

What to Cut: Four Strategic Frameworks for Budget Cutting

We all know the situation: The CEO or CFO is at your office door, making small talk but looking a bit uncomfortable. Then, after a few minutes chatting about the weather or last night's big game, the bomb is dropped: "I need you to reduce your budget by 15%. The next few quarters look tight, and we're looking for cost reductions across the business."

These days, it's not uncommon for this to be a second or even third request for cuts – maybe even within just the past few months.

So as you sit there in your office, alone now, pondering the extensive damage this next round of cuts will cause to your ability to produce revenues, shore up brands, launch new initiatives, or even maintain some semblance of positive morale in the department, you have essentially two choices. You can make the cuts the same common-sense way you always have and hope to recapture funding when things ease up a bit. Or you can try something different: recommending cuts in a strategic/financial framework that will ensure that, at the very least, the true "cost" of your proposed cuts will be recognized (and perhaps even reversed somewhat).

Conventional "cutting" wisdom

Most marketers in this situation are left operating with only their instincts. They have no training in budget cutting. There are no books on the topics. No videos on YouTube.



The conventional wisdom is to first remove from consideration "sunk costs" that cannot be un-spent (e.g. contractual guarantees) and then pursue one or more of the following:

- Cut travel and other non-program expenses that are less visible to customers, sales reps, and channel partners.
- Reduce agency fees and vendor costs and eliminate consultants.
- Switch from higher-production-cost media to lower-cost alternatives.
- Abandon your traditional media options altogether in favor of more targeted (and more measurable) offerings in the digital arena.
- Cut proportionately across each sub-group within marketing based on total spend or discretionary (non-payroll) spend.

These cuts are typically followed by some re-jiggering of the remaining

budget to get more out of less. These activities include:

- Switching message delivery from broad-reach vehicles to more targeted ones where the CPM may be higher, but the waste factors are lower.
- Integrating message execution across delivery platforms more consistently to get better "topspin".
- Leveraging your existing digital "assets" across more platforms (e.g. TV ads on web) to increase the reach and further amortize the development expense.
- Focusing on crafting a more singular, simple message in the hopes it will be more resonant at lower media weights.

There is some validity to each of these options. But unfortunately, they are devoid of any structure to assess the real costs. Further, none of these approaches plant clear seeds in the minds of the executives about the necessity of restoring marketing spend at first opportunity. They're all just further steps onto a slippery slope towards the further "tactification" of the marketing function. Taking only these approaches may ensure that you survive the battle, but you most certainly will lose the war.

If you have any hope of restoring those cuts once the storm passes, it's time to redouble your efforts to establish the financial and strategic value of your marketing programs – even as you're executing the current mandate to cut costs now.

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Establish the Context for the Cuts

The first step in framing the right cost-reduction solutions is to determine why the cuts were required in the first place. Companies that are cutting back generally fit into one of these three modes:

SURVIVAL MODE – needing to conserve cash just to live to fight another day (also known as “furniture burning” mode). Companies in this state are far less concerned about the long-term impact of today’s cuts, and seek only to maximize short-term cash flow. If your company is in survival mode, evaluate every possible cut against the expected reduction in short-term gross profit generation. If the value of the cut exceeds the expected cost in gross profit terms, do it.

SHORT-TERM EARNINGS MODE – most companies in this state have suffered some shock to the system that has disrupted the revenue or expense trajectories (or both) and have no other way of realigning

for profitability than to cut short-term costs. These companies aren’t going out of business anytime soon, but they risk failing to “hit the numbers” unless they take some dramatic steps. In short-term earnings mode, you want to be as aggressive in the near term as you can, but not blind to the implications of the cuts on next year’s performance. After all, you must manage through next year, too.

CASH COW MODE – these companies are part of a larger holding company and are being asked to generate more near-term cash flow/earnings to either cover for shortages or to fund investments required elsewhere in the portfolio. This scenario is often more driven by political pressure than pure economics, as someone in senior management is likely to be staked to hit certain targets, even if it means sacrificing mid- to long-term growth. In cash cow mode, you need to carefully weigh these economic and political considera-

tions, especially if you harbor hopes that your business will one day soon be the recipient of investment funds.

