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Radically transform your cost structure

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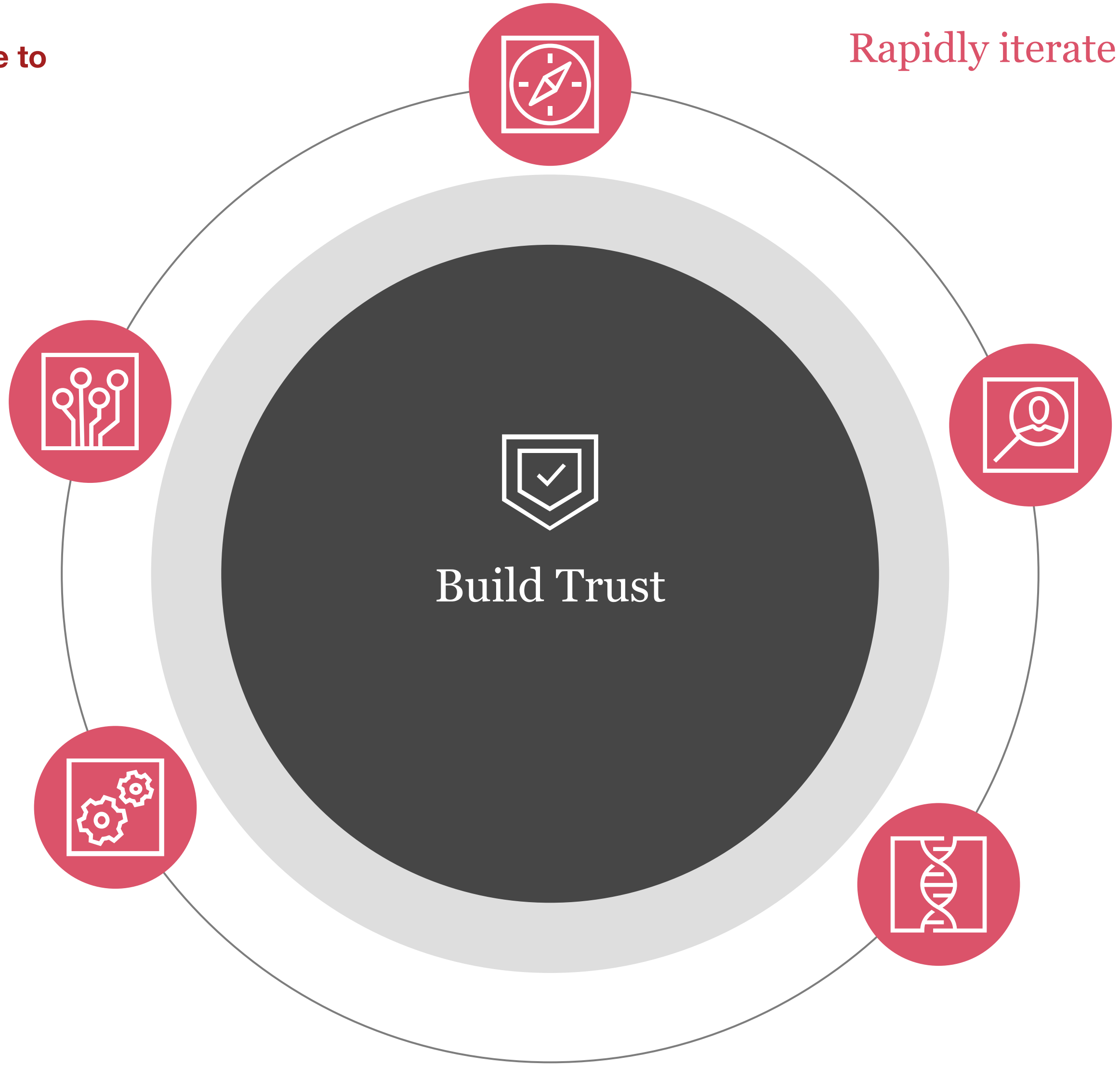
Fit for Recovery is a powerful approach to help companies reset their costs and emerge stronger from COVID-19

What actions should companies take to become Fit for Recovery?

