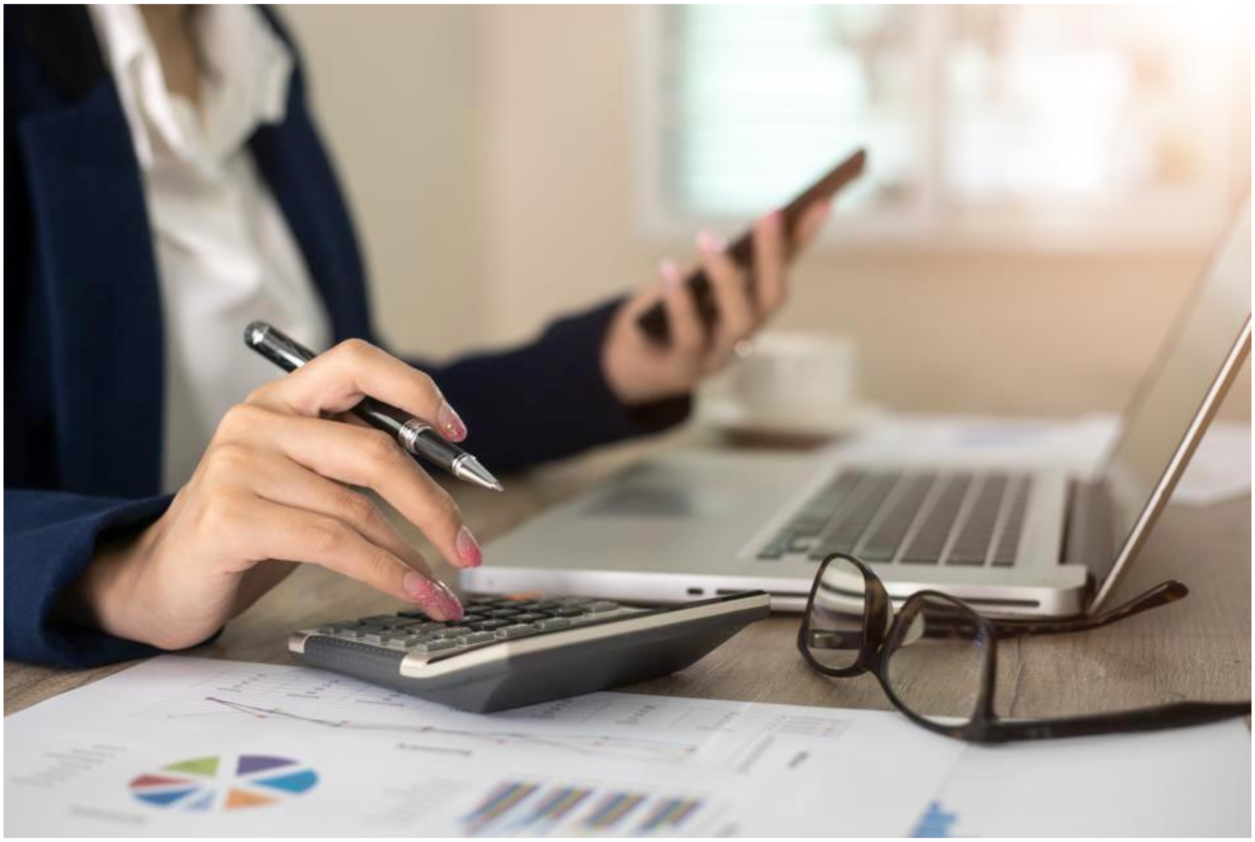
Forbes

Better Decisions | November 18, 2022

Be Careful How You Cut Costs

By Gregory Milano



Are you finding the current business environment challenging? If your answer is yes, you are not alone. Inflation is driving input costs higher, while many businesses are also facing revenue headwinds from stalled real GDP growth and supply chain constraints. Profits are being squeezed in almost every industry.

In my own research of companies in the S&P 500 index, as of November 4, 2022, 30% are expected by sell-side analysts to generate lower net income over the next twelve months versus the last twelve months. On average, these struggling companies are expected to suffer a 29% decline in net income. The worst sector is real estate, where 56% are expected to suffer net income declines, followed by the consumer discretionary (44%), communication services (43%) and the energy sector (40%).

