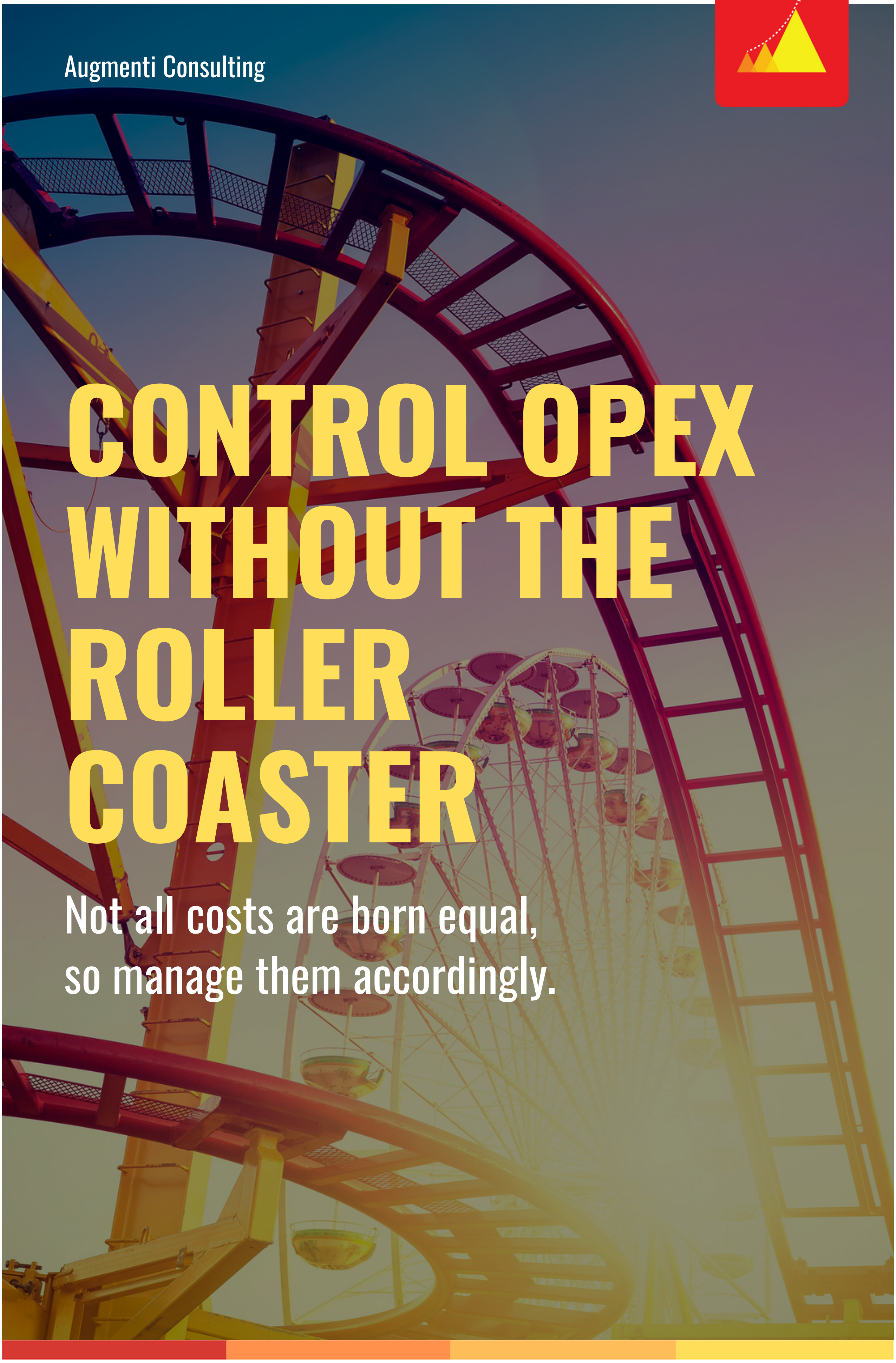


Augmenti Consulting

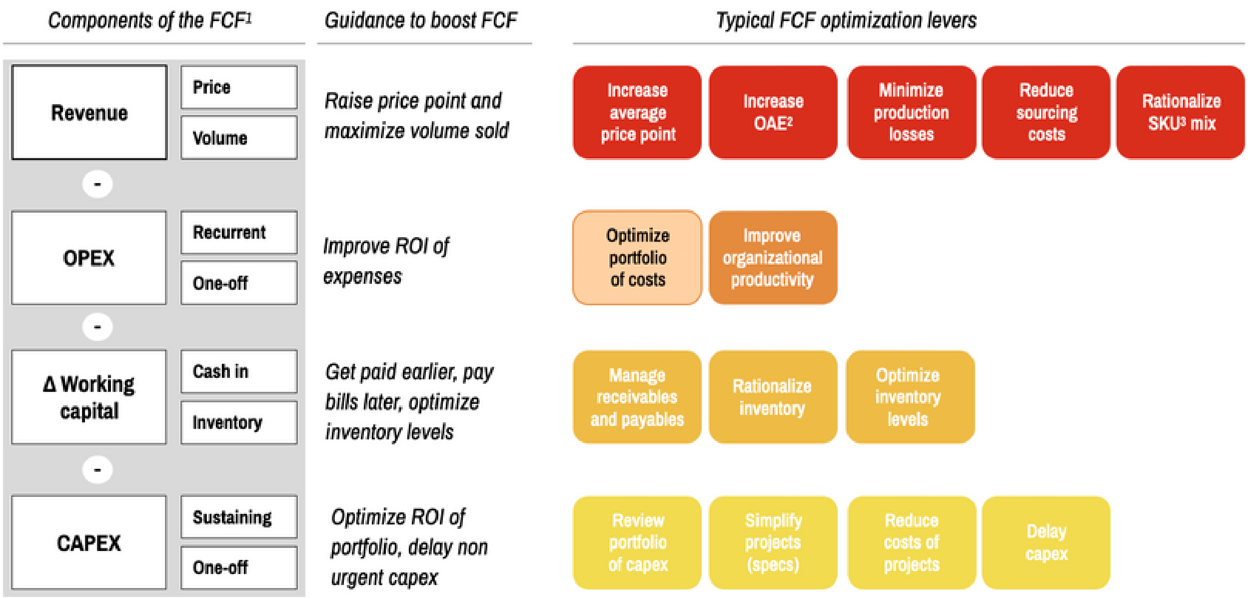
CONTROL OPEX WITHOUT THE ROLLER COASTER

Not all costs are born equal,
so manage them accordingly.

Companies incur significant costs due to operating expenses. The feeling that they creep over time persists despite management's best efforts to keep them in check. That's why, around the conclusion of the fiscal year, there tend to be across the board cut directives. Thus, the widely used roller coaster metaphor.

Uphold Healthy Free Cash Flow

Early in our careers, we learn that "cash is king". It is the lifeblood of all businesses, no matter the size. Therefore, managing healthy free cash flow (FCF) is a noble pursuit. Figure 1 shows that FCF is made up of four main parts: revenue, operating expenses (OPEX), changes (Δ) in working capital, and capital expenditures (Capex).



Notes: 1) FCF – Free Cash Flow; 2) OAE – Operating Asset Effectiveness; 3) SKU – Stock Keeping Unit

Figure 1 – How to optimize Free Cash Flow

FCF is improved by a combination of company-wide projects:

- Revenue is enhanced by a mix of top line, such as value-pricing (to avoid "margins erosions") and bottom-line projects, such as operating performance improvements (a.k.a. "full-potential") to squeeze the most out of production assets at the lowest cost.
- Opex is generally optimized through periodic organizational efficiency programs (the dreaded "downsizes") and plain cost-cutting exercises.
- Changes in Working Capital are handled by receivables policies (commonly cited as "clients are taking too long to pay us") and inventory optimization programs ("less get rid of slow-moving items").
- Capex is optimized either at the project level, where the scope can be simplified to change its cost-benefit ratio, or at the portfolio level, where the overall impact is matched with the available budget.

