Responding to COVID-19

ADJUSTING THE COST BASE
TO THE 'NEW NORMAL'

OPX | PARTNERS

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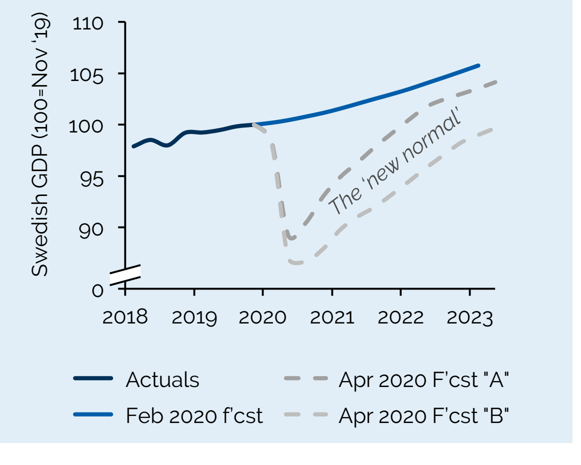
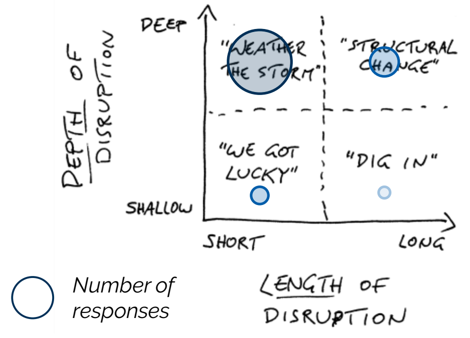
Introduction

As the Covid-19 crisis spread during the spring of this year — first slowly, and then with astonishing rapidity as stock markets set new records for losses in early March — a survey conducted by OPX Partners showed that business leaders were optimistic about the disruption being relatively short, while realistic about it being deep.

Whilst the Covid-19 crisis is far from over, a 'new normal' is gradually emerging. Though the details differ by sector, the outlines for most companies are becoming clearer: Weaker demand and changed customer preferences. The softening of demand is very visible in the scenarios used by the Swedish central bank.

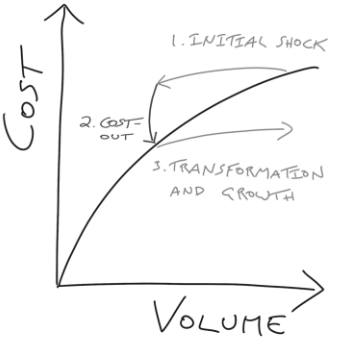


Source: Sveriges Riksbank, April 2020 Penningpolitisk Rapport



For individual companies, adjusting to this reality will be a journey in several stages.

1. The initial shock to demand, followed by immediate actions to press down operating expenses has, of necessity, been completed.
2. A cost-out phase to adjust to weaker demand; the topic of this white paper.
3. Lastly, companies will need to transform their ways of working to grow again in a world of of changed customer preferences and, ideally, following a lower cost curve



1. This will be the topic of a future white paper, but important to keep in mind through the cost-out phase

Every demand shock of this sort — and we note that the current one is unique only in its size and cause — presents an opportunity to thoroughly transform the cost base.

To seize this opportunity first requires a cost-out exercise, which OPX Partners has extensive experience with from Covid-19, from the aftermath of the global financial crisis, and from dozens of cases in between the two.

Mechanically, a cost-base adjustment must consist of three parts: Targets must be set, a plan must be agreed, and progress must be tracked as the plan is executed on.

This is, as with so many other things in life, easier said than done, but in this white paper, we hope to share three key lessons we have learned about how to do this well:

Chapter 1: The balancing act

- Successfully removing cost requires balancing many objectives and many interests. Most palpably the business needs of today with those of tomorrow, as well as the needs of the owners/investors with those of the organization itself

Chapter 2: An integrated approach

- Success demands integrating a top-down and bottom-up process, where the CEO gives clear directives and the organization delivers on the details using all the levers at their disposal

Chapter 3: The Drama

- Success is not merely removing costs, it is getting through a deeply difficult human endeavor while preserving energy and a forward-looking outlook. Visibly pair the urgency with support and empathy while driving the process

The mechanics	Cost-base adjustment done with increasing efficiency		
	1. The balancing act	**2. An integrated approach**	**3. The Drama**
Set targets	**Clear targets** from balancing all stakeholders' needs	**Committed organization** from line mgmt involvement	**Maximized potential** from fast-paced & driven process
Agree on a plan	**High-level plans** for reaching the end state savings	**Detailed plans** and activities from line management input	True **ownership** of stress-tested plans and activities
Execute and track progress	**Trackable initiatives** from understading of overall goals	Detailing allows for **close monitoring** of initiatives	Ownership leads to **course-corrections** and **pride**

CHAPTER 1

The balancing act

Any cost-base adjustment must deliver savings. A planning phase is necessary, but without successful implementation the exercise will have been for nought.