Radically transform your cost structure

Zero-base cost structures and re-prioritise capital program; Test genuine “lights-on” costs; Make hard calls on shared services and the IT stack; Assess and optimise working capital and cash flow management; Capture footprint strategy opportunities; Reduce headcount; Review corporate overheads.

Reimagine your operating model



Rapidly iterate and refine strategy

Build capabilities

Activate culture-led behaviour change

Source: Strategy& Analysis

As organisations consider the cost challenges raised by COVID-19, they should be cognisant of prior learnings and apply a structured approach

Key Cost Restructure Learnings

1. **Be prepared to tackle ‘big’ costs to meet targets –** Cost-outs often focus purely on small cost drivers and miss targets, as large measures are difficult to implement.
2. **Don’t throw the baby out with the bath water –** Focus should be narrowed to ‘bad costs’, avoiding elimination of ‘good’ costs which support differentiating capabilities.
3. **Unify the organisation behind drivers of change –** Focus the business on improving speed or quality, engage them in the design and process and effectively cascade to ensure alignment.
4. **Execution eats strategy for breakfast –** Organisations often overemphasise strategy. Ensure managers at each level are accountable to targets and establish explicit trade-off decisions.
5. **Use culture to sustain savings –** Organisations need to establish behaviours which support a low cost base over time to avoid cost cutting fatigue.

Framework For Addressing Costs

The extent to which these levers are applied depends on the systemic issues in the organisation and how the COVID-19 has impacted each industry/business.

Costs Targeted	Choices	Example cost levers accelerated by COVID	% of Cost Base
“What We Do?” *Change what is done*	**Inherent**	• Focus on the core - eliminate non-core activities • Rationalise unprofitable products and services • Explore M&A to reduce cost base and benefit from greater scale • Determine target customer segments	30 - 35%
“Where We Do It?” *Change where in the organisation service and operations activities are performed*	**Structural**	• Redesign operating model e.g. reduce silos, duplicated roles • Optimise (consolidate) shared services and corporate core • Offshore and outsource activities • Review IT stack e.g. develop strong cloud-based infrastructure, and enhance digital delivery to reduce corporate overheads • Restructure supply chain • Rationalise footprint strategy • Redesign products	30 - 35%
“How Well We Do It?” *Continuously improve efficiency of activities; change how tasks and support activities are performed*	**Executional**	• Implement ‘Connected Digital Enterprise’ - Embed new ways of working (incl. roles & decision rights), streamline (automate & standardise) processes, orchestrate workflows, deploy digital workers, enhance delivery models, develop people & capability • Shift customer engagement and marketing spend • Zero-base cost structures, re-prioritise capital program and test genuine “light-on” costs • Optimise procurement	30 - 40%

Increasing Ease of Implementation

We can draw upon examples of leading companies capitalising on crises to implement bold cost restructuring measures

Company Case Studies

Action	Targeted Cost Driver	Company	Illustration
Divest non-core assets / brands	Inherent Cost Drivers	Auto Manufacturer	During the financial crisis the manufacturer endured a government-backed bankruptcy. The company **sold off unprofitable brands** and focused on producing more fuel-efficient vehicles
		Mining Corporation	Company divested ~$10Bn of non-core assets from 2007-2009 and **reinvested in value accretive mine projects** (>150% CAPEX increase in 2010-11)
Opportunistic M&A		Large US Telco	During the 2008 recession, the company **shifted focus towards the growing wireless and broadband markets**; acquiring several companies to be able to grow in this market
		Global Insurer	Insurer **leveraged GFC for opportunistic M&A activity**, completing several acquisitions in Australia, increasing profits & further consolidating position within a fragmented post-crisis market
Product change and innovation		Global Restaurant Chain	In addition to cutting cost significantly during the crisis, the company **shifted their focus** towards connecting with customers more and **started offering a wider variety** of food and drink
Automation	Structural Cost Drivers	Electronics Company	Company **accelerated digitisation** during the financial crisis to increase operational efficiency by investing in R&D and technology capability to decrease labour dependency
Operational efficiency measures	Executional Cost Drivers	Home Entertainment Retailer	During the financial crisis, the company focused on improving productivity, **reducing SG&A expenses** by over 100 bps over 2 years whilst revenue climbed over 50%

