

Strategic Cost Reduction & Revenue Enhancement for Competitive Advantage

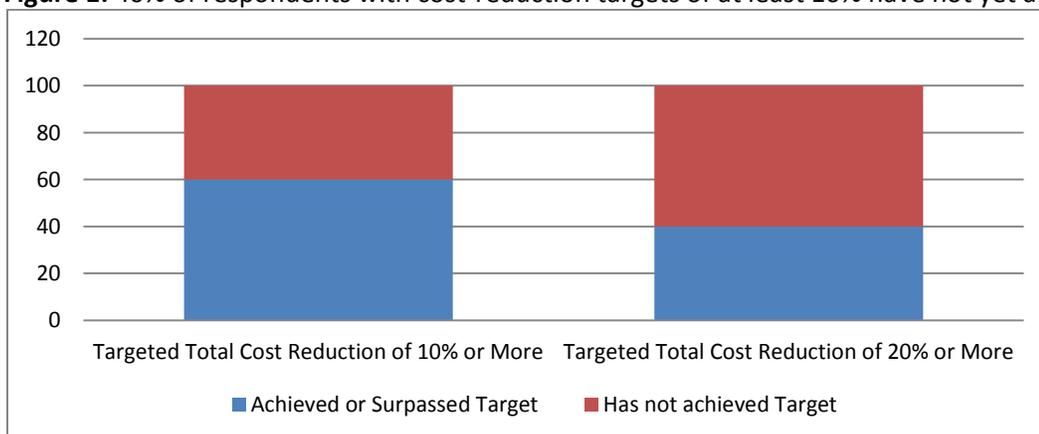
A low-cost position is a successful strategy to edge out competition in nearly every industry. Firms that have mastered the strategy for reducing cost easily out-invest rivals in areas such as research, development and marketing while still maintaining attractive margins. Reasons are clear - they have the financial buoyancy to capitalize faster and open up into new opportunities. In addition, they can easily ramp up market share because they have more price flexibility.

A study by Bain & Co. revealed that among the many ways that companies can differentiate themselves, such as by strategy, market position and technological leadership, more than 40% of industry leaders consider cost leadership to be their key competitive advantage.

The recent past global financial crises and the “almost” collapse of the Nigerian financial industry in 2010 incited the drive for organizations to embark on several cost cutting initiatives to remain competitive. Executives and consultants went crazy about saving costs – jobs were cut, jobs were outsourced, business models were re-designed. However, not much has been achieved. Cost reduction initiatives are very tricky projects to embark on, when done shabbily without consideration for the long-term effect on the firm, the results can be disastrous.

A recent independent survey of 300 executives by a renowned global strategy consulting firm shows that 40 percent of the executives in the survey who are attempting to reduce costs by at least 10 percent acknowledged their failure to achieve their goals. And among those pursuing cost reduction of 20 percent or more, nearly 60 percent acknowledged failure (see Figure 1).

Figure 1: 40% of respondents with cost-reduction targets of at least 10% have not yet achieved their stated goal



(Source: Bain & Co)

Most organizations that have embarked on cost reduction initiatives failed because they have neglected critical elements that must be taken into consideration before embarking on cost cutting measures. These elements are;