With that clearly stated, the importance of the planning phase is often underestimated. Rushing through this stage can lead to a potential which is not verified, plans that are neither robust nor detailed enough to execute on, and, worst of all, a chaotic implementation phase that results in undershooting targets.

Letting the planning phase drag on for too long, however, can be even worse. The very setup of the cost-base adjustment exercise is thus the first of many questions upon which to strike the right balance. 6-8 weeks seems to be the sweet spot.

Set targets in a top-down fashion

Oftentimes, management is neither aligned on the size of the required cost reductions nor their distribution across the business. Setting targets from the top down can therefore be uncomfortable, but it is something that the CEO must do, and must do at the outset of the process.

The keys here are to use a *fact-based approach*, ideally with an *unbiased view*, and with targets expressed as *net savings* and *buffered*.

By *fact-based*, we mean as solid an understanding of the cost baseline and its development over time as can be assembled quickly. Benchmarks are valuable – though speed is more important. Cost centers (e.g. FTEs in Sales) must be connected to cost drivers (e.g. # of FTEs required for our high-value accounts vs. low-value accounts). Companies fortunate enough to have a clearly articulated strategy and a good understanding of their market will find it much easier to balance the needs of future growth areas against the abilities to remove costs from non-priority areas.

An *unbiased view* is rarely available from management itself, where it is practically part and parcel of each individual manager's job description to ask for resources and pursue opportunities in their area of responsibility. Cuts tend to be recommended elsewhere. This is one area where independent outside advisers can provide valuable objectivity, though the CEO and Board must, ultimately, make the decisions.

It's important not to lose focus during an exercise like this. External support for the management team can really help

- PE professional

Net savings speak to the common mistake of setting targets as gross numbers, e.g. "25 MEUR cost reduction", and expecting a corresponding P&L effect. In practice, managers are running the business while the cost-base adjustment takes place, and decisions made in one arena must be balanced by decisions in the other. Taking cost out is easy when it is allowed to creep back in through parallel initiatives — the infamous squeezing of the corporate balloon.

Lastly, *buffered* net savings mean that execution leakage and unforeseen events are planned for. The savings target must not appear unreasonably high, but this has to be balanced against communicating a target that will almost certainly be undershot. Our take? A meaty 20% buffer is a good way to underpromise and overdeliver.

Special COVID-19 considerations

High uncertainty about the future, e.g. 'how much needs to be taken out to right-size?'

- ❑ Create multiple scenarios for the 'new normal'
- ❑ Establish activities for each scenario
- ❑ Commit to the scenario with the highest probability, but…
- ❑ …maintain ability to revise chosen scenarios as the situation unfolds

Agree on a plan

Getting to agreement on a plan that meets the necessary targets is where an integrated approach really shines. But there remains plenty to balance even at this stage.

Perhaps the best advice we can offer on getting started is to commit a first draft to paper quickly. Having a strawman around which the team can discuss and debate adds incredible value.

The substance of the plan then needs to fall into place. The process must balance *who* decides on the costs to be cut, *what* the cost cuts are, and *when* to make them.

The who: Left to their own devices, individual managers can generate ideas for cost cuts quickly, in line with their division's strategies, and, crucially, with ownership. They also risk coming in short of the target, however. (More on this in Chapters 2 and 3.) Their risk aversion to cuts that may endanger the value generated by their division must be balanced by the CEO's mandate to achieve cuts. Experienced external support can be very helpful, here; never is it more true than in this role that it is, in fact, lonely at the top.

Management teams need to be aligned on what will create value *in the future*. Too often, there is an unfounded nervousness about making cuts today in areas that have generated value in the past

- Industrial advisor

The what: To minimize risk, make focused cuts in areas, functions, or categories that will not be part of any future platform for growth, but think broadly in terms of the types of costs that are cut. As an example, some management teams will, by their nature, focus solely on headcount. Others will protect headcount fiercely. Neither has the right approach. Find a balance.

The when: Balance quick wins and longer-term actions. The plan must be implementable from Day One, but the momentum generated also needs to be sustained over time.