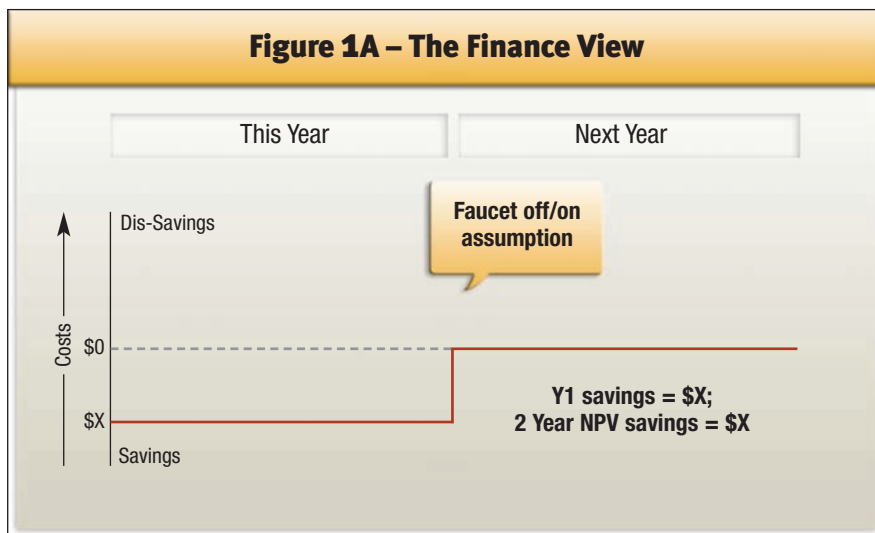
Since most people in survival mode companies aren’t generally reading literature like this looking for better solutions (they’re burning the paper too), we’ll focus primarily on the other two modes where at least some degree of appreciation for the long-term health of the business exists.

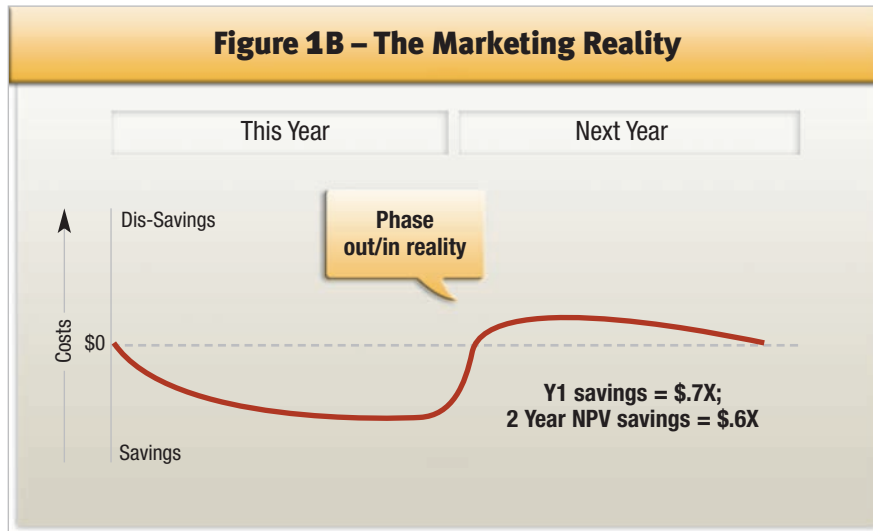
Set the Right Baseline

The second step in preparing to cut is choosing the right baseline for your business case. Many finance executives tend to think of marketing spend as a light switch – you can turn costs off when money is tight, then turn them back on again when conditions allow. But in reality, it is more like pushing a large rock up a steep hill. If you apply less effort, the rock doesn’t just come to a stop, it tends to roll backwards – picking up momentum as it goes. And at that point, it can become nearly impossible to stop the descent of the rock and get it going uphill again.

Likewise, budget cuts rarely impact just the programs or people directly affected. They often change or accelerate one or more forces in the marketplace, which may unleash even more dramatic declines. For example, if you decide to cut an education and training program for channel partners, you may lose distribution options when competitors pick off key accounts in your absence. Or if you postpone a new product launch, you may allow some heretofore unknown company to burst onto the scene and steal customers with their “better mousetrap”, even if you had conceived of it first. In either example,

Figure 1A – The Finance View





the cost of reestablishing the previous competitive position is far greater.

Figures 1A, 1B, and 1C illustrate the three views of potential benefits derived from cost cutting. In 1A, the finance view anticipates quick cuts and the ability to immediately resume at a later date. Thus the NPV benefit of the cut is always equal to the size of the cut.

In Figure 1B, the marketing view most often recognizes that cuts don't happen immediately; they require some time to take full effect. And further, if the original reductions are reversed, it often takes a bit more time to restore the functions, and requires a bit more cost to do so until operating efficiencies can be re-established. In this context, the NPV benefits are less than the actual amount of the cuts – often up to as much as 30% to 40% less.

