WHY ZERO-BASED BUDGETING—AND WHY NOW?

By Luke Pototschnik, Mark Austin, Jackie Inglesby, and Julie Graham

The economic expansion is now well past a record-breaking ten years, and talk of a recession has grown louder. So, too, has the buzz about zero-based budgeting (ZBB), as companies contemplate ways to free up funds to save money and shore up balance sheets.

Many companies have reaped big benefits from ZBB, a bottom-up approach to managing costs. But to view it strictly as a cost-control tool is to vastly underestimate its power. When used strategically, ZBB can foster top-line benefits, reconfigure cost structures, and free up investment funds. This approach, which we call growth-minded ZBB, requires a profound shift in thinking and in how a company and its people operate. At the same time, ZBB is also a catalyst for transformative change, and in that respect, it is more than just a discipline.

As with any transformation, the best time to undertake ZBB adoption is ahead of time. Rather than ponder how to survive a downturn, successful companies examine how to set themselves up to thrive regardless of the economic environment. For those companies that haven't yet adopted ZBB—or aren't using it to prime growth—now's the time, before the economy puts survival skills and preparedness to the test.

A Growth-Minded Variation of ZBB

Long-term total shareholder return (TSR) depends, above all, on growth. When companies respond to a slowdown through broad-brush cost-cutting measures, they often trigger a negative cycle of declining revenues and shrinking margins, leaving a smaller pool of capital available for investment.

ZBB rejects blanket cost-cutting. It entails meticulously scrutinizing expenditures and often resetting budgets annually to ensure the most efficient and effective use of resources. Growth-minded ZBB goes a step further: it integrates tightly with a company's business strategy and its growth levers. Growth-minded ZBB calls for distinguishing between high-value-adding costs and

low-value-adding costs. The idea is to eliminate inefficient spending and redirect it to more strategic, growth-oriented uses.

When applying growth-minded ZBB, companies start with three questions: What is our top-line aspiration? What investments are necessary to reach it? And, how should we structure the cost base to enable those investments? This approach recognizes that it takes more than cost discipline to fund investments and opportunities that foster growth. Successful companies don't regard ZBB as a one-time exercise; rather, these companies see it as a way of doing business and infuse it into everything they do.

Why ZBB Matters Now

ZBB has been commonplace among consumer products companies—its early adopters. But it has begun to spread across industries, and for good reason: it is appropriate for any industry, and it is ripe for the times. The competitive pressures and volatile conditions of the global marketplace, combined with the ever-present threat of disruption, require companies to be as lean, flexible, and adaptive as possible in order to thrive. But as the prospect of a recession grows stronger, a ZBB transformation could well be the most important way a company strengthens itself, both defensively and offensively.

ZBB supports the ability to strategically target cost reduction while freeing up funds for growth. Because expenditures are classified according to their type, rather than their point of origin, ZBB brings once-hidden costs to the surface. This added transparency, together with clear cost accountability and cost-management methods, facilitates and encourages the much-needed discipline that helps companies better identify high- and low-value costs and make conscious, strategic decisions. For global companies, this transparency enables de-averaging, which is particularly important during downturns. Applying a universal cost-reduction policy or cookie-cutter approach to operations across markets and regions with different conditions and opportunities makes little sense.

Along with securing efficiency in the cost base, ZBB also simplifies and creates organizational efficiencies. Cost reduction is essentially the strategic enabler: you remove bloat to fund opportunity and nimbleness.

Preemptive Transformation Pays

Research from the BCG Henderson Institute shows that preemptive transformation of any kind generally yields a greater payoff, because it boosts a company's capacity to grow instead of merely survive. The institute analyzed hundreds of corporate transformations that large, listed, US companies undertook from 2010 through 2014. It found that companies that implement change preemptively generated significantly higher long-term value than those that responded reactively. In the three years after a transformation began, the preemptive transformers achieved an annualized TSR that was 3 percentage points higher than the annualized TSR of reactive transformers. Furthermore, the preemption premium has long-lasting effects: the earlier a company transforms, the better its future performance. In fact, that is the most important observable success factor in corporate transformation.

