Cost reduction strategy

Business, Strategy

Introduction

Cost reduction is a key aim of business during the current economic downturn. In addition to intense competition for opportunity, businesses face myriad challenges in the sustenance of their activities and operations, often leading them to research on and implement cost-cutting strategies. These strategies are also essential for companies in their endeavour to create even higher profit margins on their products and services (Hines et al, 2004). Cost reduction strategies often come at the expense of growth potential with businesses often having to juggle, on the one hand their quest for growth, and on the other reduction of costs (Hill et al, 2001; Womack and Jones, 2003).

Cost reduction can be necessitated by several factors including revenue declines with sustainability pegged on costs having to drop to keep pace; fixed cost base with companies having to operate at a relatively high percentage of capacity in order to turn a profit, a perilous trap; as well as, creeping costs which result from the evolution to complexity of processes increasing variety of expenses, increase in entitlements over time, and the continual incurring of traditional non-essential expenses (Salvador et al., 2002).

Modular production techniques in both manufacturing and service industries bring together three well-known cost reduction methods including: economies of scope, outsourcing and product/service redesign. This paper discusses these methods exploring ways in which they contribute to the reduction of costs with particular regard to three businesses in specific industries: a car assembler, a supermarket chain, and an airline. It begins by defining the three cost reduction methods focused upon which forms the basis upon which ways in which cost reduction can be realised in the selected industries are discussed in latter sections.

Cost-reduction strategies

Economies-of-scope refers to the changes in average costs resulting from the changes in the output mix between two or more products. It refers to the potential cost savings resulting from joint production of products and offer of services that are at times not directly related. An example of this is when diverse product production or service delivery share company management structure, administration systems, marketing departments, and production facilities and other facilities (Silverman, 1999; Hines et al, 2004). Economies of scope provide firms with two key benefits: it enables the lowering of average costs of production resulting from the spread of large overhead costs across a broad range of products which enables higher profits for the company or reduced prices for customers; it also enables the diversification of revenue streams which reduces the risks associated with productfailure(Hand? eld and Nichols, 2002).

Outsourcing entails contracting out non-core business functions to third-party providers. It is viewed oftentimes as a means through which firms can cope with increasing competition through the quest for cheaper suppliers, with cost reduction being the primary motive and not the underlying economic force driving it (Wynstra et al., 2001). In some other instances, a company may choose to delegate bulky, time-consuming and intensive production processes to external contractors so as to enhance focus on core business functions even if costs are not themotivation(Campbell, 1992). External entities take charge of assigned tasks enabling the company to enhance focus on specialty lines or core business which earns a significant proportion of the company's revenues.

Product/service re-design refers to improvements on product or service and model changes that may result in greater efficiency gains in production or the reduction of inputs/raw materials required thereby leading to reduction in costs (Salvador et al., 2002). Product redesign may also enable the enhancement of demand through its appeal to customers or new markets thereby enhancing revenues accrued.

A. Car assembler

In view of a stand-alone car assembler focused on its core activity engaging in market transactions with external suppliers from which it buys or rents materials, components and other specialized inputs, and sells assembled cars onwards to independent distributors, the achievement of reduction in costs can be achieved through the pursuit of strategies such as outsourcing, product or service redesign and those that enable the realization of scope economics.

Economies of scope

The highly focused organizational structure of a car assembler could be tweaked to enhance scope in pursuit of strategies such as vertical integration; horizontal integration or unrelated diversification.

Vertical integration

Vertical integration involves the uptake by a business of tasks and functions hitherto undertaken by players participating within its supply chain, either up or downstream (Silverman, 1999). Asset specificity is pronounced in the car assembly industry with component parts such as tyres, engines, among other parts often being purchased from specialist suppliers. The assembler's engagement with these suppliers under pure market exchanges can have several challenges including unsustainable costs which make it prudent for the company to reach further along the supply chain, enhancing its capacity to produce the required components (Wynstra et al., 2001). The savings accrued from both the production of requisite component parts and conducting the assembly processes and/or engaging in later processes such as distribution, sales and marketing make vertical integration a significant competitive advantage, with reduced costs having the potential of enabling price reductions and/or enhanced profitability.

Horizontal integration

Horizontal integration involves the uptake of production processes of businesses across the industry such as those of another existing car assembler through acquisitions or mergers or diversification into related industries suchtechnologyproduction (technology-related diversification) (Silverman, 1999). It may also include customer-related diversification which encompasses the extension of the product range or broadening of the portfolio of business products offered (Hand? eld and Nichols, 2002).

Such integration enables a business to spread its costs, especially the high fixed cost base characteristic of the car assembly industry, over a wider range of revenue streams achieving overall efficiency and fully utilizing transferable proprietary know-how, skills and technologies. It also enables the shared utilization of other sources of economies of scope including purchasing, advertising, and research and development (Womack and Jones, 2003).