Figure 1C is the most common outcome. Cuts are made and implemented over a period of time. But eventually, market forces sense the vacuum in the hearts and minds of the customers and

fill it with alternative solutions, which cause a larger-than-expected degradation of sales. In this scenario, the net benefit of the cuts can actually be *negative* as the loss of sales creates a counterbalance to the initial cost reduction. In this case, the NPV of the cuts is negative – meaning that for anyone NOT in strict survival mode, this is a sucker move. It is *costing* you money to make budget cuts. But how do you estimate the potential market-

place reaction to your cuts? Start by assessing the current environment and the trends shaping the business today.

- What are the positive trends working in your favor, and how does your present pattern of marketing spend support or accelerate those trends?
- What are the forces working against you in the marketplace, and how does your present pattern of spend keep them in check?

It often helps to identify the three most positive and three most negative trends, and then imagine the impact of small, moderate, and substantial reductions in your spend on each of those trend lines. Would a given trend-line continue on its current straight-line trajectory? Or would it turn rapidly upward or downward?

When assessing the impact of marketing budget cuts, marketers will often automatically assume that the “bad” curve in Figure 2 is the likely outcome, ignoring the potential for negative



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market forces to not just continue, but to accelerate in the absence of a counterbalancing force. So the right baseline for determining the expected impact of cuts is found by estimating some level of acceleration based on what you believe competitors are most likely to do in response to your cuts.

The exercise of envisioning the right baseline is helpful not only in determining the true cost of potential cuts, but also in identifying places where you may actually need to spend MORE simply to remain competitive over the next 12 to 24 months. For more on this, see the article *What NOT to Cut*.

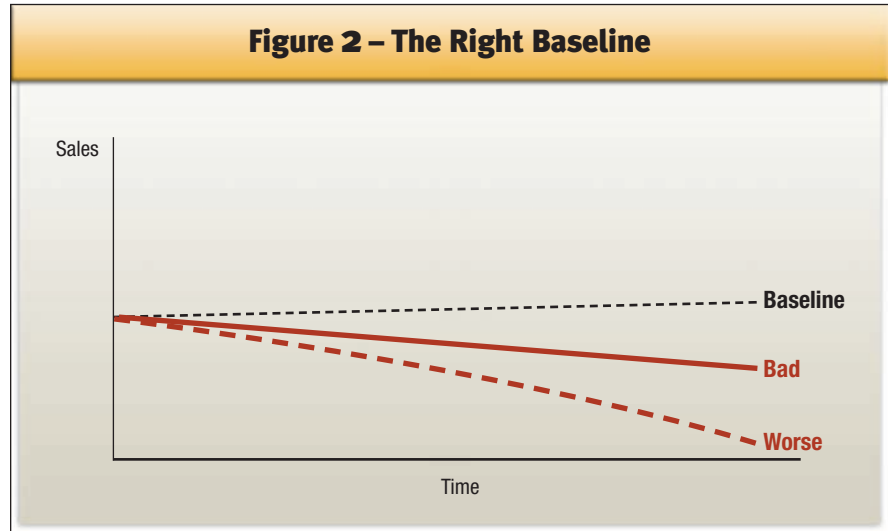
Four Strategic Frameworks for Budget Cutting

When you're ready to begin cutting the budget, there are four frameworks we've found helpful for making smart choices:

1. Portfolio management of products, channels, or geographies
2. Customer portfolio management

3. Marginal returns analysis
4. Decomposition matrix

Most companies find one or more of these frameworks applicable on the basis of several factors: how their business is structured; what information they have available; the company culture; the credibility marketing has with finance; and/or the amount of time they have to make their cutting decisions.