Source: Strategy& Analysis

The impact that COVID-19 has had in accelerating typical cost challenges can be brought to life using 7 examples

Typical Cost Challenges and How They are Being Accelerated by COVID-19

Further analysis on each of these challenges is provided in the following pages

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Cost type		Examples of Cost Challenges Facing Companies	How COVID-19 Accelerates Challenges
Inherent	1	**Portfolio not actively managed** to discontinue investment in unprofitable businesses, customers and products	COVID-19 has **negatively impacted profitability** of some business units and **materially impacted strategic coherence**, requiring organisations to reassess potential divestment value against stranded and one-off costs
Structural	2	**Investment in automation is not providing commensurate benefits** due to many disparate systems and / or historic underinvestment in technology	**Further shifts towards digitisation** in a post-COVID world necessitate investment focused on simplification, modularisation & automation
Structural	3	**Difficulties right sizing the organisation** due to operating model silos, duplicate staff and lack of cross functional teaming	**Cross functional ways of working to drive greater scale** - silos further strain companies with already declining top line growth
Structural	4	Preponderance of **management spans and layers** causes slow decision making	Swift changes in consumer needs during COVID-19 **increases the importance of efficient spans of control for decisive action**
Structural	5	**Supply chain** receiving significant investment, in some cases **reducing cost at the expense of resilience**	COVID disruption **emphasised how a resilient supply chain can become a defining and cost saving capability** - organisations to reconsider business case for automation and right-sourcing
Structural	6	**Inability to optimise footprint** across the front, middle and back office	Largely positive response to rapid **shift towards remote working provides opportunities** for companies to reconsider working model
Executional	7	Limited ability to determine **marketing channel and distribution effectiveness**	**Changing consumer preferences** in the “new normal” further push companies to critically assess their marketing effectiveness

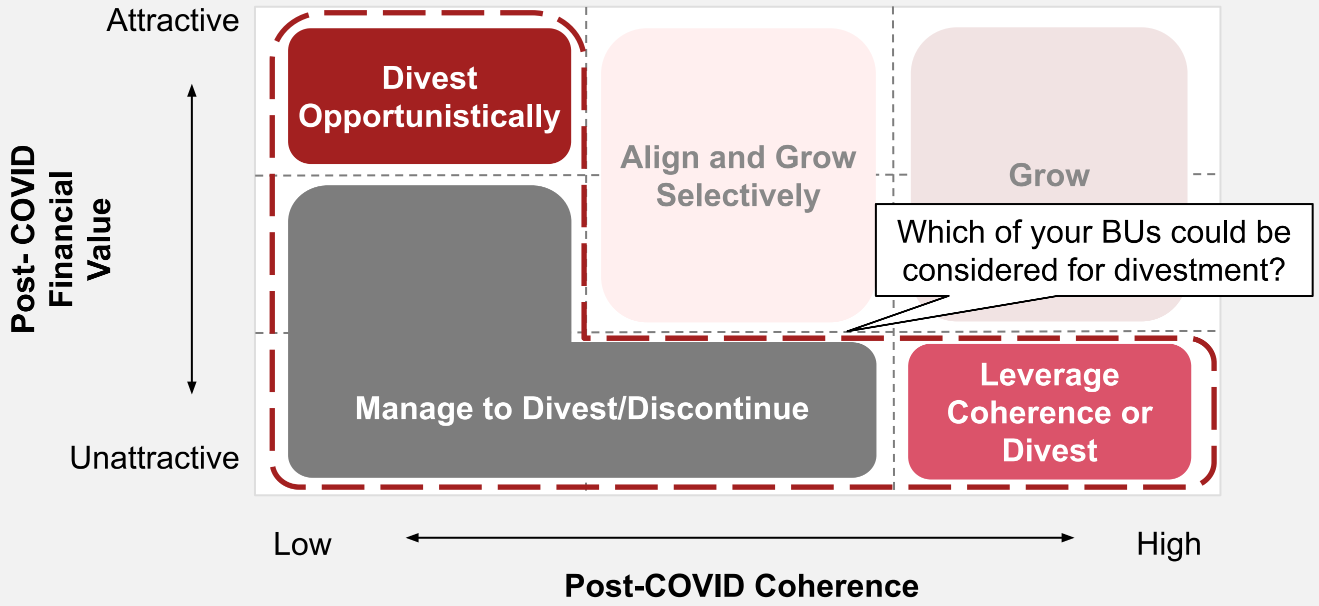
Source: Strategy& Analysis

Portfolios should be reviewed for businesses lacking strategic coherence or financial value after COVID-19, with divestment considered