Acting preemptively delivers other benefits as well: the transformation can be executed faster and for less cost. Those two benefits combine to produce a return on investment that is about 50% higher than the ROI of a reactive transformation.

The High Cost of Reactiveness

The value of restructuring the cost base proactively is, as with other types of transformation, especially striking when we consider the fate of companies that wait to act. In the period leading up to the global financial crisis that started in 2007, companies continually absorbed higher costs as long as those costs helped deliver necessary volumes. When the financial crisis struck and volumes plummeted, those companies had to reduce their absolute cost base in order to preserve the bottom line as much as possible. Most companies were caught off guard; although the signs of a

slowdown did not escape them, they had underestimated the severity of the prospective downturn and its potential impact and waited to act. For most, their actions amounted to too little, too late.

Additionally, an extensive BCG survey conducted during the initial months of the recession found that even as events unfolded, some companies remained surprisingly complacent, neglecting to create contingency plans in the event of a deepening and prolonged slump. At the time, the CEO of a large industrial company observed, "Managers look at their balance sheet and cash reserves and think they are safe. But they are very surprised by how little time they have once demand drops like a rock."

Consider the example of a major consumer goods company. Because the company wasn't proactive, it had to take draconian measures after suffering a double-digit decline in profit in mid-2009. The company was forced to promote basic versions of its major brands, cut prices, and increase package sizes in order to compete with private labels. Analysts cautioned that these stopgap measures would do little to promote long-term profit growth or support innovation.

The delayed response of many companies cost them in another painful way: they had to use savings culled from their emergency austerity efforts to shore up their balance sheets to protect access to financing. Thus, their savings assisted only in the short-term and could not help improve their long-term positions.

Maintaining Momentum

To stay primed for growth, companies must maintain strategic momentum, regardless of market conditions. They must keep up marketing support, carry out internal improvements, seize M&A opportunities, and pursue innovation. An upside is that such activities are generally cheaper in downturns and out of the reach of cash-strapped competitors.

During the height of the Great Recession (2007 through 2010), Reckitt Benckiser, the UK-based multinational consumer goods company, took such steps. It not only carried out its advertising and marketing plan, taking advantage of the decline in media prices to secure more coverage for the same cost, but the company also invested more than it ever had in marketing, increasing its 2008 expenditure by 25%.[1] So, while peers disappeared from consumers' view and were forced to cut prices amid rising costs, Reckitt Benckiser ratcheted up investment in its brands, shrugging off widespread concerns about the encroachment of private-label sales. Despite anemic growth in household products, the company achieved organic top-line growth of 10% in 2008.

Cutting R&D, inevitable for most companies in reactive mode, can also have debilitating long-term consequences on innovation. During the recession, as competitors pulled back on R&D spending, Reckitt Benckiser continued investing in innovation—a critical decision given that new products and line extensions typically sell better and command higher prices in the consumer goods industry. Then-CEO Bart Becht was convinced that consumers would gladly pay more for innovation regardless of economic conditions—and he was proved right. Amid the worst global recession in 70 years, the company not only achieved stellar results but also, as one Wall Street analyst noted, experienced one of the biggest upgrades to its performance estimates since the company's beginnings.

Even more compelling than outperforming during tough times is that the company sustained the long-term effect of its stellar results, an outcome that is not unique to Reckitt Benckiser. Outperformers in a recession remain market leaders (in revenue and stock price) for years afterward. From 2007 through 2012, a period that spans the depth of the recession and extends well into the recovery, Reckitt Benckiser significantly outperformed its peers with a TSR of 5.9%. It also outperformed the S&P 500, with a TSR of –0.6%, and the S&P 500 Consumer Staples Index, with a TSR of 3.8%. More impressive, the company sustained its robust TSR performance for more than a

decade. From 2007 through 2017, Reckitt Benckiser returned a TSR of 9%, compared with 6.2% for the S&P 500 and 7% for the S&P 500 Consumer Staples Index.

