including some of the capitalized costs in the scope of the AVA, are backed out with savings in these areas and tracked separately.

In addition to recasting departmental budgets, detailed budget monitoring tools are developed. Management now has the ability to review personnel and non-personnel expenditures at a more detailed level than is possible with typical budgeting processes. This is a critical aspect of why the AVA process enables management to "keep the cuts cut."

Lastly, there is a critical Human Resources component to the implementation planning phase. Since many of the workload-reducing ideas result in reductions of fractions of FTEs, staffing and departmental restructuring adjustments must occur. Sometimes entire departments are combined, or work is shifted from one group to another in order to capture the intended savings. The objective is to reach 100 percent "Capturability," one of the many unique AVA terms. The other aspect of HR planning is to decide how reductions will be achieved, usually through a combination of attrition and one or more reductions in force. These too are laid out on the calendar. And of course, names must ultimately be chosen.

An Enduring Solution with Big Value

John Neuman started something important in 1975. And while the AVA process has certainly evolved, its basic tenants stay consistent to those conceived by John from the beginning. The AVA remains both art and science, and when well done, continues to have profound effects.

ARTICLE CONTRIBUTOR

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