Capabilities-driven Portfolio Assessment Framework

To ensure that post-COVID cost actions align to creating value, **organisations need to re-evaluate product/service portfolios across two metrics**:

1. **Post-COVID Financial Value**, which factors in the structural changes in markets and customer demand
2. **Post-COVID Strategic Value**, which factors in the coherence with the firm's post-COVID capabilities system



Discussion

1. **COVID-19 has shifted the financial and strategic value of business units:**
   - Economic downturn and changing demand reducing financial value
   - Strategic coherence shifting, as companies discover new capabilities and realise others are no longer differentiating
2. **Organisations should assess the value of divestment now vs. in the future and manage assets accordingly**
3. **Organisation must remember you cannot 'shrink your way to greatness'**
   - As organisations divest business units, they will need to reduce indirects costs previously supported by the lost revenue to avoid stranded cost problems
   - Organisations should also quantify one-off transaction costs (redundancies, advisor fees etc.) to inform their decision

Source: Strategy& analysis

Total productivity in Australia has not increased at the same rate as technology spend and cost reduction programs

Australian Productivity and Technology Investment

0.1%

increase in **AU multifactor productivity[1]** per annum, 2014 - 2019[2]

- Australia's total multifactor productivity[1] (value added output per unit of input) across industries has been relatively flat since 2014
- There has been large variance across industries, with top performers increasing multifactor productivity[1] by up to 3.3% p.a. (Mining) and the worst performers declining by up to 4.0% p.a. (Construction)

4.3%

increase in **AU Tech product and service spend** per annum, 2017 - 2021F

- Australia's total spend on Technology products and services is forecast to increase from $87Bn in 2017 to $113Bn in 2021
- $8Bn (~48%) of this increase is expected to be invested in Data Centre Systems, with a further $6Bn (~38%) in IT Services

63%

of AU corporate respondents **developed IT** from 2015 - 2017[4]

- Australian corporates were more likely than their APAC peers (55%) to have developed IT infrastructure, systems and business intelligence platforms as a cost cutting capability
- Investment in IT was the third most common capability developed, behind improved forecasting, budgeting and reporting (87%) and implementation of policies and procedures (76%)

1) Multifactor productivity (MFP) measures the growth in value added output (real gross output less intermediate inputs) per unit of labour and capital input used. Quality adjusted hours worked basis measures both changes in hours worked and changes in quality (that is, changes in educational achievement and experience).
Source: 2) ABS 2019; Estimates of Industry Multifactor Productivity, 3) Gartner, 4) Deloitte's first biennial cost survey: Cost improvement practices and trends in Asia Pacific 2017, Strategy& Analysis

Executives should assess their tech stack spend for simpliciation, modularisation and automation opportunities relevant post-COVID-19

The Technology Stack Productivity Placemat

Cost type	Tech Organisation & Operating Model	Tech Delivery Management	Tech Service Management	Application Management	Tech Asset and Inventory Management	Tech Vendor and Sourcing Management

Inherent

- **Technology & Digital Strategy** (e.g. Overall Tech Strategic delivery choices such as NoOps)
- **Architecture Cleanup/Standardization** (e.g. domain framework, complexity reduction, SOA)
- **Leveraging of new Technologies** (e.g. cloud computing, SaaS)
- **Outsourcing and Offshoring** (e.g. business process outsourcing, increased use of offshore resources)

Structural

- **Implementation of HR-Related Measures, Operating model tuning, Agile roles etc.** (e.g. switch external/internal, activity based resource, relocation, Agile operating model and roles rollout)
- **Integration business and Ops with Tech for integration planning, prioritization and implementation** (e.g: DevOps roll-out)
- **Application Consolidation** (e.g. ERP, end-user client applications)
- **Infrastructure Consolidation** (e.g. data center, middleware, Operating system, servers etc.)
- **Asset Cleanup** (e.g. short-term capacity cuts, asset assignment review)
- **Vendor Consolidation** (e.g. ERP service provider bundling)