As if squeezing profits were not enough, interest rates are rising as the federal reserve fights inflation and higher rates further reduce the value to investors of these already diminished profits.

We have become accustomed to declining interest rates when the economy slows to stimulate a recovery. But for the first time in over four decades, the Fed's hands are tied with high inflation.

Some companies have overcome these pressures by raising prices. On October 12, PepsiCo announced revenue and earnings per share that exceeded analyst expectations. Their revenues year-to-date were up 14% over the prior year, mostly due to price increases. But most companies don't have brands with such strong differentiation and would likely lose market share if they raised prices to offset inflation. So the leaders of these companies may often resort to across-the-board cost-cutting to salvage their profits. Indeed, some view this as an opportunity to eliminate excess waste, thinking, as Winston Churchill (likely) said, "Never let a good crisis go to waste."

But indiscriminate cuts can have negative implications for future performance. Everybody knows this, yet many companies still cut deeply into important investments. Across most managements, we typically see two approaches to this problem.

• **Protect The Future**: Some employees, often in departments like marketing and R&D, criticize cost-cutting initiatives and point to the loss of capabilities and future opportunities that reduce the strength of the eventual recovery.

• **Lean Machine**: Others, especially in finance and accounting, criticize inefficiency and waste and promote extensive cutting, claiming little will be lost down the line.

In most companies, I find both the "Protect The Future" and "Lean Machine" factions are partially right. There are often plenty of opportunities for healthy cost-cutting, but also initiatives that should remain untouched to avoid sacrificing future performance.

The challenge, of course, is identifying which areas can be cut without significantly harming the company's long-term potential and which should be protected *at all costs*. Across the organization, there are many vested interests, so no matter what one targets, there will be someone warning of dire consequences. Those in charge of cost-cutting initiatives may face many sleepless nights as the disparate warnings of department heads reverberate in their heads.

Although there is no approach that makes this easy or stress-free, there are ways to make it more effective. You can begin by instituting a rigorous cost categorization process to increase objectivity, as outlined below.

1. Investments In Intangible Assets: This includes spending that is expensed on the profit and loss statement for accounting purposes but is really an investment in the future, such as R&D, brand-building advertising and employee training. This is the primary area we want to protect, but don't keep projects that are failing. This is an opportune time to revisit the outlook for each of these investments and eliminate those with poor prospects for success.

2. Core Capabilities: These aspects of our business make our products and services differentiated in the eyes of customers. Consider a spacious fine-dining restaurant that occupies two storefronts. To reduce the cost of rent, they might squeeze the tables into half the floor space and stop renting the second storefront. But this makes the experience less desirable, leading to less demand. It's conceivable, in this case, that revenue declines more than costs. What's worse, this may happen gradually. Maybe this year's revenues only drop marginally, and the cuts look to be a success, but over time more patrons become disenchanted and seek alternatives. By the time you realize the mistake, the restaurant's appeal may have eroded in irreversible ways.

3. Waste And Inefficiency: These are the costs that can be eliminated with little loss of current or future benefits. Often, we find expenditures here that were once important but no longer are—as often happens when technology makes old processes or activities redundant. As an engineer in the 1980s, I witnessed the widespread implementation of computer-aided design. Yet the efficiency gains often went unrealized, at first, since many engineers still produced design drawings at the same pace, just with more time for chatting. By realigning work practices and expected outcomes, some costs can be eliminated with no loss of productivity.

Categorization is helpful but not sufficient since employees still have an incentive to favor the segments they oversee. Accountability is needed to make sure the right decisions are made, which can be achieved through a "look back" later on to see how cuts turned out. For example, if one argues against discontinuing a research project, they should be accountable for its results in future years. Getting managers to treat capital as their own, which I wrote about recently, would be essential for this. Just be sure that projects are evaluated with a reliable measure of value creation like economic profit rather than incomplete measures like return on capital, revenue growth or even EBITDA, as these often lead to adverse outcomes for shareholders, especially when linked to executive compensation.

Inflation, declining real GDP and supply chain constraints present a perfect storm of profitability headwinds. Many companies must take action to weather the storm and make the best use of their capital. Those that are thoughtful about how they cut costs may be rewarded in the quarters to come.

Gregory Milano is Founder and Chief Executive Officer of Fortuna Advisors LLC.