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Leadership (A Special Report) --- Adventures in Cost Cutting: As companies have sought to slash expenses, plenty of fat has been cut -- and plenty of mistakes have been made; What lessons have companies learned?

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COST CUTTING is tough business.

The past 30 years are littered with examples of companies that have tried to cut costs -- only to have their efforts go awry. Who can forget the famous slashing ways of Albert J. "Chainsaw Al" Dunlap, who flamed out in 1998 at Sunbeam Corp., the household-appliance company that later filed for bankruptcy-court protection. More recently there are plenty of examples like AT&T Corp., Ford Motor Co., or American Airlines parent AMR Corp., whose share prices are lower today than they were five years ago, despite aggressive cost-cutting efforts.

Academic research has shown that repeated rounds of layoffs can backfire, destroying the morale and productivity of surviving workers. Even seemingly innocuous moves like offering buyout and early-retirement packages to workers can be mishandled, with damaging results.

"There sure are a lot of organizations that don't do it right," says Kim Cameron, a management professor at the University of Michigan Business School who studied the airline sector after the Sept. 11 terrorist attacks and found the most aggressive cost cutters were also the poorest stock performers.

Now comes the good news: Executives may be learning from their mistakes.

After taking knives to their expense lines during the past three years, corporate profits are surging and the nation's businesses have enjoyed their best three-year run of productivity growth since the 1950s. In another sign of change, a study by University of Illinois economist Kevin Hallock found that investors began reacting positively to corporate downsizing announcements in the late 1990s, after punishing share prices for such announcements for much of the previous 25 years.

Have companies become more effective at cutting costs? And if so, why? What lessons have they learned about the wrenching slash-and-burn mind-set that so often dominates corporate boardrooms around the globe?

It is probably too early to say for sure that companies have figured it out. Adrian Slywotzky, a managing director with Mercer Management Consulting and author of the book "The Art of Profitability," says today's productivity gains might be just a one-time event, grown out of the massive investments that companies made in technology during the late 1990s. Mr. Slywotzky and Mr. Cameron both say there are still plenty of examples of companies following old -- and possibly dangerous -- cost-cutting ways during the most recent downturn.

But enough time has passed, and enough expenses have been cut, that clear lessons have emerged about what works best when it comes to reducing expenses. Here are some of the most important ones:

Beware of the Simple Path

From 2001 to 2003, more than 18,000 workers left Procter & Gamble Co. with voluntary buyout packages in hand. It was part of a company effort to shrink its work force. Scores of large companies around the globe have taken a similar approach to cost cutting, including Lucent Technologies Inc., UAL Corp., Germany's DaimlerChrysler AG, Japan's Isuzu Motors Ltd. and Italy's Fiat SpA.

The voluntary-buyout route is often seen as a compassionate cost-cutting tactic, a way to let workers walk out the door on their own. And for Procter & Gamble, it seems to be working: The company recently reported a 20% jump in net income for the quarter ended March 31, and in March it raised its earnings guidance for 2004.

But Ron Nicol, a principal at the Boston Consulting Group, warns that this approach can have long-term consequences on the talent of a company's work force. "The thing that doesn't work is just asking for

volunteers," he says. "You get the wrong volunteers. Some of your best people will feel they can get a job anywhere. Or you have people who are close to retirement and are a real asset to the company." In 1994, for example, General Motors Corp. had to scramble for factory workers a year after a retirement plan left it short-handed in plants in Arlington, Texas, and Shreveport, La. The company was forced to offer GM retirees in California as much as \$21,000 in incentives to return to work.

Mr. Cameron has a similar view of across-the-board job cuts. Such cuts might be easy to sell to employees, because they don't single any group out. They might also be a straightforward choice when profits are sinking fast and action needs to happen fast. But as with early-retirement plans, Mr. Cameron says, across-the-board cuts often leave companies cutting too much in vital areas, and not enough in areas that can be reduced aggressively. He points to a 1994 study by the American Society for Work Redesign that found that patient-mortality rates rose at hospitals that went through across-the-board job cuts and that cost savings dissipated within 18 months of the cuts.

Be Strategic

The antidote to these cookie-cutter approaches, says Mr. Cameron, is a more systematic approach to shedding costs, surgically getting rid of operations or businesses that aren't big moneymakers and focusing on the ones that can bring in the most profits as you come out of the downturn.

Raven Industries Inc. is an example of how this works in real time. As Ronald Moquist became chief executive of this Sioux Falls, S.D., diversified manufacturing company in 2000, a bone-crushing manufacturing slump was just about to hit the company, which made a wide variety of products, including hot-air balloons and plastic tops for pickup trucks. Rather than cut across the board, Mr. Moquist took a long, hard look at his company and started shedding businesses, including some he had been involved in acquiring during the 1990s.

The strategy, he says, was to "China proof" his business, meaning getting out of low-margin businesses like pickup-truck supplies and focusing on more profitable products such as high-tech farm equipment.