Executional

- **Demand Mgmt Optimization** (eg. centralized demand & supply balancing)
- **Lifecycle process optimization** (handover and lean approach reduction)
- **Service Streamlining** (e.g. rightsizing of service portfolio, SLAs, OLAs)
- **Contract Renegotiation and Termination** (e.g. license management, re-negotiation, and enforcement of contract compliance)
- **Effective Tech Governance** (e.g. IT performance management)
- **Reassessment of Project Portfolio** (e.g. legal and strategic only)
- **Service Management standardisation and automation** (eg. SM tools, Performance Improvement, RPA roll-out)
- **Utilization Improvement** (e.g. postponements/optimization of re-investments for infrastructure)
- **Automation and removing manual handover** (rolling out of IT4IT automation and CICD across the organization)

Discussion

- It's likely that Australia's 'productivity leakage' is as a result of tech stack spend without targeted simplification, modularisation and automation
- Without targeted investments, business units of large functionally based teams are not subject to role compression or size reduction and costs escalate
- Identifying where the productivity 'leak' has occurred is critical to fixing the glide path to a digitally led business
- We recommend executives review their tech stack, investing in simplification, modularisation and automation capabilities most relevant in a post-COVID world (e.g. Operating model tuning, Vendor consolidation)

Source: Strategy& analysis

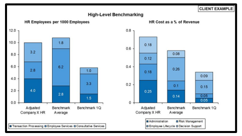
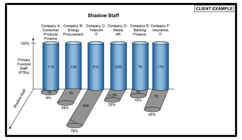
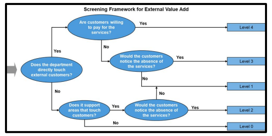
Right-sizing is difficult, however as COVID-19 constrains top-line growth companies should proceed using proven assessment methods

Several factors lead to difficulties in right-sizing for organisations…..

1. **Difficulty reducing duplicated effort across op. model silos, which arise from:**
    - Resourcing decisions and shared service charging models which rely on legacy methods rather than contemporary business drivers
    - Highly-customised user needs (e.g., establishment of teams to meet diverse, rapidly changing needs in COVID-19)
    - Conflicting cultures
2. **Lack of cross-functional teaming**, which reduces transparency of true direct and indirect costs
3. **Processes which have become increasingly complex** in response to disparate, aging IT systems and need for multiple handovers

…. however, it is more important now than ever for organisations to use proven methods to assess their efficiency and design a path forward

Organisational Efficiency Assessment Methods

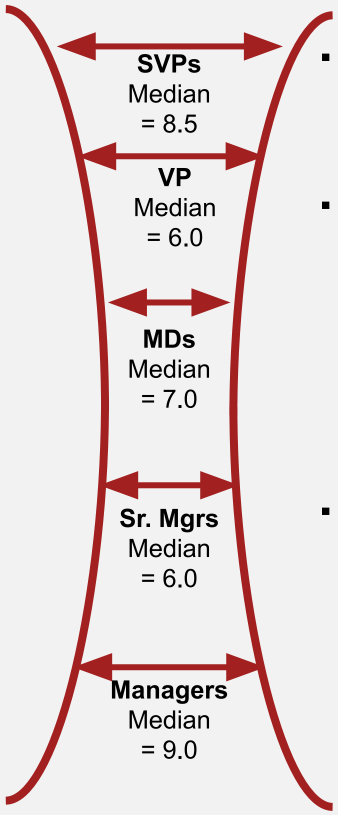
	1. High Level Benchmarking	2. Shadow Staff	3. Activity Analysis
Area of Focus	 Very rapid assessment of the potential scale and scope of organization structure misalignment	 Gaining scale in front line staff organisations through the elimination of redundant activities across orgs and consolidation of spans	 Taking non-value added work away from front line staff and redirecting towards higher value-added activity
Diagnosis Approach	▪ Development of key staff metrics – e.g. staff function per 1,000 employees ▪ Development of key cost metrics – e.g. cost of function as % of revenue ▪ Comparison to industry and functional benchmarks ▪ Identification of areas of disconnect ▪ Second-level diagnostic of high opportunity function	▪ A rapid assessment of the potential of the existence of significant numbers of shadow staff is conducted through interviews of key business unit heads to look for indications across the five drivers of shadow staff: – Cost – Availability – Access – Quality – Governance	▪ Rapidly baseline organisation by function, department, etc. ▪ Determine which functions/ activities are value added and which are not ▪ For non-core functions/ activities, determine which: – Should be retained and where they should be embedded – Should be outsourced – Should be offshored

