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CORPORATE CENTRES IN THE RECESSION

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INTRODUCTION

THIS WHITE PAPER FOCUSES ON HOW THE ECONOMIC DOWNTURN HAS AFFECTED LARGE COMPANIES' APPROACH TO THE CORPORATE CENTRE.

It also looks at whether those companies which had restructured their corporate centre prior to/in the early days of the economic slowdown have performed better than those which had made no change to the way in which they run their corporate centre. Furthermore, this paper seeks to examine the role and relevance of the corporate centre during a recession, to review the trigger points that can provoke a change in the corporate centre and the direction of those changes.

We hope the paper makes for interesting reading.

We would welcome your feedback to:
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1/CORPORATE CENTRES IN THE ECONOMIC DOWNTURN

THE ECONOMIC DOWNTURN WHICH BEGAN WITH THE CREDIT CRUNCH OF 2007 WILL SURELY BE REMEMBERED AS ONE OF THE MORE UNUSUAL PHASES OF THE ECONOMIC CYCLE.

In previous downturns, interest rates went up, but businesses could still borrow (though it was expensive to do so). In the credit crunch, interest rates are at all-time lows but credit has dried up, products are cheaper and deflation has been highlighted as a key threat to many developed economies.

However, there are some universal truths that apply in any economic downturn. Most businesses will not go too far wrong if they focus on the basics (and indeed, many of those that struggled during the recent downturn had lost sight of the basics). When things are not going well in the wider economy, it is impossible for a business to focus too much on its customers and its service. The closer you are to your customers, the more likely you are to survive the downturn in reasonable shape. There also needs to be an extremely tight control on costs. Those companies which fail to manage their operating costs will simply not survive a prolonged downturn; they will run out of cash.

This much is obvious, but what do leadership teams need to consider when they are reviewing their existing corporate centre with a view to improving its ability to cope with a downturn?

The trigger for change in the corporate centre

When a recession occurs, it should stimulate change within companies both large and small. A downturn should provoke a business to take stock of its operations, from the corporate centre right through to the divisions. It should also challenge systems and processes that have become ingrained within the corporate structure and culture. Furthermore, it is an opportunity to ask whether the management layers and structures within the corporate centre are truly focused on helping the divisions to add value to the end customer. Surviving a recession can actually help businesses re-focus and emerge from the downturn in better shape than they entered it as modern, well-run institutions.

What are the symptoms that characterise a corporate centre which sits at the head of a struggling organisation?

- The decision making authorities between the corporate centre and the business divisions are unclear;
- Too much time is spent in the corporate centre preparing and analysing financial information on behalf of the business divisions;
- There is an accumulation of capabilities and resources within the centre to compensate for poor or absent capabilities within the divisions;
- A breakdown in trust and/or weaknesses in capability results in too many controls, reviews and checks;
- The centre is drawn into ongoing crises management – constantly managing a flow of bad news to investors and stakeholders is rarely a sign of a healthy corporate centre;
- Leadership time and energy is expended on heightened internal politics rather than on the needs of the business and its customers – which results in the necessary changes being made too slowly if at all.

Real change is not just about cutting costs. We have seen a number of centrally-led corporate change programs focused on the size and shape, role and purpose of the centre that have hit their targets in terms of reducing headcount but never got close to changing the way they operate. Just as importantly, they never changed the way that the business divisions deal with them and perceive them. In these cases, central teams have focused on cutting central overheads rather than looking at how they could do more with less.

An example of how to achieve change effectively was the Chief Executive we worked with who sat down and mapped out how much time he spent with each of his five core constituencies – his investors, his board, his clients, his direct reports and his central team. In the recent past, he had spent a lot of time with his central team poring over the financials, as the key factor in success had been detailed financial management. He realised that this was no longer the best thing he could do and set himself a new personal goal to define what it was 'good' for him to do: to spend more time growing relationships with key clients and his Divisional Presidents on a one to one basis. This commitment backed up the changes he was making to the centre of his business, which today has quadrupled in size and is much more successful as a result.

2/REVIEWING THE CORPORATE CENTRE

ONE CRUCIAL ELEMENT OF ANY CHANGE PROGRAM INVOLVING THE CORPORATE CENTRE IS TO ASSESS THE VULNERABILITIES OF YOUR APPROACH TO THE CORPORATE CENTRE IN A SYSTEMATIC WAY.