Lastly, assign owners to initiatives. Rule number one for execution is accountability.

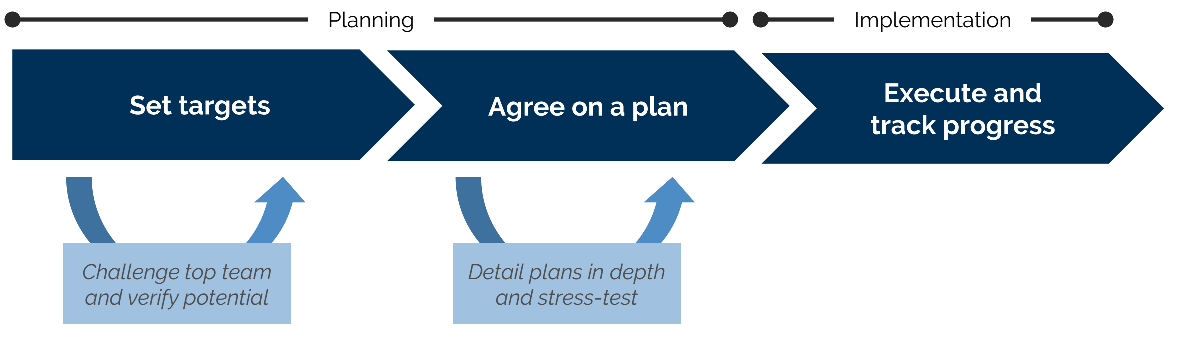
Execute and track progress
Execution needs to start decisively, typically with headcount reduction announcements, and then be tracked in a structured and rigorous fashion.

As the organization undergoes the actual cost-base adjustment, however, it is important to remember the famous dictum that "no plan survives first contact with the enemy." Balancing discipline in execution with flexibility in adopting alternative measures ensures continuous progress.

One additional note on execution concerns resourcing: There is a lot to be done in the early phases of execution, but it can be hard to predict exactly what will be more difficult than expected. A Project Management Organization (PMO), with a mandate to not only track progress but also support where necessary (sometimes called an 'ambulating' or 'activist' PMO), can be of great assistance.

CHAPTER 2

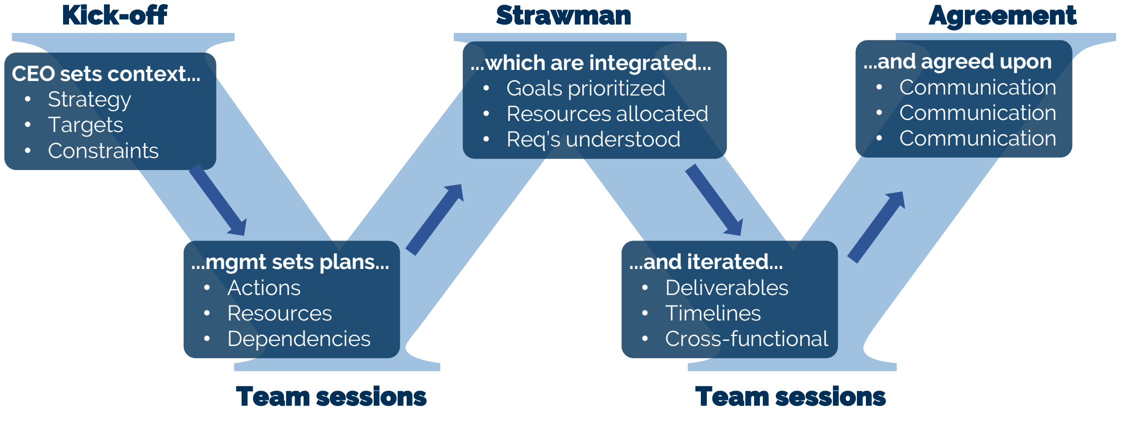
An integrated approach



To run an integrated approach means assembling a holistic view through an inclusive process with a broad scope. It manifests as a process where everyone is heard, and everything is — at least to start with — on the table.

We like to think of the process as looking something like the letter 'W': A top-down mandate is responded to thoughtfully by individual managers, integrated, then iterated cross-functionally to get to an agreement with the entire team.

This may well require more than two iterations, but, in this way, the planning process itself becomes a thing of value, as it lays the foundation for successful implementation by promoting ownership. Disagreements are better dealt with up front, in potentially heated discussions, than in failures of execution later.