Source: Strategy& analysis

Spans of control often grow into an ‘hourglass’ shape over time - companies need to reset based on complexity and organisational layer

Span of Control ‘Hourglass Symptoms’

Span of Control Distribution by Layer



- **Wider span at top levels**, reflecting desire to justify division existence with full span of control & set example
- **Narrower spans at middle and officer levels** a consequence of:
  - Fixed layer structure combined with top-down, philosophically determined division boundaries
  - Higher spans at top and bottom layers force middle spans to be lower
- **Widest spans at manager layer**
  - Easily influenced by middle managers
  - Increased consciousness of need to design departments with higher spans
  - Focus of most organization redesign at lowest levels

Spans of Control - Complexity Assessment Framework

Factor	Organisational Layer			
	Level 4	Level 3	Level 2	Level 1
Functional Diversity of Department	• Direct reports are very heterogeneous, wide variety of functions	• Direct reports have significant diversity in functions performed	• Some mix of function in direct reports, perform different functions	• All direct reports perform similar functions
Degree of Process Standardisation	• Dept. processes are performed differently each time executed	• Some standardised processes, others are developed when required	• All dept processes standardised, standard method is tailored for applications	• All dept processes performed in the same documented way
Level of External Interfaces	• Extensive need for manager to interface with people outside (>50% of time)	• Significant need for manager to interface with people outside (20%-50% time)	• Manager has some need to interface with people outside (5%-20% of time)	• Manager has little need to interface with people outside (<5% of time)
Level of Internal Interfaces	• Extensive need for dept head to interface with other internal organ (>50% of time)	• Significant need for dept head to interface with other internal organ (20%-50% time)	• Dept head has some need to interface with other internal organ (5%-20% of time)	• Dept head has little need to interface with people outside (<5% of time)
Project Maturity	• All projects handled by dept. in early stages, conceptual & changing	• Dept handles mix of projects, mostly in early some in late stages	• Dept handles a mix of projects, some in early most in late stages	• Projects handled are matured, established, and well understood
Geographic Dispersion	• Dept resources and work are dispersed equally across many locations	• Dept resources and work are dispersed equally across several locations	• Dept resources & work are dispersed across several locations, with one clearly dominating	• All dept resources and work are in one location

“Good practice” Spans of control: Most complex *4* ⟷ *8* *12* *15* *20* *30+* Most stand-ardised

Source: Strategy& analysis

COVID-19 has exposed supply chain vulnerabilities, accelerating the need to implement measures that improve resilience