Ideally, the management team will have mapped out several different scenarios and worked out how each one will affect the business as a whole, the individual business units and the corporate centre itself.

In addition, it is important not to formulate strategies and plans in a vacuum. When developing your corporate centre strategy, an accurate assessment of your rivals' vulnerabilities is vital. You need to understand your own strengths and weaknesses relative to your competitors. To emerge from the downturn in a position of market leadership, you need to calibrate the actions you plan to take in light of the actions your competitors are most likely to take.

Any review that looks at the corporate centre in isolation is doomed to failure as a classic case of the tail wagging the dog. The corporate centre structure and strategy needs to be aligned to support the business drivers and not the other way around – and this is truer than ever in a downturn. These drivers include (but are not limited to):

- An understanding of the local markets, customers and competition with which the company currently engages, and those with which it plans to engage;
- Directing the company's resources to best support this using the lowest cost structures possible.

As one Chief Executive pointed out to us during the process of reviewing his company's corporate centre: "The corporate centre doesn't sell anything, it's there to support, not do the work of the divisions!"

Getting fit for growth

Before we move on to consider the different corporate centre styles, there are a series of logical steps that all companies need to go through – regardless of the structure and shape of their corporate centre – in order to begin the process of getting themselves fit for economic recovery.

These steps are:

- Focus on what customers really want and/or need to buy. What does the company need to do in order to provide the appropriate services/products?
- Assess existing and potential market opportunities. Are there new markets that could be exploited? Are the existing markets being fully exploited?
- Work out what each organisational layer in the company actually does. Are there layers that could be removed without harming the business?
- Measure things that matter to the business (and measure them effectively, and on an ongoing basis). What are the things you don't currently know about the business that you need to get a grip on?
- Work out what the important steps are along the path to restructuring and make sure that you take those steps. Remember to take each step once only – too often we see companies repeating stages of a process unnecessarily.

3/CORPORATE CENTRE STYLES

MAXXIM'S BESPOKE BENCHMARKING ANALYSIS (SEE SECTION 4) DEMONSTRATES THAT CORPORATE CENTRES CAN BE CATEGORISED INTO FOUR DISTINCT STYLES, EACH WITH ITS OWN CHARACTERISTICS, STRENGTHS AND WEAKNESSES.

We categorise the styles based on the number of FTEs in the corporate centre and on the strength of the corporate processes managed by the centre.

The styles can be divided into two basic camps: '**lean centres**' typical of the Holding Company and Private Equity styles, and '**larger centres**' as seen in the Tactical Partnership and Active Partnership styles. The main characteristics of each style are detailed below.

NOs of FTEs in Corporate Centre: Low – High

Tactical Partnership

- Evolution driven by 'powerful few' who own company history
- HQ has grown by adding management layers Corporate centre role is to check and assess what is proposed by operating divisions
- Few standardised processes or management information
- Centre not seen to add value

Active Partnership

- Large powerful corporate centre with high level of control over strategic planning
- Strong functional leadership with most senior and well paid people at centre
- Change driven from the centre
- Greater emphasis on shared services and common processes
- Longer term focus

Holding Company

- Minimal corporate core
- Focus on financial targets & results
- Few central functions or leadership
- Few centralised processes leading to more headcount
- Businesses at every life-stage

Private Equity Model

- Minimal corporate core
- Focus on financial performance and returns
- Little or no central functional leadership
- Strong governance between Group Executive and business units exerted through 'investor directors'
- High control over make-up of executive teams
- Best paid people mostly in the business
- Short sharp decision making cycles and horizons

Strength of Corporate Processes: Low – High

Fig.1 The main characteristics of the four corporate centre styles

> “The challenge for Holding Companies is that much of their best talent is buried within the amorphous layers of the operating companies”

Before we attempt to assess which, if any, of the styles is best suited to surviving (or thriving) during a downturn, we need to examine the key characteristics of each style in more detail.