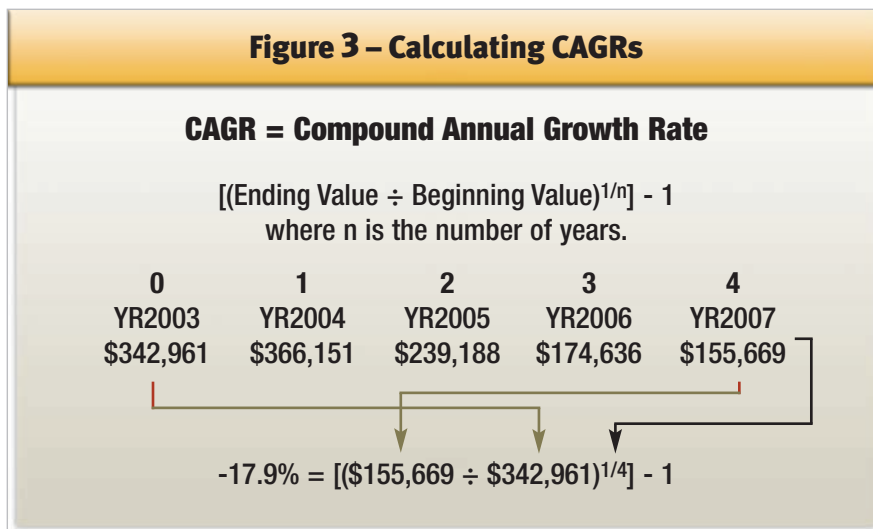


Product/Channel/Geo Portfolio Management

Do some of your products, geographies, or channels offer better performance options than others? Are some less risky guarantees? Are some more competitively insulated so as to withstand some starving of resources for a period of time? Depending on your answers, consider making deep cuts in one or more product or geographic areas while leaving others intact instead of spreading the cuts evenly.

Most marketing budgets are tracked by tactic or functional spend element – advertising media costs, agency fees, market research, email campaigns, etc. If you don't have those categories broken down on the basis of allocation by product or channel, it's a relatively easy calculation for your product, channel, or field marketing managers.

Next, for each of the products or channels or geos (whatever makes the most sense based on how your department is organized), calculate the following three scores:



- **Performance** – the Compound Annual Growth Rate (CAGR) of the growth in gross profit over each of the past three years. We prefer to use gross profit versus revenue as it takes any pricing dynamics into account and is most closely aligned with the hard cost of budget cutting. We also prefer CAGR as it smoothes out trends more accurately than just taking averages. (See Calculating CAGRs - Figure 3)
- **Opportunity** – the projected CAGR of gross profit over the next three years. Here you're looking at the growth you believe you could reasonably achieve with all the tools at your disposal today. Avoid the temptation to stretch the opportunity based on what you "wish" you could do – keep it grounded in the reality of the current business plan.
- **Leverage** – the CAGR of the rate of change in the \$ of gross profit produced per \$ of marketing spend. The time period for this is also three years - last year, this year, and next year.

Once you have the three scores for each product (or channel or geography, but we'll stick with products for this example), you can place them into an investment strategy cube (Figure 4) where Performance, Opportunity, and Leverage can be determined for each product to be Attractive (A), Neutral (N), or Unattractive (U) compared to all other products. You can do this by cluster analysis or by simple ranking into three groups, depending upon how sophisticated you want to get.

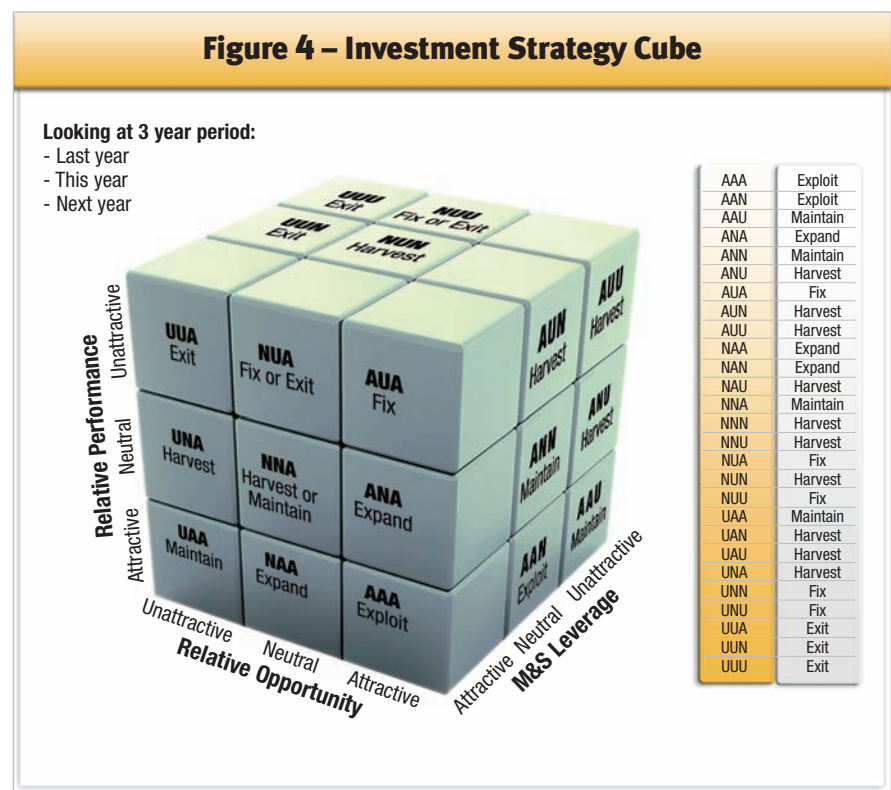
Each sub-cube in the investment strategy cube has a default investment strategy associated with it. If a product

