MAKING THE APPROPRIATE EXPENSE CONTAINMENT DECISIONS in the midst of a pandemic

The Covid-19 pandemic has introduced untold disruption to the world economy and resulted in at least 25% losses in global stocks and millions of lost jobs. Country by country there are differences in contending with the pandemic and getting people back to work. At the company level, some have been decimated and some are scrambling to add capacity and hire more employees. However, an environment of uncertainty still exists, and many questions are yet to be answered.

- When will revenues return to previous levels?
- What type of market shifts will we experience?
- How will our supply chain evolve?
- What will be the balance of on-site vs remote workers, given the recommendations of continuing social distancing?

The uncertainty that will linger for an indefinite period has required businesses to make rapid decisions about removing expenses from the enterprise. Already 2nd waves of the virus around the globe are being reported in the news media. It appears, though, that the US is still in the 1st wave with half of US states reporting a rise in new cases.

What is the starting place for most companies?

Of course, one of the obvious actions to be taken is to reduce headcount. Employees are readily identified and the impact of their salaries and benefits are objectively measured. These savings are instantly realized and their impact on cash flows into the future are predictable.

A recent survey of 161 CFO's conducted by Gartner have revealed that 11% reduced staff in March 2020 and 25% plan to reduce staff in May and June. "CFOs are unsure what reopening will look like and have little visibility into when revenue will start to normalize. This is driving CFOs to look for the next round of structural cost cuts to preserve cash for the coming months," said Alexander Bant, practice vice president, research, for the Gartner Finance Practice.

There are several inherent risks with a reduction in force.

- Will the fabric of the company be disrupted?
- How will organizational culture be impacted?
- Are team members' responsibilities and duties well documented?
- As business conditions improve, how will these individuals be replaced?
- What company folklore and industry knowledge will leave the company with the employee?

It would be rare for a company to not identify their team as their greatest strength. However, building and nurturing that team to perform optimally takes time and a deliberate focus, not only on the individual but the organizational culture.

With a strong economy over the past several years, recruiting and retaining talent has been a challenge. It has been a seller's market, as employees have moved freely from one company to another.

Further frustrating recruiters is that employees will often accept a job offer and fail to show up on the agreed upon first day of work. Perhaps this is a backlash toward recruiters that rarely return calls and emails from job seekers.

Factoring in the cost of job posting, recruiting, training and other activities, the Society of HR Management estimated in 2016 that companies spend an average of 42 days to fill a position at $4,129 per hire. Of course, structured training must be supplemented with guidance and coaching from managers and coworkers. Additionally, integrating a new hire into the environment and culture take time. According to a survey of 610 CEO's by the Harvard Business School, typical mid-level managers require 6.2 months to reach their hiring breakeven point.

Companies will be stretched to the limit to bring back employees or new recruits, conduct the onboarding process and see to their assimilation into the company. These challenges are confronted within the overall uncertainty as to when normal business levels will be approached.

Smaller companies are particularly challenged given their lack of scale and dimension. Their ability to increase productivity, streamline innovation and seek new markets is generally inhibited by a lack of resources. Locating and hiring employees would be an additional burden on already stressed organizations.

Financial structures are also very fragile, with a lack of equity capital, great recourse to bank indebtedness and privileging non-repayable government incentives, with almost no recourse to the capital market or venture capital.

Thus, identifying cost savings opportunities becomes crucial to maintain liquidity, restructure the business, pursue organic growth and potentially external growth through M&A activities.

Where can companies uncover savings opportunities?

Non-core expenses, or "tail spend," is an area in which significant savings can be derived through a comprehensive expense reduction initiative. This purchasing activity is typically unmanaged. An illustration of the Pareto Principle, "tail spend" refers to 20% of a company spend and it typically involves 80% of the suppliers. Conversely, 20% of the suppliers account for 80% of the spend. This "managed spend" would include materials, engineered components, CapEx, occupancy - - areas which are usually quite well scrutinized within the company.

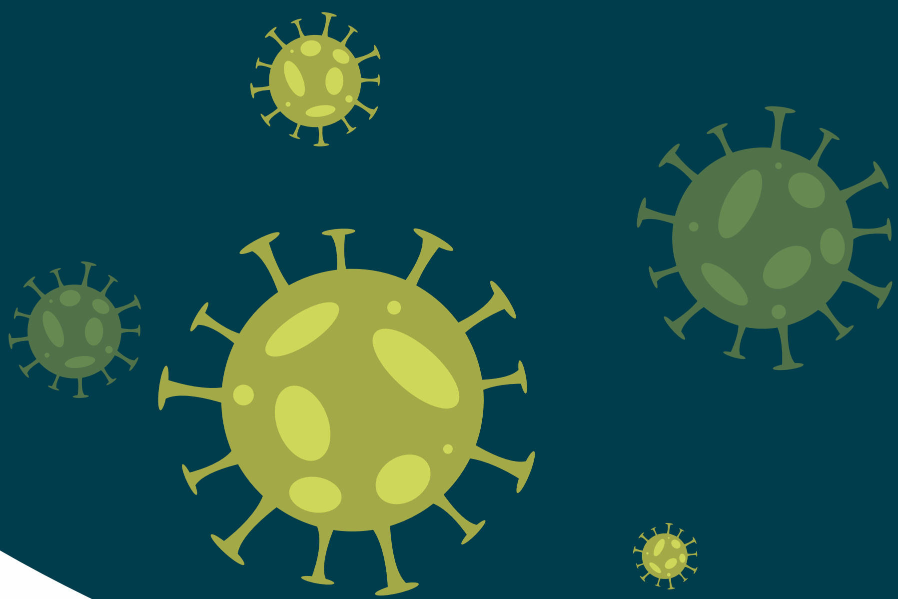
In the tail spend, consider the 1,000's of SKU's required to run the business, not only packaging and other supplies, but logistics by multiple modes, insurance, telecom circuits and services, and other services that could include waste, uniforms and payroll processing.

Bottom line savings of 2-4% of revenue are generally available in the tail spend. On a category basis, savings of 10-40% or more can be realized.

Even in ordinary circumstances internal teams are ill-equipped to go after these savings due to lack of benchmark data and deep understanding of these markets and internal resources. In the Covid-19 environment, companies have already reduced staff thereby placing greater pressure on those that remain. Factor in that most companies have team members that are working remote, and it becomes near impossible to take on the challenge of reducing these expenses.

Consider a McKinsey study conducted on SG&A expense reduction initiatives within the S&P Global 1200 - companies with considerable resources and 70% of the global capitalized market. McKinsey studied 238 companies that announced internally conducted expense reduction initiatives and only 25% sustained savings into the 4th year, underscoring the challenges of not only uncovering and implementing expense reductions – but sustaining them. It's all too easy to take one's eyes off the ball.

To conclude, before additional staff reductions are initiated, an expense review could improve working capital conditions and liquidity, with the funds coming right out of what's being paid across 30+ expense categories. Human capital could be retained and be ready for the time when business conditions improve.



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