SHAPES 1 & 2 – LEAN CENTRES

Shape 1

The Holding Company

The Holding Company style of corporate centre is the simplest of all the corporate centre structures. Under a Holding Company structure, the corporate centre is focused entirely on financial returns and creating shareholder value. For this reason, it is tempting to think that this style will be a successful model to adopt during a downturn, because the corporate centre will usually have been pared back to a bare minimum. The corporate centre costs the business less and the people closest to the market – the divisional heads – make the key day-to-day and medium-term decisions about products and services. This is true to a certain extent, and well-run Holding Companies can do well when times are hard.

The Holding Company has a low level of strategic influence and headcount at the centre is low. Indeed, the corporate centre often springs into action only to review capital expenditure and potential acquisitions. However, the lack of standardised processes and limit on numbers at the centre can often lead to a corresponding lack of control on numbers in divisional teams – but this is not the concern of the Holding Company CEO.

The Holding Company is typical of organisations that have a number of different operating divisions each with their own unique products, customers or markets.

Holding Companies in a downturn

We naturally would expect this ‘leaner’ style of corporate centre to do well. However, unless the Holding Company central team has been particularly strategic and focused on performance management, then the business is likely to own a portfolio of different companies, not all of which will perform well in hard markets. If the centre has not pruned the portfolio effectively, or if too much power still lies with the divisions, performance will suffer. This often means that while divisional performance is good in some areas, overall performance suffers. In addition, Holding Companies usually fail the ‘only do it once’ test. Repetition and ‘reinventing the wheel’ are all too common in this type of corporate entity, which means that when the total functional cost is calculated, it often ends up being more than the benchmark average for a similar-sized company run with a more unified structure. This can be problematic when assessing overall business performance and return to investors.

The other challenge for Holding Companies is that much of their best talent is buried within the amorphous layers of the operating companies. If you do not know where your best talent is, it will lead to wasted resources or to trying to compromise with those resources close to hand when there are better options elsewhere within the business. The financial structures of Holding Companies can also create extra costs and make disposals a more expensive and lengthier process.

Holding Companies also run myriad P&Ls at a business unit level. The business units are not integrated; there is no sense that they are aligned to the overall strategy for focusing on customers, service and new markets and the units simply drive profit without any investment from the centre. This often means that decisions are made that undermine the capacity of the business to service a bigger company-wide opportunity. For example, if a local business unit/P&L owner can increase short-term profitability by changing price structures he/she may well do so. However, this could have been at the expense of a focus on productivity. When hard times arrive, suddenly our local hero can no longer ramp up prices when he likes. As a result, he finds that his cost prices are too high to be competitive and that he is being cut out of the market. Furthermore, the centre is blind to the issue until it is too late. In short, Holding Companies can hinder flexibility and value – which are crucial in a recession.

Finally, accurate financial forecasting and re-forecasting in Holding Companies (so critical in a recession) is a slow process, hampered by the divisions, in which it is very hard to compare numbers against a meaningful financial baseline. We have worked with at least one company where this was clearly a problem. The managers and executives were defending a company structure and cost base that clearly did not stand the test of the new market conditions simply because it was the one they were used to working with and they were reluctant to try a new approach. In this situation, one of the key issues is that there is no mechanism for settling disputes between functional leaders (where they exist) and divisional leaders, so almost all decisions go to the CEO. In turn, the CEO becomes increasingly stretched and starts to lose patience with his managers – leading to strained management relationships and tortuously slow management decision-making.

> “In the Private Equity model, a key requirement of the central HR function is to be able to identify and recruit top talent to run the businesses”

Shape 2

The Private Equity or ‘Portfolio’ Model
A style which has gained an increasing presence in blue-chip companies during the recent past, the Private Equity Model is defined by a minimal corporate core and a strong focus on performance targets and a clear time-period in which to deliver them. Strong governance processes between the Group Executive and the business units are common, and there is a high degree of control over the make-up of the executive team. Private Equity centres have short, sharp decision-making cycles.

Organisations that have embraced this model are those which are focused on driving up the value of the business over a short timeframe. Typical examples of this model are Cable & Wireless and the Virgin Group.

In the Private Equity model, a key requirement of the central HR function is to be able to identify and recruit top talent to run the businesses. Considerable expertise is required in weeding out poor performers and replacing them with CEOs and finance directors who will be able to deliver the business plan. A natural corollary of this is expertise in reward and remuneration packages to attract and retain world-class leaders and management.