To avoid possible adverse consequences of asset specificity in the industry, major assemblers have sought to develop long-term close, collaborative relationships with suppliers of components. These relationships are designed to tap into the benefits of vertical integration though costs such as would be incurred in the case of complete mergers are avoided. These become the critical pathways through which modern businesses create value (Hines et al, 2004)). Sharing and efficient utilization of resources results in significant cost savings in light of enhanced revenue inflows and the spread out of costs over diverse product and service offerings.

Outsourcing

Outsourcing for a car assembler would entail contracting external entities to undertake bulky non-core activities so that the assembler can maintain a lean organizational structure and enable enhanced focus on activities it considers to be its core competences (Sanchez, 2000). It is often the case that production costs incurred by an external supplier are smaller probably because of larger scale or superior learning which could be difficult to replicate, or other specialization advantage (Salvador et al., 2002).

A lean structure and focus would imply reduction in staffing and asset acquisition costs, as well as transactional costs needed to cover for the completion of the outsourced tasks, costs which are passed on to the contractors (Womack and Jones, 2003). Savings on such fronts, which may include throughput on operations, may be used to enhance performance and quality of core activities to achieve greater competitive advantage, or they may be factored in for price reductions or profits.

Some component manufacturers are moving into the final assembly segment of operations encouraged by major car makers. Such include Valmet (Finland) which assembles cars for Saab, Lada and Porsche, and Austrian company Steyr which assembles Chrysler and Mercedes. This move is enabled by policies of extensive outsourcing. Toyota, on the other hand, built itself a flexible manufacturing system in which it is heavily reliant on subsidiaries and other suppliers, with its degree of outsourcing typically estimated at 60-70% (Hampson, 1999).

Product/service redesign

In the case of a car assembler working with expensive items such as steel, the cube-square rule finds appropriate application for cost reduction. This rule explains that doubling the diameter of a hollow sphere increases its volume eightfold, but its surface area is only increased fourfold (Womack and Jones, 2003). In a production process, the cost of a vessel or component may vary with surface area while its capacity varies with volume. Such balancing in design and reworking of components and parts may result in significant cost savings with regard to expensive inputs in car assembly such as steel (Salvador et al., 2002).

Toyota's success is majorly attributed to its Toyota Production System (TPS) which is a system of continuous improvement, an interlocking of many strategies and business practices developed through iterations over time and learning which create complementary synergistic effects for Toyota and which are difficult to emulate (Hampson, I., 1999). This system enhances strategic fit and complementarity which yields economies of scope which enables Toyota to meet customer demand for diverse models to meet varied preferences, and with less wastage than would be in mass production systems (Campbell, 1992; Hill et al, 2001). This strategic fit enables the company have a significant competitive advantage with the resultant efficiencies saving up costs.

B. Supermarket chain

Considering a supermarket chain which is involved in basic retail activities including reception of goods from producers, stocking in shelves, and checking out customers who make purchases, reduction in costs could be achieved through pursuit of scope economics, outsourcing of non-core processes, and/or redesign of products or services.

Economies of scope

The pursuit of economies of scope can be achieved through linked supply chains which entails integrating a vertical supply chain, as well as operating two or more hitherto independent businesses under centralized management (horizontal integration) (Abernathy et al, 2000). With optimal efficiency, this strategy results in productivity gains, waste reduction and cost improvements.

Vertical integration

To get fresh products, Morrison's, a UK supermarket chain, has reached back through its supply chain to the farm, cutting off middlemen and warehouses which would have led to increases in costs to cover the margins of the individual participants in the chain. This, as well as its ownership of its own slaughterhouses, bakeries andfoodpreparation sites, has significantly enhanced its efficiency and enabled reductions in costs, a distinctive competitive advantage (Morrisons, 2012).

Horizontal integration

Supermarkets have economies of scope when they offer a variety of products or services that do not comprise the usual basic goods and services available in supermarket stores (Abernathy et al, 2000). Such products and services may include ready cooked meals, financial services (such as retail banking), fuel stations, clothing and furniture, among other diverse provisions through a single service infrastructure, the store. These not only meet today's busy shopper's preference for a one-stop shop, but also lead to the provision of a complementary variety of products concentrated on the supermarket's core competence (Hines et al, 2004). This results in the distribution of costs over a wide and diverse range of products resulting in overall savings.

The expansion of stores such as Morrison's, Tesco and Sainsbury into various service-provision segments (demand-driven diversification) so as to appeal to the modern consumer illustrates this strategy (Morrisons, 2012).

A supermarket chain may also pursue related diversification building upon and extending existing capability, resources or expertise to achieve greater competitiveness. Cost savings are enabled when a business transfers expertise in one business to a new business, as well as in the businesses sharing operational skills and know-how, facilities, equipment or other existing assets including intangible assets such as corporate core competence (Hand? eld and Nichols, 2002). This can be illustrated by the entry of supermarket chains such as Morrison's, Tesco and Sainsbury into the convenience store segment in pursuit of customer preference for smaller stores and small frequent shopping trends. This venture is in order to supplement waning revenues of larger stores (Morrisons, 2012).