Supply Chain Challenges Intensified by COVID-19

Key Australian Supply Chain Issues

	1. Limited Transparency	2. Supplier Over-reliance	3. Global Risk Exposure	4. Demand Uncertainty
	• Difficulties in gauging supplier location, availability, and operating capacity • Limited data preservation to support future potential claims and loss mitigation / tax costs etc.	• Reliance on key suppliers exposes vulnerabilities • Companies bear the burden of supplier capacity, channels, pricing and reputational risk	• Organisations face exposure to supply chain threats wherever they occur • Supply chains are vulnerable to a wider breadth of regional shocks • Organisations navigate global logistics and differing compliance standards	• Lack of connectivity to coordinate responses to varying demand shifts: – Short-term unprecedented spikes – Fluctuations in mid-term consumer behaviour – Long-term behavioural changes
Australian Sector Covid-19 Examples	**Resources** • Upstream disruption in light of COVID-19 lockdown workforce restrictions • Limited supplier, transport company and warehouse operator collaboration causing lengthened delivery disruption lead times	**Consumer Goods** • Electronics retailers may be forced to shut down plants / temporarily cease operations due to disruption to critical suppliers	**Resources** • Supply chains particularly vulnerable to falling global demand for air travel and associated oil price drop • China's economic shutdown leading to sector-wide inventory turnover disruption	**Grocery Retailing** Difficult to coordinate responses to trends: • Short-term irrational buying behaviour (e.g. toilet paper stockpiling) • Mid-term grocery spending fluctuations with potential long term ramifications (e.g. impact of COVID restaurant restrictions)
	Industrial Manufacturing • Manufacturers may have insufficient financial reserves to weather COVID storm • Difficult to gauge untenable contractual obligations without AI enabled platforms	**Agribusiness** • Crop production threats due to pesticide and chemical import disruption • Horticultural access to migrant labour impacted	**Retail** • Delayed order fulfilment due to global transportation disruptions (eg. aeroplane cargo haul cancellations / freighter delays) • Global retailers must respond to increased logistics costs, new regulations, customs changes and shipping delays	**Resources** Difficult to coordinate responses to trends: • China's halt on production causing short-term stockpile build up • Potential long-term impact of slowing orders for coal and iron ore production

Source: Strategy& analysis

Organisations should invest in developing connected and autonomous supply chain capabilities to reduce the impact of future shocks

Resilient Supply Chain Capabilities

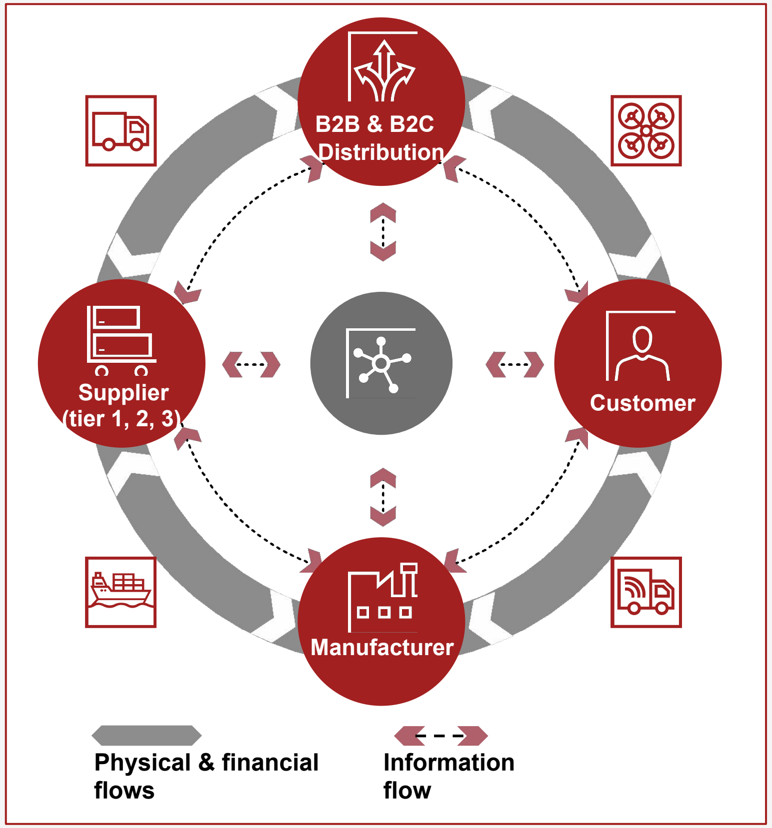
1. Transparency and sustainability

Integrated supply interface:
- Detects & manages risks & supply failures that may cause bottlenecks
- Gages raw material options
- Identifies potential supplier alternatives

2. Closed loop integrated planning and execution

- Planning synchronised in real-time with execution to respond to shocks
- Planning across strategic, tactical and operational horizons

Connected and Autonomous Supply Chain Ecosystem



3. Smart logistics flow

- Connects all entities along the supply chain to support through shocks
- AI platform predicts supplier capacity/delivery status to allocate supplies
- Customers can track order fulfilment data in real time