Private Equity in a downturn
Under a Private Equity model, the guiding principle is that the centre should create shareholder value by serving as an active investor in the businesses it owns. This structure is typified by the internal non-executive role that is often played by group level directors under the Private Equity style. The businesses are incentivised by overall performance and, importantly, value targets that are driven by the share price. This structure is underpinned by a remuneration model which is designed to reward the players in the businesses when they deliver above-average performance (usually typified by EBITDA plus calculations), and the Group team by terminal valuations.

When times are good, this structure makes the hard work and grind of running a business on weekly and monthly re-valuations seem to be worth the effort. In a nutshell, it’s very easy to measure shareholder value and for the management team to measure and re-measure their wealth. However, it does not work as well when the economy is not performing.

In a downturn, the central team needs to posses the skills required to manage the portfolio through troubled times. However, their skills are often more focused on financial engineering than operational expertise. As such, the corporate centre starts to look and feel much more like an expensive team which seems to the businesses to have little real value to offer but nonetheless keeps on nagging! Furthermore, those same incentive schemes that worked so well in the good times often fail to pay dividends when times are bad, leading to a loss of motivation among the leadership team.

On the business side, the teams are often formed in a hurry and not built with long-term goals in mind. In one company Maxxim Consulting encountered, the make-up of the senior team had changed every 13 – 15 months over a three-year cycle and had never managed to settle into a steady operating state. The team was congenitally built for crisis management. It had an inbuilt capacity to manage cashflow correctly but continued to drive through projects, whether they were a strategic fit or not. Change was constant and rarely followed a cohesive plan, strategy had descended into tactical and tensions began to occur at all levels of the business.

SHAPES 3 & 4 – LARGER CENTRES

Shape 3

The Active Partnership
The Active Partnership is defined by a powerful corporate centre with great control over strategic planning and corporate development activities. The Active Partnership style has a high level of strategic influence combined with the ability to make decisions quickly. For this reason, it is the model to which many businesses aspire. There is greater emphasis on shared services and common processes (especially within R&D, Marketing, Procurement and HR), combined with less focus on short-term results. The Active Partnership concentrates instead on achieving its strategic goals.

The Active Partnership style is often involved in providing functional leadership across the organisation. For example, the centres of expertise for HR and Finance will be based in the centre, managing and promoting professional development throughout those functions in the businesses. The Active Partnership lends itself best to organisations where there are shared characteristics across the business divisions and their processes, such as similar customers or similar products. Typical organisations are those in financial services or retail.

> "The Active Partnership makes the most of synergies by having a strong set of central functions providing services across the corporate entity"

Active Partnerships in a downturn

At the other end of the spectrum from the Holding Company, the Active Partnership makes the most of synergies by having a strong set of central functions providing services across the corporate entity.

This approach can create a number of advantages in terms of having a coordinated approach to responding to a downturn.

Firstly, there is a good chance that management information is comparable across all companies in the business and that KPIs can be changed across the Group to reflect the new reality fairly quickly. Supporting this, there should be a clear working model adopted for each function which allows for the assessment of talent across the whole group and the minimisation of repetition between and across divisions. This means that when re-forecasting becomes a necessity it is possible for the central team to have a reasonably robust picture of the situation fairly quickly without having to create a new group financial baseline (and then getting the divisional financial directors to agree it!). Furthermore, the key functional leaders should be able to name and look after key talent in the businesses and work with the divisional teams to ensure that the best people are retained, if at all possible.

The downside of the active partnership in a recession is two-fold. Firstly, for those out in the businesses, decision-making can seem very distant from the coal-face. Management often appears to be unresponsive to the needs of customers and markets. If this situation becomes too pronounced, the business unit leaders will become disenfranchised. In order to remedy this problem, businesses with this type of activist centre need to work harder than ever at communicating company strategy. Also, leaders at the centre need to be seen to be out on the hoof in businesses weekly (or even daily) in order to maintain morale and to gauge the effects of structural change. The 'ivory tower' syndrome from the centre can mean that businesses become more focused on their internal value and less on the needs of customers – the global retail financial services is a good example of this problem.