falls in to the AAA sub-cube, it likely warrants an "exploit" strategy, meaning an even greater allocation of funds than it presently has. A product falling into an NNN sub-cube may warrant either a "maintain" or "harvest" default strategy, depending upon how aggressive your cuts need to be. And a product falling into NUU, UUN, or certainly UUU might warrant a total cut of all associated spending, as these segments indicate some fundamental problem that isn't likely to be overcome by any reasonable amount of spending in the near term. (Note that new products in test modes often fall into these categories during their piloting stages and should be evaluated separately from mature products.)

Once each product has a default investment strategy associated with it

(Figure 4), we can compare the recommended strategy against the relative marketing spend received by that product (total \$ marketing as a percentage of total gross profit for the product). Figure 5 shows how a simple matrix would help identify which products could be harvested (lower-right corner) and where there might be better growth opportunities (upper-left corner).

This analysis framework can be adapted for different situations by altering the nature of the Performance, Opportunity, or Leverage calculations, or by applying differential weights to each of the three, or by skewing the default strategies toward more conservative or aggressive postures. Once you successfully apply the basic scheme, you can fine-tune it until you reach the right version for your scenario.



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Customer Portfolio Management

The second framework for strategic cutting is largely the same as the first, but the unit of analysis is customers (or customer segments) instead of products, channels, or geographies.

Many marketers debate the wisdom of focusing on customer retention over acquisition when funds get tight. That determination should be based on a careful assessment of the normal customer switching patterns in your business, and the likelihood of those trends changing or accelerating during difficult economic times. This framework, however, can incorporate elements of both acquisition and retention by analyzing three dimensions:

- Profitability – what is the past three-year CAGR on customer

profitability (again, measured preferably in gross profit terms.)

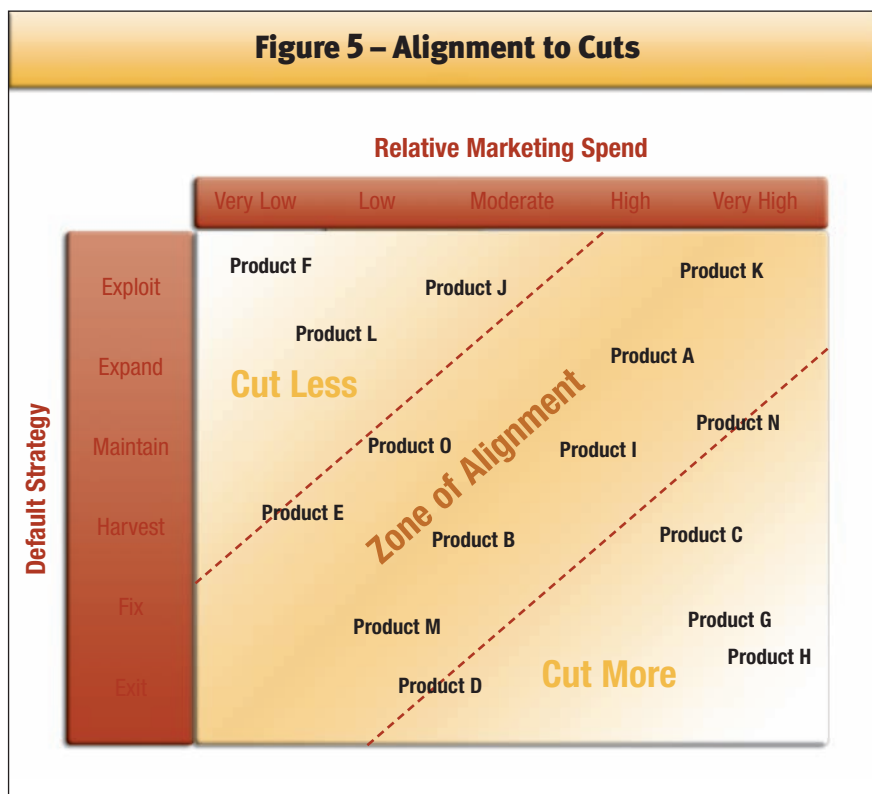
- Potential – what is the future three-year CAGR of the customer, taking into account short- and long-term obstacles to customer behavior change? Here as before, we want to resist the temptation to estimate what growth *could* be and stick with what we believe it *will* be based on our best understanding of our company's capabilities, the capabilities of our competitors, and an estimation of how the marketplace may change.
- Switching Risk – what is the probability of a customer defecting to a competitor or dropping out of the category in the next 12 months? What do you know about her loyalty – her propensity to defect or do nothing in the absence of stimulus from you?