In our experience, the FCF opex line is frequently neglected. Below, we will describe an effective approach for managing opex that we've implemented for an energy distribution company. As well as discuss some of the best practices.

Managing Opex Is Hard In Many Ways

Most managers don't have the time or patience to carefully sort and evaluate their company's costs. Because of this, the process devolves into either arbitrary cuts across the board, cuts based on benchmarks, or cuts based on subjective evaluation of the value of each function. As a result, costs creep back in and add up over time. Only to be looked at again and cut. This can go on for an extended period of time.

This can happen for a number of reasons. Such as: the lack of an accurate picture of total support costs and how these costs have been evolving; the absence of a clear picture of how specific areas of cost behave; the lack of a measurement of how value is created by function; the dearth of executive focus due to fragmented decision-making authority; poor oversight of one-time initiatives, not measuring the results delivered; and not considering all options on the table, such as doing make-vs-buy assessments.

To get around these limitations, a change of mindset is required.

Strategize Your Opex As A Portfolio

Opex is not a monolith. We recommend establishing an "asset view", where opex can be broken down into four groups, as shown in figure 2 below.

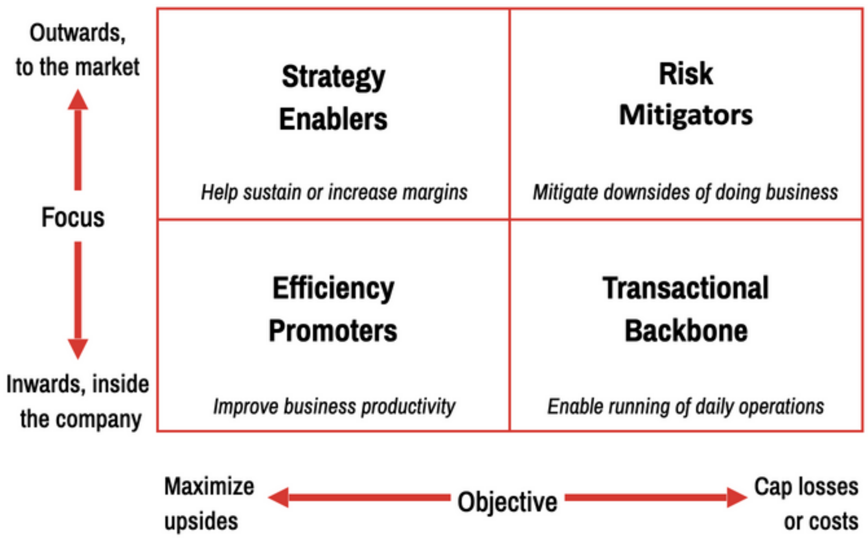


Figure 2 – Opex classification Matrix

This classification matrix should embrace all operating expenses, based on the perspective and objective of each line, as seen in table 1 below.

Classification	Nature	Examples
Strategy Enablers	• Cost of activities, initiatives needed to win in the marketplace • Market facing capabilities, capacities, and resources providing competitive edge ("must haves")	• Marketing campaigns, competitive research, innovations programs, omni-channels strucutres
Efficiency Promoters	• Cost of initiatives that will make the company run better • Generally done as corporate services or delivered in projects	• ERP systems, temp labor contracts, workforce training, supply chain enablers
Risk Mitigators	• Compliance-driven costs to mitigate a wide range of risk factors • Usually functions relying on expertise (except already commoditized by AI)	• Maintenance, workplace safety, regulatory compliance, internal audit, hedging policies
Transactional Backbone	• Cost of activities that are important for the legal and practical operations • Basic "utilities" type of services that serve as backbone of companies	• IT infrastructure, financial reporting, accounting, payroll administration, transactional legal services

Table 1 – Description of Groups

For faster and stronger impact, we recommend creating an Opex Cube, as shown in figure 3, where expenses are grouped by group, function, and time frame.