Shape 4

The Tactical Partnership

The Tactical Partnership style is defined by the corporate centre having a high level of influence on the company but a relatively slow speed of decision-making. Strategy is often talked about but rarely delivered. The evolution of a Tactical Partnership has typically been driven by a powerful few, who alternate between roles in the centre and running the company's different divisions – hence their high level of influence. Indeed, the primary role of the Tactical Partnership corporate centre is to act as a check and balance upon proposals made at a divisional level. All of the processes within this type of corporate centre have been designed to support great control over the divisions - but they often lack clarity in terms of handover points and ownership of decision-making.

In the Tactical Partnership confusion is also usually present over the key issue of 'who does what.' For example, in strategic business planning, the business units will be each asked for their commercial plans, which are then edited, consolidated, aligned with Group business plans and returned to the businesses unrecognisable from their original submissions. Therefore, the next year, the businesses either do not bother to submit a plan, or send in such poor efforts that the centre complains bitterly about the lack of strategic capability in the businesses. The planning cycle is extended by the time it takes to resolve the bickering.

This type of partnership is most commonly seen in organisations that have grown rapidly but have not thought actively about how to evolve the way they run the business as they go. This is often related to a close-knit, long-serving team that shares out the jobs amongst itself.

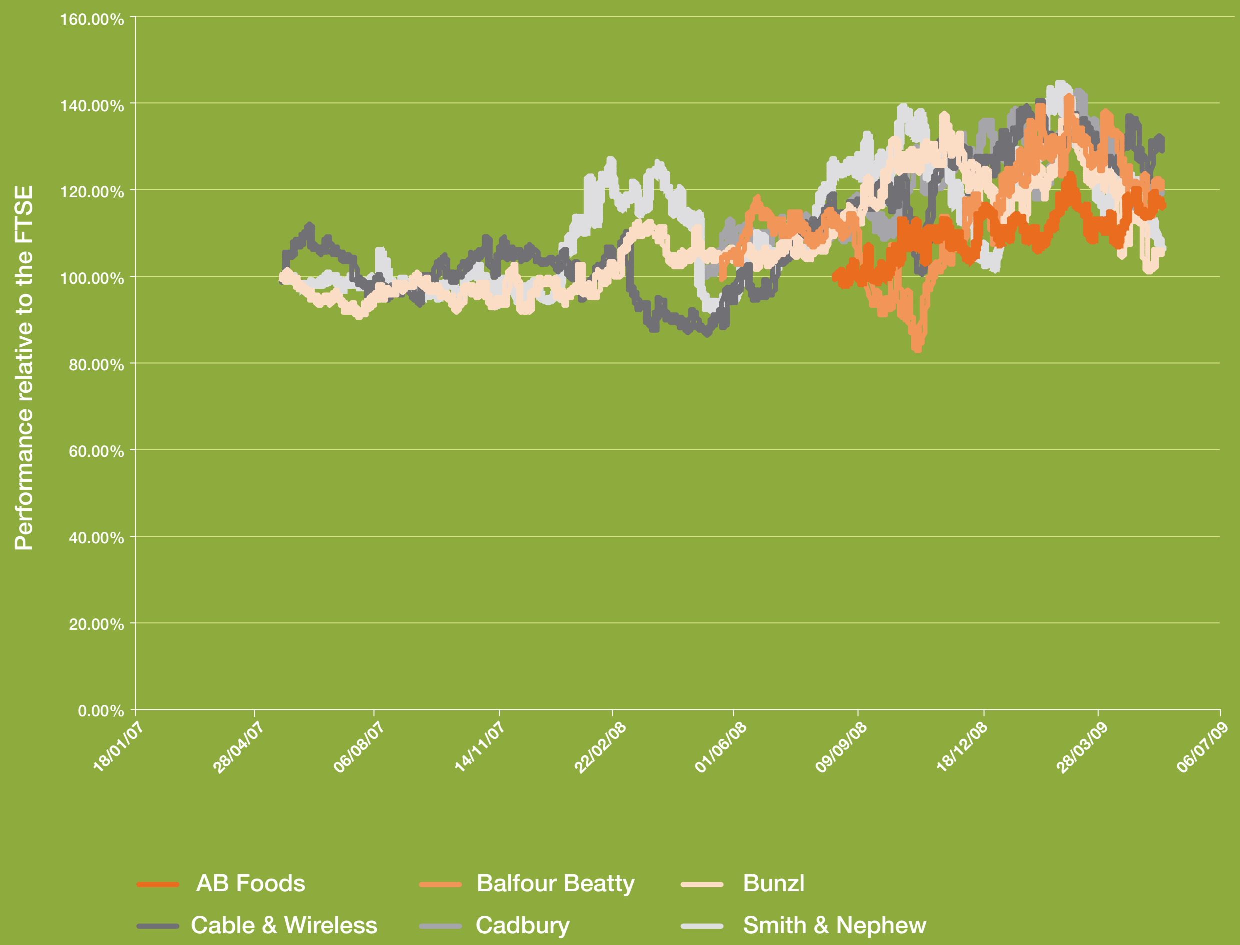
Tactical Partnerships in a downturn

Tactical Partnerships do have one strength in a downturn. Tactical Partnerships are, by definition, tactical – and so on occasion we have observed them delivering, short-term solutions to challenges that arise in a recession.

However, Tactical Partnerships more typically suffer from paralysis when the economy turns sour, and respond far too slowly to changing market dynamics. Furthermore, even when Tactical Partnerships do see the need for change, it is often the case that the level of reconstruction is so great that the company can neither deliver it nor afford it. We often see leaders in Tactical Partnerships during recessions disputing the need for change and/or the cost of change: the scale of the challenge is simply too big for them.