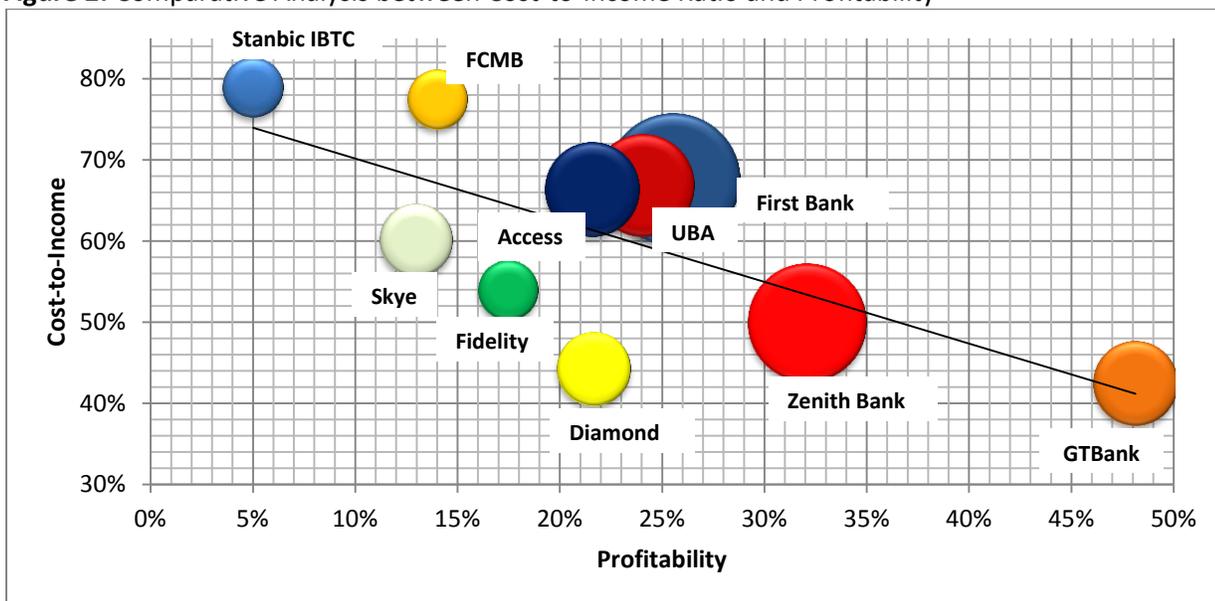
- I. Focus more on external and market-based data to set targets not on internal benchmarks;
- II. Ensure cost-cutting is in line with corporate strategy, thus tailor cost-cutting efforts to long-term company's goals and objectives;

- III. Focus on the “Whole” of the organization and the interconnectedness of value contributed from several units, not just on individual units.
- IV. Get the metrics right;

Cost-to-income ratio (CIR) is a widely accepted performance measure to assess the efficiency of financial institutions. It is also an indicator of how profitable a financial institution can be. Several researches (empirical and theoretical) have pointed out the importance of CIR in assessing the profitability of financial institutions. Francis, 2004; Ghosh et al, 2003 showed that there is an inverse relationship between profitability and cost-to-income ratio, their research concluded that efficient banks generate more profits.

Similarly, in Nigerian banking industry, CIR holds true. The less efficient banks are generally more profitable while the least efficient banks are less profitable (see Figure 2). In addition, the CIR ratio when compared to best-in-class in the same industry is also a good indicator to access the opportunities available for financial institutions to cut down costs.

Figure 2: Comparative Analysis between Cost-to-Income Ratio and Profitability



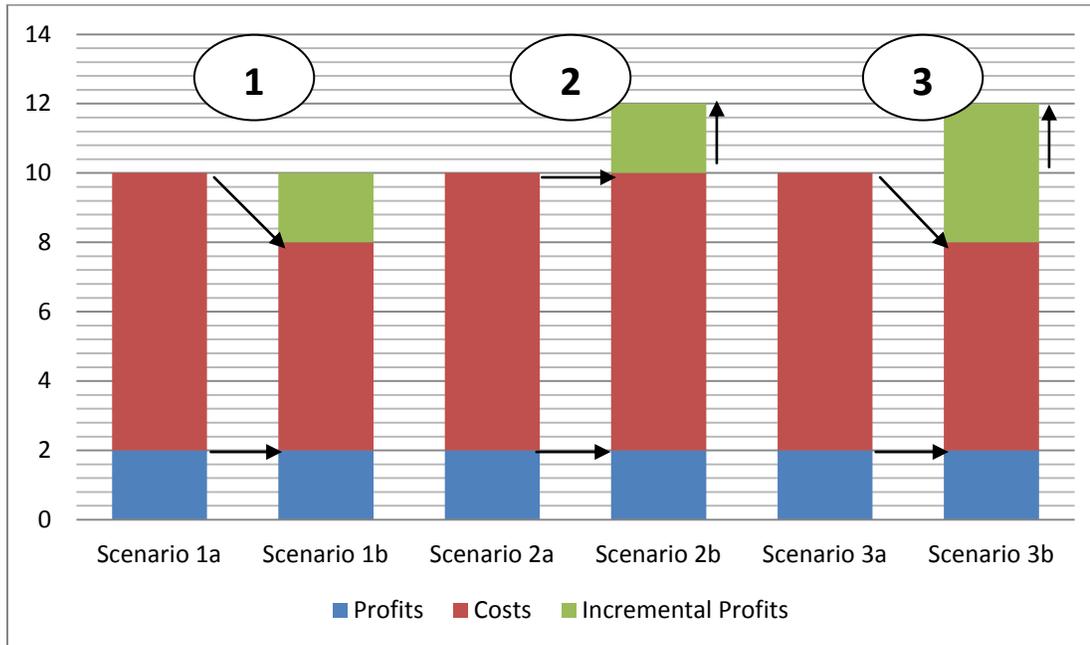
Source (Index Research)