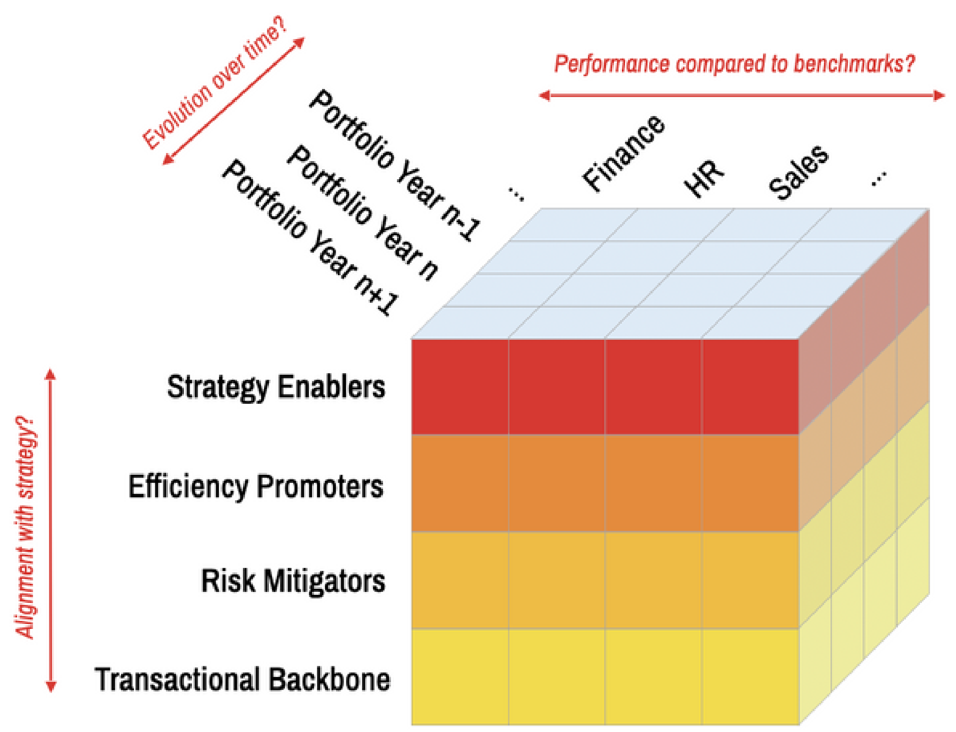


Figure 3 – Opex Cube

This cube will enable us to address questions that will help us generate relevant, actionable insights:

- Is the relative size of the classes in line with the company's strategy? Inside each class, do we have the right set of activities to meet the desired strategic goals?
- How does the portfolio evolve over time? Can we smooth out erratic trends?
- Are the costs of the activities executed inside each function in line with benchmarks? Where do most of the under- and over-performances happen?

At this point, it is important to invest in making sure that the data in the opex cube is accurate and complete. This will be essential for the quality and usefulness of the insights from the analysis's findings. External benchmarks, that can be purchased or estimated from primary and secondary sources, don't compensate for badly made opex cubes.

Once the as-is portfolio is clearly understood, it is time to build the desired "to-be" version. This is achieved through top-down portfolio rebalancing, which addresses the following questions:

- What type of portfolio do we want? How does it change over time?
- Given the future goals of the portfolio, where are we over- or under-investing and why?
- How should we rebalance the portfolio and redirect spending?

To ensure a credible top-down "to-be" portfolio, the CEO must ratify the goals and establish a clear mandate for change. This resolute communication will set the stage for the bottom-up operating expenses optimization, as seen in figure 4.