A Change in Thinking, Ways of Working, and Culture

Because ZBB is as much a mindset as it is a way of working, it can only take hold with a broader cultural change that creates the right organizational context. (See the sidebar "Shaping a Growth-Oriented ZBB Culture.") Cultural change must start at the top. The CEO and CFO must be actively involved not only to determine why ZBB should be adopted but also to articulate how they see its contribution to the company's long-term growth. The CEO and CFO must also design the most appropriate ZBB program. They, along with other leaders, will need to refocus the team's energies,

SHAPING A GROWTH-ORIENTED ZBB CULTURE

As with any transformation, embedding ZBB successfully requires a change in organizational culture. Through our research and experience, BCG has found that it is the organizational context—for example, how leaders behave and what kinds of performance management systems the company has in place—that shapes and sustains company culture. By making changes in five key context areas, companies can instill behaviors conducive to a ZBB culture.

The Operating Model. Companies should alter their organization's structure, layers, and spans of control, as well as the processes, roles, and decision rights. For example, a company could establish dual accountability for costs by having a cost category owner as well as the budget owner.

People and Development. Companies should change the kind of employees they seek, the career paths and development programs they offer, and how they promote and retain talent. Companies want to be sure to hire and retain employees who diligently live up to ZBB values.

Performance Management. Companies should adjust their compensation packages, including the types of benefits they offer. They can also change incentive structures, including how they track and reward performance, how they recognize and reward exemplary work and behavior (for example, compliance with ZBB policies and performance above and beyond ZBB standards), and how they handle undesirable behaviors.

Resources and Tools. Companies should change the types of projects they fund and the access they give to people resources and tools in order for people to do their work. For example, companies should ensure that prospective IT solutions support ZBB aims and ways of working.

Rituals and Norms. Companies should rethink how they bring employees together to learn and embrace the cultural changes. For example, companies could use quarterly or annual budgeting meetings to let employees share their ZBB success stories and lessons. Such gatherings would also give leaders a chance to clarify and bolster the organization's commitment to redirecting savings to investment and growth.

With any change program, it is incumbent upon the leaders to clarify the purpose and set an example. Employees must not perceive ZBB as a euphemism for yet another cost-cutting program. Leaders need to be unflinching in exercising ZBB's key principles. That means consistently making choices that advance the company's position and eliminating expenditures that do not serve this purpose.

recognizing that ZBB is a long-term journey and that the team needs to embrace the new culture of cost ownership. Leaders must model the desired behaviors, demonstrating how to communicate, set priorities, and interact with others. Leaders can also agree up front on how to reinvest savings for growth and communicate that commitment to the larger organization.

Companies can shape the organizational context in many ways, such as by linking desired behaviors to performance management incentives, training and engaging people, communicating the *what* and the *why*, and putting in place the right tools. Efficiencies are the aim. The point is not only to eliminate waste but also to streamline processes and structures—and avoid adding new ones.

For all these reasons, change management is essential to make ZBB stick. At the macro level, companies need to establish the rationale and messaging, identify those most affected and create a plan for involving them, and support the development of all the levers that will help shape the right organizational context. At the micro level, companies need to help frame the messaging for each initiative in a positive, actionable light ("go paperless," for example, instead of "no more printing").

ZBB, WHEN ADOPTED in the right spirit, can do much more than inject cost discipline—it can help companies maintain their strategic momentum, regardless of economic conditions. History shows that freeing up resources to invest for growth is particularly important during a downturn. It gives companies a significant edge over competitors, many of whom will find themselves struggling to survive. And that edge can have staying power: companies that perform well during a downturn enjoy a performance premium long after recovery sets in.

Because it is not a one-shot effort, ZBB adoption calls for a new mentality and a new culture—which take time to instill. By taking action now, companies can be nimble, strong, and ready for anything when the inevitable happens.

NOTE

1. "Consumer Goods in the Recession: The Game Has Changed," *The Economist*, August 20, 2009.

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