4/BENCHMARKING CORPORATE CENTRES THROUGH THE RECESSION

Chart 1



THE MAXXIM CONSULTING BENCHMARK CONSISTS OF 25 LEADING COMPANIES, AS WELL AS A NUMBER OF MAJOR PRIVATELY-HELD COMPANIES.

Chart 2: Total Corporate Centre FTEs as a % of total FTEs

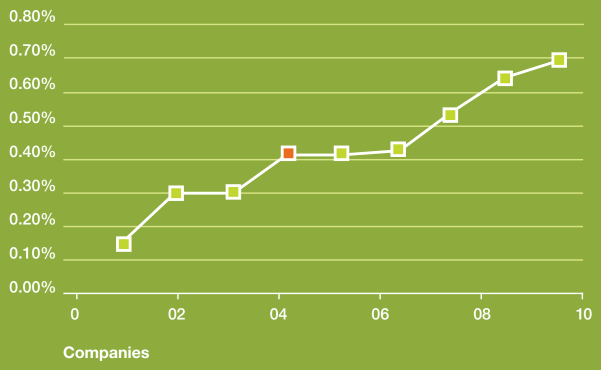


Chart 3: Total Corporate Centre costs as a % of turnover

Our analysis involves combining in-depth interviews of board members with analysis of the FTEs and costs of each of the core corporate functions.

We group the functions into those that add value, to the business strategy and proposition, those that perform compliance activities and those that provide consolidated services for the Group's businesses. The emphasis on each of these groupings and mix between them drives the style of corporate centre.

Corporate centres in the recession

When we analyse those publicly-traded companies that we have benchmarked, 25% of them have outperformed the FTSE through the recession period (autumn 2007 – autumn 2009). A third of these above-average performances can largely be attributed to acquisitions or demergers. The remaining two thirds of the outperformers have 'lean' corporate centres (Private Equity or Holding Company styles). *See Chart 1.*

The lean corporate centre

We have defined what constitutes a 'lean centre' in terms of the number of FTEs in the corporate centre as a % of total FTEs and the costs of the corporate centre as a % of turnover. Charts 2 and 3 show the figures for the ten companies in our benchmark cohort with lean centres. On average, a lean corporate centre represents 0.38% of total FTEs and costs 0.65% of turnover. However, to be a top quartile performer in the 'lean' sphere, a corporate centre needs to be at 0.25% of total FTEs and cost under 0.4% of turnover.

6/THE MODERN DAY CONGLOMERATE – THE ANSWER?

FROM THE EVIDENCE PRESENTED BY THE BENCHMARKING DATA, THE LEANER STYLES OF CORPORATE CENTRE TEND TO PERFORM BETTER IN A RECESSION.

However, we must ask whether there is a combination of some models that might be an effective solution to the downturn. Is a modern version of the conglomerate – that darling of the 1970s – back in fashion?

