

Leaders: Time to put ideas into practice; Corporate strategy

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ABSTRACT

Many companies seem to have become so hooked on cost-cutting that a sort of anorexia has set in. That cannot be healthy in the longer term. Cost-cutting is an effective way to increase earnings, but it has its limits. There is a price to being Scrooge. Costco, a big American retailer, pays its staff over 50% more than the industry average. Not only does it get a chance to employ higher-quality staff--there were 5,000 applicants for 160 jobs available when it opened a store recently in Michigan--but its staff turnover rate is a mere 6% compared with the industry's average of 59%. Many companies, realising that their biggest cost item is purchased materials, have been regularly switching suppliers in an elusive search for the cheapest. Not only are the transaction costs of this high, but it also destroys any longer-term trust with suppliers.

FULL TEXT

Companies should shift their attention from cost-cutting to business-building

BOSSES seem to have lost their nerve. After the over-exuberance of the dotcom boom they wisely focused on cutting costs. And they have been very successful at it. Switching their manufacturing to low-cost developing countries (to China in particular) and outsourcing their business processes to specialists with higher skills and economies of scale have brought about dramatic savings. So has simply making fewer costly if adventurous mistakes. The evidence is visible on firms' balance sheets and bank statements.

And yet many companies seem to have become so hooked on cost-cutting that a sort of anorexia has set in. That cannot be healthy in the longer term. Cost-cutting is an effective way to increase earnings, but it has its limits. In a recent article, consultants at Booz Allen Hamilton warn that "sourcing in China can become a source of woe". A consultant at Hewitt Associates, a human-resources consultancy, says, "If you think China is a cheap place for labour, think again." Shortages of skilled workers there are rapidly pushing up prices.

In any case, cheap labour is not always as cheap as it seems. There is a price to being Scrooge. Costco, a big American retailer, pays its staff over 50% more than the industry average. Not only does it get a chance to employ higher-quality staff--there were 5,000 applicants for 160 jobs available when it opened a store recently in Michigan--but its staff turnover rate is a mere 6% compared with the industry's average of 59%.

Many companies, realising that their biggest cost item is purchased materials, have been regularly switching suppliers in an elusive search for the cheapest. Not only are the transaction costs of this high, but it also destroys any longer-term trust with suppliers. A recent study of the aerospace industry found that the assumption of the industry's giant manufacturers that they could indefinitely force their suppliers to lower prices led those suppliers to sell some replacement parts directly to the airlines, bypassing the aerospace firms.

A bigger reason to worry is that many firms have not yet found good uses for the cash raised through cost-cutting. In America and Europe, some are beginning to dabble in mergers and acquisitions. But M&A has such a bad track record that it will be a lucky (and skilful) minority who can create and sustain value from their deals. A recent McKinsey study found that 70% of mergers fail to produce expected gains in revenues.

It would be much better in most cases to redistribute the money to shareholders, which fortunately is what many firms are doing. In America and Europe, companies are buying back their shares like never before, one of the most convenient ways to distribute cash. Last year the S&P 500 companies repurchased a record \$197 billion-worth; this year the figure is expected to be even higher.

This is much wiser, but it is also a kind of admission that the firms' managers cannot find something to do with their assets, skills and cash that they believe will earn their shareholders a return greater than that to be gained from squirrelling the cash away in a bank (which, let's face it, is no great hurdle these days). Shareholders might rightly take a dim view of the long-term prospects of a firm which went too far down this route. Some firms may already be wondering whether they have done so. Intel and Yahoo!, two companies which recently announced share buybacks, reported surprisingly big increases in first-quarter profits and revenues this week. Yahoo! found the online advertising market unexpectedly buoyant, and Intel found (to its surprise) that it can sell premium-priced chips--which persuaded it to announce a 10% increase in its investment on plant and equipment this year.

Innovate and differentiate

With so much stress on cutting costs, there is reason to fear that too few companies are investing in innovative new ideas that might generate organic growth. The paucity is not due to a shortage of advice. Books and articles on innovation and how to generate new businesses are as plentiful as ever. The cover story of next month's issue of the Harvard Business Review is entitled "Building Breakthrough Businesses Within Established Organisations", and describes how Corning, a glass manufacturer, and the New York Times Company recently made bold strategic experiments work. Michael Porter, a leading theorist on competitive strategy, has long argued that firms gain advantage either through lower costs or through a differentiation of their products that can command a premium price. With so many firms stressing cost-cutting, it might be clever to try, like Intel, to stand out from the crowd.

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