Set targets, but challenge and verify

Challenge division and functional heads on their targets. No one will understand an operation better than its head, but no operational head will be completely disinterested in the fate of his or her operation, either. Back challenges with data, and listen thoughtfully to the responses. Done well, a side effect of setting targets through an integrated process will be an education for the entire management team about what really drives value in the business.

Once the targets are set, however, they must still be *verified*. Cost avoidance, speculative activities, re-classifications, and their ilk will not lower the cost base, and any signs of overly optimistic forecasts must be carefully followed up on, as well. This verification should be done in the form of probing questions, if possible, not overrides or outright dismissals that lead to reduced ownership in the management ranks.

Agree on a plan that is holistic

If setting targets is difficult, it is worth remembering that a plan for realizing the savings will be an order of magnitude more complex. A target might be summed up in a number, but the plan will consist of thousands of to-dos, all with interdependencies, sequenced out over time, and each carrying an element of risk.

Here, an integrated approach — iterative and inclusive — becomes absolutely essential for crafting a workable plan. The major difficulties must all be understood, considered, and agreed upon by the entire management team that is to carry them out.

Importantly, top management can never reasonably be expected to understand all the nuances of the entire plan. The inclusivity of the integrated approach therefore has to extend to their trusted lieutenants, who understand the business in more depth and will need to be responsible for the details of the plan. For planning, then, and only for trusted lieutenants, the deeper in the organization the 'W' reaches, the better.

This depth also permits a 'hard wiring' of the targets into budget plans. Until line managers have had an opportunity to iterate the plans, commitment to them through inclusion in budgets is unlikely to be forthcoming.

In addition, the plan itself needs to be able to draw on all the levers at the organization's disposal. Cost-out exercises where only short-term (and possibly short-sighted) headcount reductions are considered rarely lead to long-term success.

> ” The devil is in the details. But once those have been worked out, typically by those who are responsible for them day-to-day, you've de-risked a lot of the execution
>
> **- Industrial advisor**

Special COVID-19 considerations

Travel bans and social distancing will limit face-to-face interaction. This may slow down the process when taking a holistic approach

- ❑ Allow for certain activities to take longer than expected
- ❑ Where possible, utilize interaction modes not requiring face-to-face meetings
- ❑ Make use of more frequent but shorter interactions

Instead, support the idea generation process, and benefit from the opportunity. Reviewing the full cost base and generating a “long list” of anchored longer term actions will serve the organization well.

Execute and track progress

Executional excellence in cost-base adjustments often comes down to what we have cheekily called The Drama in the next chapter. However, an integrated approach to the planning phase lays the groundwork for executing and tracking progress for three simple reasons.

Firstly, the very fact of having iterated the plans gives ownership. Secondly, the additional detail arrived at by letting managers work with their trusted lieutenants provides a more readily executable plan. And, thirdly, that additional detail also allows the tracking function to have real teeth.

Typical cost reduction levers (non-exhaustive)

Indicative time to impact

Typical transformative cost action

Organization

- Delayering
- Eliminate roles, combine tasks / functions
- Reduce headcount per function / unit
- Reduce permanent staff, use part timers to handle demand variations

Operating model

- Reduce # units or locations
- Consolidate, e.g. create "shared services"
- Outsource / off-shore / insource