With customers scored on each of these three variables, we proceed just as we did in the product portfolio analysis, possibly changing the nature of default strategies to more appropriate activities like Engage, Nurture, Defend, or Ignore. You may also want to use somewhat different scoring structures for your Investment Strategy Cube such as those shown in Figure 6.

The next step is to reallocate resources in the same way shown in Figures 4 and 5, by translating the default strategies into a strategy-vs.-spend matrix and making cuts from the bottom-right quadrant.

When taking this approach with a customer-level analysis, keep in mind the risk of competitors picking off middle-value customers and thereby elevating your marginal costs per customer, which may render your customer value scores invalid at some point.

Figure 5 – Alignment to Cuts

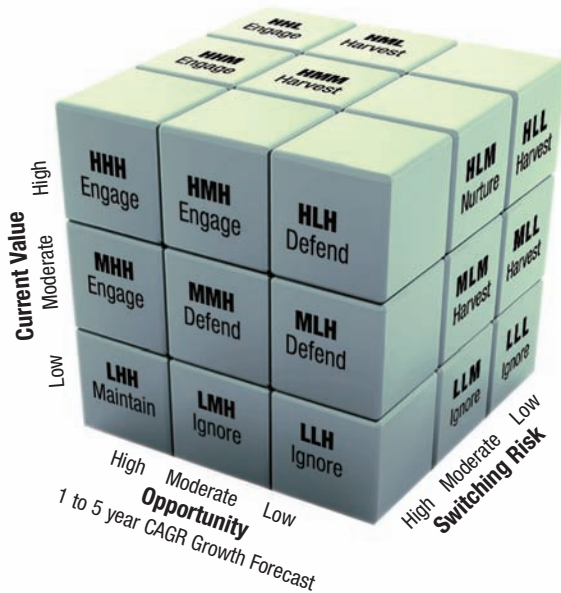


Marginal Returns Analysis

The marginal returns analysis framework uses the classic “s” curve as a starting point to help focus the discussion on cutting dimensions in one of three places (see Figure 7):

1. The Zone of Diminishing Returns – where the incremental benefit per dollar invested is declining rapidly. In this zone, a dollar cut presumably has less impact on sales or margins than it would in the steeper portion of the curve. For example, a collateral materials program where you are fairly certain that producing new versions of collateral materials or re-printing older ones would have no discernable effect on sales.
2. The Zone of Immature Returns – where your current total expendi-

Figure 6 – Customer Portfolio Management Investment Strategy Cube



ture isn't likely achieving critical mass, thereby suggesting that a cut here would be far less noticeable in the market and less risky to your plan. For example, a print advertising campaign that is appearing in only two or three publications and reaching a relatively small portion of your target decision-makers. Killing this campaign may hurt from an emotional perspective, but if you already know deep-down that it is too small in scale to be really effective, you're better off cutting it than nibbling away at other tactics that may have crossed the critical-mass threshold.

3. The Zone of Efficiency – Opportunities, where identifying new approaches to spending help squeeze out incremental return per dollar from the current budget, thereby helping you insulate your sales plan from the cuts in other

areas. For example, finding ways to reduce waste in direct marketing programs may help you trim expense dollars without reducing the expected benefit. These expense dollars could then be reallocated. Alternatively, you may find an email campaign