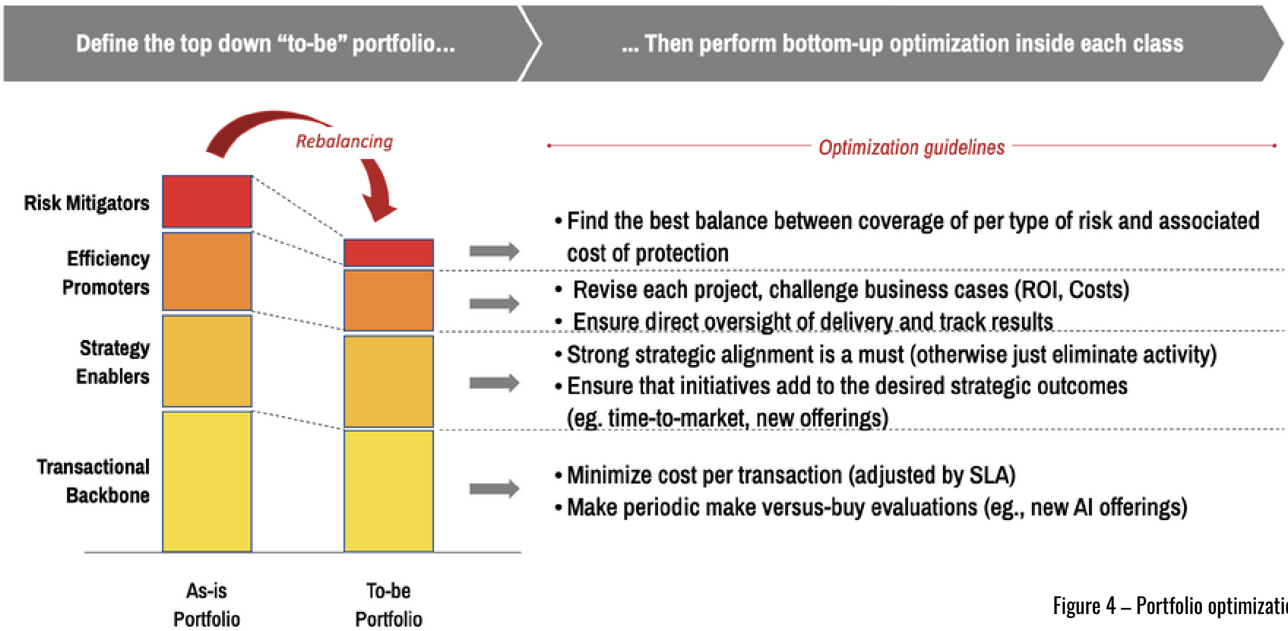


Figure 4 – Portfolio optimization

It is important to remember that the optimization guidelines are not the same for each group of operating expenses. Also, the amount of improvement will depend on how much each class of opex needs to be scaled up or down. In the case given above, for example, there is a bigger focus on making the risk mitigators smaller.

The success of the bottom-up optimization exercise is conditioned on the active participation and buy-in of the "owners" of each activity. To ensure productive working sessions, it is critical to be prepared with the right set of timely data, internal and external benchmarks and detailed optimization guidelines. In addition, it is essential to scrutinize all drivers of costs, as people tend to use outdated ones out of sheer inertia (rarely challenging them).

Once the top-down portfolio goals and the bottom-up optimization efforts match up, a detailed "from-to" action plan must be made and shared with the rest of the organization. Putting the plan into motion is the trickiest part of any project.

Get Results That Matters.

In our experience, most plans fail to deliver the expected results. Common reasons are: poor execution, “forgetting” initiatives laid down in the plan, not making course corrections to comply with changes in top-down directives, or simply neglecting to report the results. These failures affect morale and make a new implementation wave more unlikely.

To make sure results show up on the bottom line, we recommend following three building blocks:

- Visible leadership: periodically reinforce priorities with observable leadership behaviors. Avoid sending confusing signals.
- Alignment and motivation: make sure that every single opex has an assigned single accountability line. Also, warrant that individual's roles, measurements, and incentives are aligned with the portfolio’s goals.
- Relentless execution: this is not a one-off event, but a continuous process owned by the line. Track results, assess outcomes, and make sure that all parties are held to account.

The asset-based approach presented in this paper is an effective strategy for competitive operating expenses. Roller coasters are avoidable if you are up to it.

Source: “A Strategic Approach to Overhead Management”, Strategy & Leadership, Vol 36, No 2

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Augmenti Consulting is focused on providing advice to boards and C-level executives on the practical steps they need to take to produce tangible bottom-line impacts. Our purpose is to assist you in reaching your full potential and accelerating your growth. More on us at **www.augmenti-consulting.com**