Process & Automation

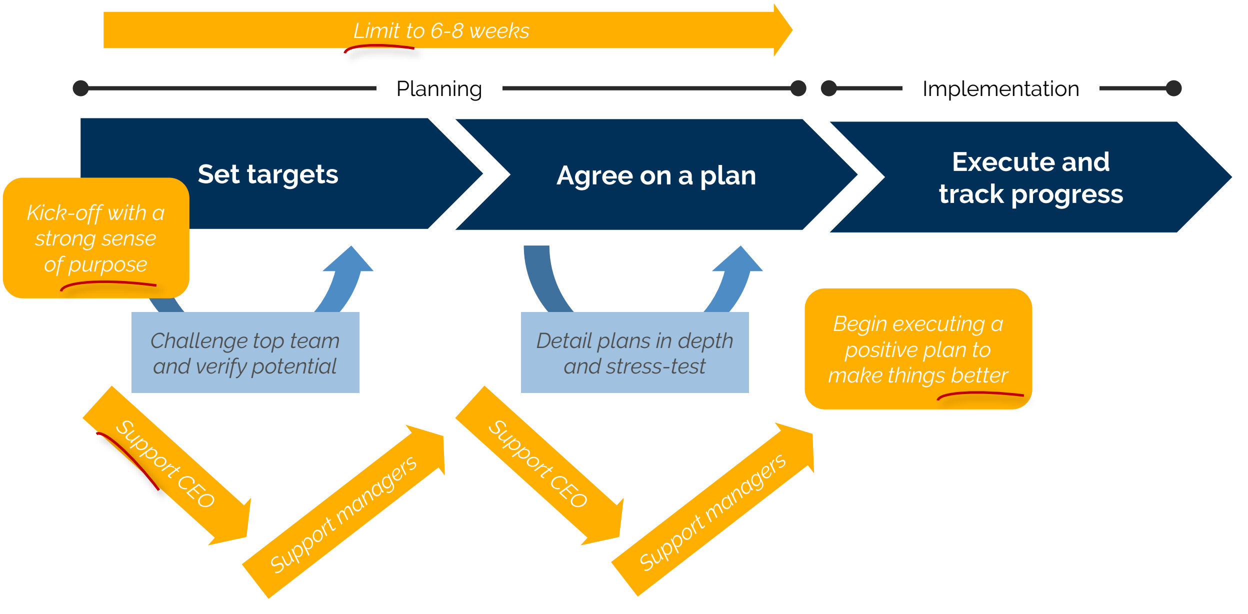
- Productivity transformations of key processes and units / functions
- Process automation

Purchasing & Spend control

- Cost / expense budgets
- Cost control., e.g. procure to pay process
- Policies (expenses, travel, etc)
- Targeted savings initiatives
- Develop purchasing strategy and organization

CHAPTER 3

The Drama



The Drama. There. We have said it. Perhaps even somewhat sheepishly. Now what do we mean by it?

An eye-opening moment in OPX Partners' history was a call from a new CEO at a company we had previously supported. His observation and subsequent question were direct and to the point: "My team is almost ecstatic about our cost-out program, and these guys actually like you. What the heck have you done?"

To us, the answer to the question was obvious. We had supported them. All of them. And, as a team, they had created a stronger and more competitive company than they had ever led.

Fundamentally, removing cost is not about dollars, but about people. They need to be heard. They need to matter. And they want to succeed. This is true in all human endeavors, and that includes cost-out programs. Such programs just happen to involve rawer emotions.

The process, then, is not best thought of as a mechanical act. Done well, it inspires people to take a company from 'troubled' to 'recovering,' even 'thriving.' And that means pairing the inspiration of purpose with the perspiration of running harder than ever before. We have seen CEOs force their teams to work Christmas Eve to heighten the urgency and sense of drama.

Because at its zenith, cost-base adjustments are a production. The boardroom is the stage, the CEO is the director, and the actors bring their best to the table: ethos, logos, pathos, and all. It is, in short, The Drama.

Set targets in an air of seriousness
There is little to be said about the mechanics of setting targets that has not been mentioned above, but a touch of the dramatic will let companies maximize the potential found, and do so through two mechanisms: A *fast pace* will minimize resistance, and a *driven* process — and we do mean pushed along — will leave no doubt about the seriousness of the situation.

A *fast pace* may seem counter to the advice in Chapter 1 to take ones time with the planning phase, but the lion's share of the planning phase should be agreeing on a plan, not debating targets. A week or two may be all that is needed, and perhaps the Board and CEO know on Day One what the needed number is. Every additional day spent discussing targets allows new counterarguments to surface.

> I never thought we'd get through this so quickly, or accomplish so much. I feel good about the future, again!
>
> **- Portfolio company executive**

A *driven* process is what allows this fast pace to be sustained. Here, a hefty dollop of the dramatic is called for, and every trick that injects energy and drive into the process will pay dividends. Rapid follow-up questions, demands for details, even weekend and holiday work all send the signal that "this is serious" stronger than any telco introduction ever could.

Agree on a plan through rapid iteration
An integrated process of inclusive iterations is what will make the plan workable, and, as with target setting, driving this process along will enhance it many-fold. Demanding multiple iterations and further details will speed up the process of refinement, and asking difficult questions about what-if scenarios will stress-test the plan.

In truth, many of the future objections to actually executing on cost cuts are eminently foreseeable. Risks to major lines of business, reputational risks, operational risks, and various other forms of risk will rear their heads.

The planning phase, however, is the right time to very openly confront these risks (within the management team, that is). CEOs with a touch of the dramatic will paint these risks very vividly during this phase, then demand concrete plans for mitigating them from the management team. Once these mitigation tactics are committed to, they become part of the plan, and those who devised them have a true ownership over the now stress-tested plans.