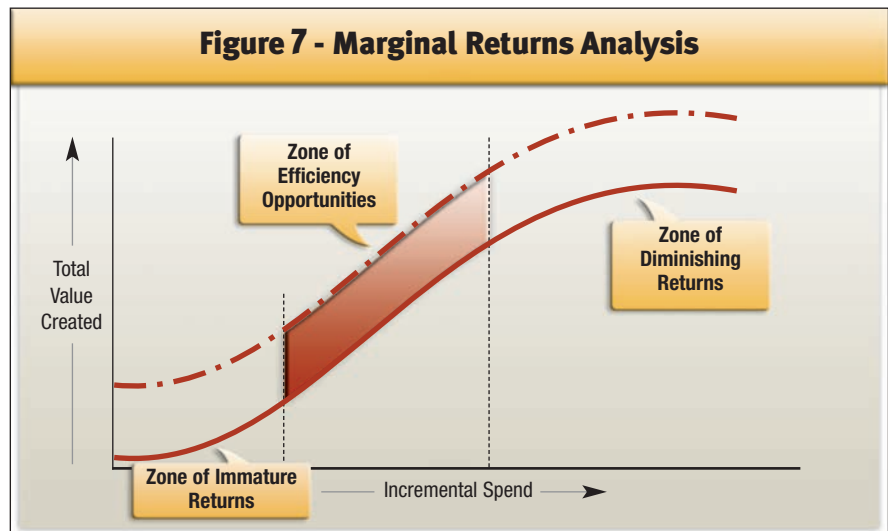
generates better response if you alter the offer structure, in which case you can expect more benefit for the same dollars, allowing you to more confidently consider eliminating that ad campaign in the Zone of Immature Returns.

If you have data to support your placement of items on the curve, great. But most companies don't, which is why this analysis is a perfect discussion-starter for a group of managers to determine where different products, programs, or customers might fall on the "S" curve, and thereby identify the likely candidates for cutting. In our experience, it is far less important to come to consensus on exactly where to place something than it is to agree that it is in a certain general area of the curve.

Decomposition Matrix

Despite the implication of the name, the Decomposition Matrix is not a place where your rotting budget parts go to die. Rather, it is a way of relating proposed budget cuts back to the company's specific formula for driving shareholder value, and in the process determining which cuts would hurt shareholders the least.

Figure 7 - Marginal Returns Analysis



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The “decomposition” in this framework comes from parsing out (or decomposing) the elements of shareholder value and identifying the specific elements in marketing programs that are most impactful. Figure 8 shows a simplified decomposition formula for shareholder value. The elements marketing might be most directly responsible for include distribution, market share, customer value, and brand value. We call these “impact centers”. Your challenge is to identify all the impact centers, as they will become the yardsticks used to evaluate which marketing programs stay or go.

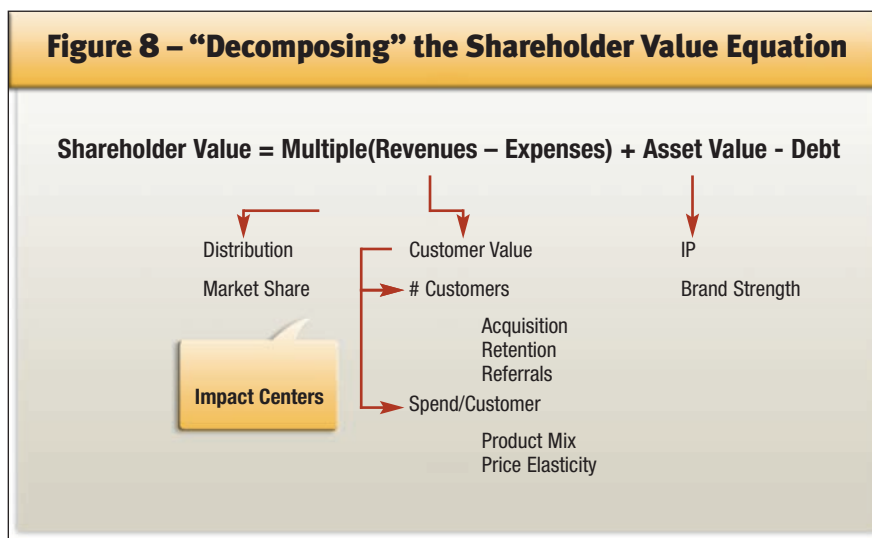
where discretely funded marketing programs are shown as rows and the impact centers become the columns (see Figure 9). In each cell, we again apply weighting factors to estimate the extent of damage to a particular impact center if a given program/tactic is cut. Only this time we use negative weights (-1, -3, -9) to create this “damage index.”

We then calculate the weighted scores for each column and row and evaluate the wisdom of making cuts where the damage index is lowest (e.g. the numbers are closest to zero). In Figure

what a “1” weighting means versus a “3”. And there is the very real risk that the CEO will not find it credible since the marketers themselves did most of the weighting.