The modern day conglomerate has several notable advantages. It is really a combination of some of the best aspects of the Private Equity model and the Active Partnership. In a modern day conglomerate, the centre has a clear remit to drive value on behalf of shareholders and is heavily focused on the performance of each division whilst actively managing the mix of businesses in the group. Moreover, it can leverage group scale to minimise the cost baseline of the Group and maximise advantage from functional synergies. This means that the divisions focus on their customers at the lowest possible cost to them.

To make this model work there are some essential ingredients:

Strong governance

Often including formal operating boards at divisional level with representation from the centre.

Functional leadership

Who count their power through few clear policies rather than many busy layers of management.

A sound financial baseline

For the whole business which is communicated to all and actively managed to a minimal level.

7/CONCLUSION

IS THERE A BEST SHAPE TO SURVIVE THE RECESSION?

Our research indicates that those organisations with a leaner centre have fared better than others in the current economic climate but the single most important factor is that the organisation of the centre and therefore its relationship with the business units must be consistent with the organisation's strategy. More so, irrespective of shape and size of centre there are some basic rules that apply that are simply good practice, especially in a recession.

Simplicity

Whatever the shape and size of the corporate centre it should be simple to see and understand. We have seen organisations downgraded by analysts because they simply can't understand their structure. A good indicator is how much recharging goes on between the centre and their business divisions. If it is more than 15% of the centre cost, not including shared services, your resources are in the wrong place.

Accountabilities and authorities must be clear

Who calls the shots and who gets shot. The most ineffective centres are where executives have both Group responsibilities and operational responsibilities in the line. As a rule, an organisation's core business capabilities should be as close to the customer as possible.

The centre should avoid stepping in to correct shortfalls in the businesses.

Fix the problem where it occurs. For example, problems with reporting and getting control data are often attributed to poor systems rather than poor management.

Finally, a downturn is a serious test of the effectiveness of the executive team both in the centre and in the businesses.

Those organisations with a clear and legitimised set of ground-rules for how the centre works with its business divisions are better placed to focus on the customer and business success.

8/CASE STUDY

BUILDING THE MODERN DAY CONGLOMERATE – SMITHS GROUP PLC

Smiths Group is a world leader in the practical application of advanced technologies. Listed on the FTSE100, Smiths Group has five divisions - Smiths Detection, Smiths Medical, John Crane, Interconnect and Flex-Tek. The company delivers some of the world's most advanced industrial sciences, making everything from airport x-ray machines to high technology control systems. With a turnover of £2.32bn and 22,600 employees, Smiths has operations in Europe, the US, China and Central America.

When Smiths elected to dispose of its aerospace business, it prompted a wide-ranging strategic review of the company's head office. Arnold Wagner, HR Director at Smiths, says:

"One particular issue was forcing us to make a change to our head office – namely that in 2007 we sold our aerospace division. Contributing one third of our turnover, we had to make a decision about what we did with head office. We were unwilling to simply load the remaining divisions with extra costs, so we took the strategic decision to review our head office function and put in place a change program to ensure that head office was suited to the new shape of the business."

"Maxxim really project managed the whole piece for us, looking at what the head office was and what it needed to be, what the role of the divisions should be, what the sticking points were, and so on. They helped us to define the roles, to size the corporate centre and they benchmarked us against other organisations to give us a feel for how we stacked up against our peers in the FTSE100. Their attention to detail was a real asset in terms of helping us fine tune the changes we needed to make."

Smiths defined what each of the divisions did, what they were to be responsible for and how they should carry out their roles.

Smiths' corporate centre is now focused on the prime role of running the business. The key role of the new head office is to define the Group's overall strategic direction. Beyond that, the head office team is focused upon assessing and allocating capital, managing the interface and communication with critical stakeholders and promoting and protecting Smiths Group's reputation.

What Smiths was really doing was moving from a 'tactical partnership' structure in the corporate centre to a 'modern day conglomerate' style of corporate centre. When we started working with the company, Smiths' corporate centre was spending most of its time checking and assessing what was proposed by operating divisions. Processes and management information were not standardised, and in some areas, the centre was not seen to be adding value.

Now, Smiths operates along the same lines as a private equity-owned business. The head office is characterised by a minimal corporate core, and is focused on financial performance and returns. There are clear lines of governance between the Group Executive and business units, and the head office is empowered to operate short sharp decision-making cycles and horizons.

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