Execute and track progress
When the time arrives to begin executing on the cost-base adjustment, the mood can shift decisively. Thoughts can turn to the future, and CEOs can shift the rhetoric from a focus on urgency and risk mitigation to the good that will result. A stronger company, a base from which to grow; a difficult exercise well concluded.

Time and time again, we have seen difficult cost-base adjustments turn into course-correcting endeavors, and we think the trick is what we have called The Drama. Limit the pain to the planning process. Ferociously drive that process along and proactively deal with the upcoming roadblocks at that stage. Then, when the time comes for execution, the hard work — emotionally speaking, at least — is completed.

The past can swiftly be left behind. The management team can shift their focus towards the future and begin to build again.

Two recent examples

Case example 1

- Global manufacturer of equipment for heavy vehicles listed on Stockholm OMX; Growing in line with industry peers but deteriorating margins driven by both declining prices to customers (to defend market shares) and steadily increasing cost base of indirect cost.
- Size disadvantage to main competitors in a price focused market resulting in difficulties to reach scale in critical functions such as R&D, Sales & Marketing, Customer Service
- Long-term margin target building on aggressive revenue growth to gain scale synergies on cost base, however revenue remained flat and impact from Covid hit hard on underlying demand creating urgent margin and cash flow issues
- OPX Partners was asked to support the Management team to design and execute a cost reduction program to manage both the immediate margin situation created by the sudden demand drop due to Covid, as well as the long-term right-sizing of the organization to reach communicated margin targets
- The program consisted of 4 main phases; (i) define target levels for savings, divided across Management team, (ii) detail activities to reach targets, (iii) develop action plan for execution, (iv) Execute plan
- Given the urgency of execution and realized impact, the project was divided into two parts, one targeting the personnel cost (i.e. long-term savings), the other targeting non-personnel cost that could be realized immediately (i.e. short-term savings), with the savings target aggregating up 200 SEKm (~14% of total cost)

Results

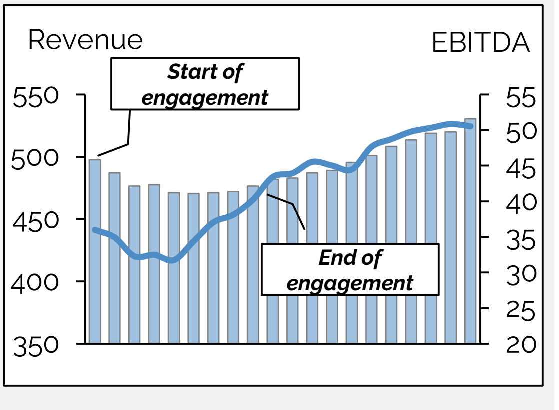
The project had a frontloaded action plan that executed 80% of savings actions within 4 weeks after launch

Case example 2

- PE-owned company within road safety and infrastructure
  - 2 600 employees in 23 countries (76 operating units)
  - Turnover of NOK ~4.5bn
- Buy-and-build case that had fallen behind the investment case timeline and as a result breached bank covenants
- OPX Partners was asked to support the Chairman and CEO to design and launch a cost reduction program targeting NOK 100mn in annual EBITDA impact
- Diagnostic uncovered main potentials in central costs and the production footprint; program designed covering: (i) HQ and divisional overhead restructuring, (ii) OPEX reductions in divisions and (iii) footprint rationalization
- PMO setup including: (i) project team roles and responsibilities, (ii) processes and governance as well as (iii) clear and anchored targets with line organization

Results

17 mEUR EBITDA improvement (+50%) within 9 months from project initiation; Cost effectiveness targets exceeded



About OPX Partners

OPX Partners is a Nordic management consulting firm. We support our clients in solving complex strategic and operational problems, from diagnosis to implementation – across a range of business topics.

Our approach has been shaped through working extensively with PE-owned companies across a variety of industries. Our approach is characterized by 3 factors:

Smart: By bringing experienced teams that know, and have first-hand experience of the problem at hand, but also have top-tier management consulting experience, we can hit the ground running, quickly understand and design the solution, and then move into implementation mode.

Pragmatic: Our extensive line experience and senior teams
ensure that solutions are pragmatic, implementable and
tailored to the client's specific environment.

Collaborative: We take a partnership approach with our clients and are normally present on the ground for the duration of the project, and especially during implementation to help ensure successful change. We work together to build our clients' capabilities and ensure ownership at all levels and functions of the organization.