In our experience however, these risks can be controlled. First, by including finance people in the process of defining the decomposition equation and weighting the impact centers. That helps the CEO feel there was a suitably critical eye in the process. Second, by “calibrating” participants weighting patterns before you begin. This can be a fun exercise involving weighting things like the appeal of TV shows, or the probability of getting “heads” three times in a row when flipping a coin. Participants can quickly learn to apply weighting factors more consistently. And finally, as with the other frameworks, there is no actual need to come to consensus on precise weights for each cell. If the group cannot agree on a single number, use the range of perspectives to construct probability distributions and apply Monte Carlo simulation to calculating the likely range of the damage index.

Figure 8 – “Decomposing” the Shareholder Value Equation



Once you’ve identified all the impact centers, assign a weighting factor to each one based on your understanding of how important it is in helping the company achieve its financial plan. For this exercise we use a simple non-linear scoring process where the options are limited to 0 (no impact), 1 (slight impact), 3 (moderate impact), or 9 (significant impact).

The “matrix” component of this framework lies in constructing a grid

9, this suggests we would seek to cut first in Tactics E, D, and G to minimize the risk to the company achieving its financial plan.

Many marketers (and finance people) are initially uncomfortable with the highly subjective nature of the weighting approach used in this framework. There is a risk that no consensus emerges on weights or damage factors. There is a risk that the group may not be aligned in its understanding of

Choosing the Right Framework

When it comes time for you to decide which of the four frameworks (or some derivative thereof) above would work best for you, consider the following variables:

1. How much time do you have to make your cuts? Less time may steer you in the direction of the more qualitative frameworks like marginal returns or decomposition.
2. How much data do you have? Less data may also steer you toward the latter two frameworks.
3. How do you presently allocate

Figure 9 - Weighted Decomposition Matrix

Weighting of Impact Centers	Distribution	Market Share	Customer Acquisition	Customer Retention	Product Mix	Price Elasticity	Product IP	Brand Strength
	3	9	1	9	1	1	3	3
Program/Tactic A		-3			-3		-3	-39
Program/Tactic B		-3	-1	-3	-1		-1	-63
Program/Tactic C	-9		-3	-1				-43
Program/Tactic D	-1		-3	-1	-1			-19
Program/Tactic E						-9		-9
Program/Tactic F		-3	-1	-1	-1		-3	-47
Program/Tactic G						-3		-30
Program/Tactic H		-9			-9			-90
	-30	-162	-8	-54	-15	-12	-51	-36

your budgets? If you allocate by product, then the portfolio-by-product approach may fit your current model best. But if you allocate by customer segment, then portfolio-by-customer would work better.


- Who do you need to engage in the process? If you must involve a large group of constituents, you may be better off relying on one of the two portfolio approaches to provide more structure to the analysis. The marginal returns and decomposition approaches lend themselves best to smaller groups.

Regardless of which framework you choose, there are a few keys to success to include in your process:

- Define and think about your cutting objectives first, then revisit them

often. Pay particular attention to the objective about “credibility” to ensure your approach will be judged as you’d like it to be.

- Establish the right baseline when estimating the cost/benefit of the cuts.
- Construct your business case carefully. There are subtle considerations around using Monte Carlo simulations or discounted cash-flow/NPV methods that a financial manager might be better suited to navigate for you.

Remember that once the budget gets cut, you and your team will have to work effectively with whatever remains. Cut strategically now and you’ll ensure you have the resources and credibility to succeed when the crisis passes – however long that may take. 

The Cutting Objectives

Most of us have an emotional reaction when asked to cut the budget. These emotions tend to emanate from our fears of losing our jobs or our concern for our fellow associates who may lose theirs. It’s natural (and downright human) to feel that way. Cry, scream, throw something, pout, do whatever you have to do to let go of the negative emotion. Then suck it up and get back to the challenge at hand.

Realize that you have already lost this battle over the value of marketing in the overall mix of company investments, and that your efforts at establishing the financial and strategic value of your marketing programs have not been as successful as you’d hoped. Then begin to restructure your thought process around a whole new set of objectives:

- Achieve the required short term budget reduction goals.
- Clearly identify the expected short-term negative impacts on revenue or margins.
- Minimize the long-term negative impacts.
- Gain credibility for thorough, objective analysis.
- Establish the groundwork for subsequent budget discussions.

These five goals now become the measures of success. The new plan is to emerge from this experience with the wisdom, credibility, and strategic foundation to win in the future.