Outsourcing

The progress of the general-purpose technology such as information technology (IT) enables the reduction of market transaction costs which leads to increased capacity for outsourcing (Abernathy et al, 2000). Outsourcing for a supermarket chain may entail contracting suppliers to undertake time-consuming and logistically challenging tasks such as warehousing and distribution, as well as new services such as the ready-cooked food segments. Such a strategy is necessitated if the existing mode of in-house performance of these tasks is more costly than obtaining it through market transactions or some form of long term contractual relationship (Hines et al, 2004). Efficiency is thereby enhanced in the conduct of the supermarket's core activities, reducing costs associated with outsourced tasks and enhancing potential revenues increases.

Product or service redesign

Many supermarket chains are seeking to tap into new segments such as the online marketplace not only to meet customer preferences but also to reduce costs associated with its usual processes (Abernathy et al, 2000). In this customers order for product items which are then sent to their stated locations cutting off a number of processes that were hitherto undertaken thereby enabling significant savings. Morrison's, Tesco and Sainsbury, among other supermarket chains are pursuing such new market segments in pursuit of enhanced competitiveness and customer preference (Morrisons, 2012).

Airline

We consider an airline whose business provides basic services of passenger travel including scheduling, preparation and planning for flights, check-in, actual flight to destinations, and customer service. Pursuit of scope economics, outsourcing and product or service redesign which are the cost reduction methods focused upon in this paper are herein discussed with regard to an airline business.

Economies of scope

In this regard, vertical and horizontal integration mechanisms are discussed outlining their contribution to cost reduction.

Vertical integration

Vertical integration for an airline may entail the uptake of activities beyond its usual scope such as ticketing commonly undertaken by local service providers along its supply chain. Progress into such fronts is greatly enhanced by developments in internet technologies which enable customers to book flights, buy and print out tickets online, reducing the need for staff and investment on facilities dedicated to this task (Abernathy et al, 2000). This removes the costs of commissions paid out to the service providers as well as related organizational costs resulting in cost savings and greater efficiency.

Horizontal integration

To achieve economies of scope and thereby reductions in cost, an airline might venture into the cargo segment, customizing some of its existing planes for this purpose and delegating some staff under its organizational structure to run processes associated with cargo handling and transport. Through this related diversification of operations, the firm is able to build upon or extend its existing capability, resources or areas of expertise to achieve greater competitiveness (Hand? eld and Nichols, 2002).

An airline could also pursue mergers or scope acquisitions, to enhance or extend its product portfolio. This is a common trend in the industry with airlines frequently collaborating and coordinating their activities to achieve efficiency gains as well as to widen their geographical markets, reaching to routes across the globe and specific markets served by partner airlines which might not be feasible for it as a single entity (VBA, 2011).

It has also become a common trend for airlines to invest in hotels and other facilities in the hospitality industry so as to tap onto an existing demand, as well as to reduce their costs in cases of delays and other unforeseen circumstances which usually result in added costs for the airline. This strategy turns the airlines previous challenges into strengths, as well as providing a revenue stream from related divestiture.

Horizontal integration can be illustrated by Virgin airlines in its strategic alliances with Etihad Airways and Delta Air Lines which enhance its reach to the TransPacific Los Angeles route and the Abu Dhabi route, its gateway to Europe, Africa and the Middle East, with the collaboration benefiting all the partner airlines (VBA, 2011).

Outsourcing

Outsourcing for an airline is undertaken to streamline operations and enhance service quality (Wynstra et al., 2001). Tasks such as aircraft maintenance and ground support, as well as food processing for service on-board are labour-intensive and specialized tasks that can be outsourced if costs of contracting them are favourable. This would enable the airline to enhance focus on customer service and operations related to flight reducing overheads and other cost requirements.

An example is Navitaire, a service supplier for airlines, which offers an extensive global distribution suite enabling low-cost reservations which has enabled the improvement of profitability especially among the low-cost airlines using the service, lower operational and distribution costs and generation of ancillary revenues (Abernathy et al, 2000).

Product/service redesign

To enhanced service offerings in the competitive businessenvironmentand, as well, to rein in on rising costs, it is incumbent upon airline companies to conduct frequent network reviews, fleet realignments, operational integration so as to ensure that they remain profitable, effective and efficient in their processes. The company in the redesign and realignment should be bold enough to undertake thought-out exit from the non-profitable routes lowering its liabilities and costs. An example is Virgin Australia's endeavour at restructuring in 2011 following its poor performance evident in its 2010 financial results (VBA, 2011).

Conclusion

For sustainability, the aim of the cost-cutting strategy is to maximize efficiency without compromising growth potential. To achieve this, companies need to identify core competencies upon which focus is enhanced and efficiency improved, with the non-core functions being trimmed and consolidated to achieve reduction in unnecessary costs (Hines et al, 2004). Such savings can be reinvested in critical assets, enhancing core competencies and thereby improving overall efficiency.

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