4. Dynamic supply chain segmentation

Segmentation strategies to adapt to market conditions and product specifics:
- Dynamic segmentation
- Inventory evaluation
- Alternative sourcing strategies

5. AI-driven supply chain management

Uses machine learning and AI to:
- Proactively model new risks/costs
- Sense demand fluctuations
- Test viability of mid-term revenue optimisation strategies

6. Operating Model Development

- Develop operating models with next level connectivity and autonomy
- Support lasting change for a more resilient supply chain ecosystem

Source: Strategy& analysis

Organisations are reassessing their real estate footprint post-COVID-19 – benefits are available, but no 'one size fits all' model

The rapid shift to remote working models has seen various benefits for companies…

1. Improved productivity

- Reduced travel, ability to concentrate on delivery without office distractions and increased efficiency in requirements gathering and UAT
- 10% productivity increase by moving 1,500 software company contact centre staff to remote working[1]

2. Cost reductions from reduced footprint

- 10-15% cost reduction through onshoring and increased efficiency of complex, high-touch telecoms contact centre teams working from home

3. Improved working efficiency

- 11% decrease in "long" meetings in Microsoft China
- Shorter, more efficient meetings increased by 22%[2]

… However, businesses need to assess the appropriate models and potential benefits for their industry and for specific job families

Remote Working Models

Flexibility

Virtual Office
- Working from home or another remote location using devices
- Suitable where no local site
- Virtual environments can enable focused work and drive increased productivity

Co-Working Site
- Drop-in or membership model or shared working space (operated by third party service provider)
- Maximum portfolio flexibility
- Managed cost
- Maintain employee collaboration

Company Office
- Branded office space (Operated by company or third party)
- 'Hot desking' or specific desk (latter more effective for OH&S)[3]
- Choice of workplace setting with technology to enable working from anywhere in the office

Job Family Suitability to Remote Working

Telco Example

Job family	% of Total FTE	Suitable for remote working	
		% of function	% of total FTE
Network & IT	27%	20%	**5%**
Marketing	13%	80%	**10%**
Sales (Call Centre + instore)	53%	35%	**18%**
Back office	7%	80%	**6%**
Total FTE that could work flexibly			**~40%**

Source: 1) PwC Perform Plus data, 2020; 2) Microsoft 365 'How remote work impacts collaboration: findings from our team', 2020; 3) Safe Work Australia 2020 'COVID-19 Information for workplaces'; Strategy& Analysis

Companies can take targeted actions to improve the impact of their marketing spend

Actions Addressing Effectiveness of Marketing Channel Spend

Common Company Issues		Post-COVID-19 Actions
1 **Marketing spend is not showing clear effectiveness**	▪ Marketing initiatives may not impact product and services sales growth ▪ It is difficult to correlate spend and revenue ▪ Inadequate consumer insight data collected	▪ Harness digitisation to improve **sales reporting data and analytics** ▪ Employ data-driven effectiveness metrics to **understand the impact of reducing areas of marketing spend**
2 **Distribution strategy is not rationalised**	▪ Distribution strategy lacks coherence across channels and partners ▪ Marketing channel effectiveness is not critically assessed	▪ **Develop an omnichannel marketing strategy** ▪ **Eliminate channels** that are unprofitable or which do not form part of a coherent channel strategy post-COVID-19
3 **Marketing costs incurred outside function**	▪ There is marketing spend contained within company that is not controlled by central marketing unit	▪ Use post-COVID-19 cost reduction measures as an impetus to: – **Clarify roles** of corporate core vs. embedded marketing – **Eliminate duplicate activities**
4 **Duplicated marketing efforts**	▪ Target audiences for different business units are similar, leading to potential effort duplication ▪ Incoherent marketing messages where opportunities for alignment exist	▪ **Combine BU marketing units** where possible to reduce labour costs and align messaging
5 **Initiatives are not integrated into strategic objectives**	▪ Various firm initiatives (eg. Corporate Social Responsibility spend) are seen as not adding value to the business and are overlooked in marketing spend	▪ **Review the strategic alignment of spending initiatives** (eg. CSR spend) as customer values shift

Source: Strategy& analysis

How will you radically transform your cost structure through recovery?

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