"If we're going to grow, we're going to grow on a strong, healthy, profitable platform," Mr. Moquist says. "We got out of businesses that didn't have long-term profit-growth potential." Raven went from having 10 separate divisions to having just four. As it exited businesses, annual revenue fell by \$37 million, or 23%, and its payroll was slashed in half, from 1,511 to 770. But revenue has since rebounded, and Raven's share price has increased by a factor of nearly seven, to more than \$30 from \$4.50.

Right now, the evidence is mixed about whether companies in general are becoming more strategic when it comes to cost cutting. Mr. Hallock, the University of Illinois economist, studied 30 years of downsizing announcements in *The Wall Street Journal* and found a shift in the reasons companies gave for downsizing. During the 1970s, just 10% of all cost-cutting announcements were described as part of a plan to restructure the organization. But during the 1990s, that had increased to 24%. That suggests that managers are becoming more strategic. But a survey of business executives by Mercer Management in 2001 found that 70% of the 130 interviewed were planning to make cuts across the board and wait for the tough times to pass.

Technology Is Only Half a Step

For nearly a decade, economists had puzzled about why companies were investing so much money in computers and new technology, and yet this technology didn't seem to be producing an economy that was functioning much more efficiently. Then in the mid-1990s, all of that changed, when measures of the nation's productivity growth started surging.

What happened? Erik Brynjolfsson, a productivity expert at the Massachusetts Institute of Technology's Sloan School of Management, says the big change was that executives learned they wouldn't reap cost savings just by investing in new technology. They also had to completely rethink how they went about doing work to get the most use out of that technology. That took time. Mr. Brynjolfsson, who studied the performance of hundreds of companies, found it also took loads of additional investment in worker training and in reorganizing practices like sharing information with suppliers or tracking inventories. For every dollar that companies invest in technology, Mr. Brynjolfsson estimates they had to invest an additional \$5 to \$10 in this kind of reorganization to get a longer-term cost-cutting payoff from the technology.

"You have to lay the foundation [for cost cutting] by innovating your business processes," Mr. Brynjolfsson says. It's no coincidence, he notes, that the most effective cost cutters are companies like Wal-Mart Stores Inc. or Dell Inc., which use technology to keep processes such as inventory management at the cutting edge.

Reorganizing business processes around new technology is no easy task. Consider the case of radio-frequency identification tags, also known as RFID tags, which involve tiny computer chips that transmit radio signals that can be read by a scanner. RFID technology has been around since World War II. Now such retailers as Wal-Mart and Metro AG of Germany hope to use it to reduce inventories and theft by closely tracking products as they flow from suppliers to warehouses to store shelves and then to customers.

Kara Romanow, a research director at AMR Research in Boston, says it will take years before RFID is a standard practice in retailing. To make use of the technology, retailers will have to completely reorganize how products move through distribution centers. Their suppliers, meanwhile, will have to transform how they manage production schedules to become more responsive to fluctuations in retailer inventories.

"They have to make some major changes to their current applications," Ms. Romanow says. She estimates suppliers will have to spend \$8 million to \$13 million on average just for the software needed to reorganize these practices.

Talk is Cheap -- and Crucial

(MORE)

When recession struck Dallas-based Marlow Industries Inc. in May 2001, Barry Nickerson, president of the privately held company, had to act fast. Revenue at Marlow, which makes temperature-control instruments for high-tech companies, dropped 60%. Mr. Nickerson, a former Xerox executive, moved low-end production to China, automated other work and removed a layer of midlevel managers, including a personal assistant who booked all his travel. Employment plunged from 800 to 200 workers in less than a year's time. Those who kept their jobs had to take a 5% pay cut; managers took an even larger cut.

Reshaping the company was only part of his challenge. Another part was keeping morale up among the workers who survived the rapid and severe downturn. Research has shown that cost cutting can have serious consequences on the productivity of surviving workers. Executives love to say that their workers are their most valuable assets. But downsizing done poorly often leaves workers feeling exactly the opposite.

"I may feel like I could just as easily be the next person laid off," says Peter Cappelli, a management professor at the Wharton School. "My response to that might be to freeze up, start looking for another job. That also happens if [the company doesn't] have a plan going forward. That panics people."

Mr. Nickerson's response was straightforward.

"Communicate. Communicate. Communicate," he says. He held monthly face-to-face meetings with all of his employees in a large room at the company's Dallas plant to update his workers on the company's finances and where it stood in the restructuring. "Every time we had a change we had a meeting to explain exactly what we were doing," says Mr. Nickerson. "We were very open with our employees about where we were financially. We would explain exactly the current status and where we were."

The strategy also entailed convincing his surviving workers that they had a future at the company. He drilled home his strategy of keeping the company's highest-end production in the U.S., while China would handle only low-end production. "We implemented a strategy that was turning Dallas into the center of technical excellence," he says. He also updated workers regularly on when their full pay would be restored, and he stuck to the plan by restoring pay in February. The approach, he says, helped the company weather the storm.

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