There are various arguments that suggest ways a firm can improve its cost position; you can trim down on cost while maintaining revenue position (in low growth, stagnant market) or you can improve revenue by keeping cost low (especially in a high growth market), or you can just do both - improve revenue while at the same time improving cost position. The third option seems not only difficult but tricky especially when the strategy is to ensure cost-cutting initiatives do not impact negatively on the long term strategic objectives of the firm. Cutting cost simultaneously with improving revenue position is not a new concept, in-fact, it is a thriving strategy which dated back to the 60s when firms like Texas Instrument were gaining high on revenue and market share while shedding costs simultaneously. The strategy, crafted out of a concept - *the learning curve* (created by BCG's Bruce B Henderson) explains why the market leaders can generate more revenue; acquire more market share while at the same time keep a lower cost position than competitors.

Nigeria banking industry is a high growth market with potential for huge opportunities. Customer deposits have been growing at a cumulative average growth rate (CAGR) of 26.5% and gross earning, 30% over the past six years.

In a country where only 18million adults have bank accounts and about 64million adult (74% of the adult population) have never banked, therefore one can easily conclude the industry is underserved and not competitive. However, when we consider that about 70% of the nation still live in poverty and just only 20% of the nation’s top income earners controls about 59% of the national consumption expenditure, then it is more glaring that the banking industry is not as less competitive as perceived.

Figure 3: Scenarios for Improving Cost Position



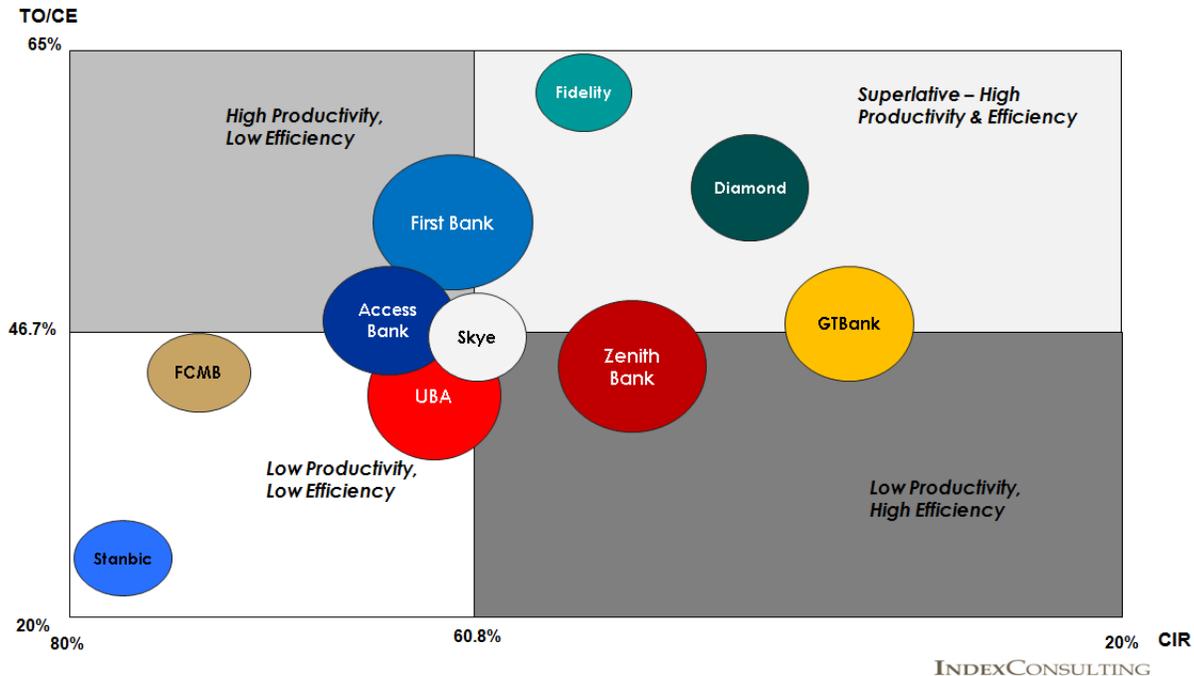
Recently, the Central Bank of Nigeria has been implementing initiatives to curb the banks from making “easy money” - charges on Transactions (COT) has been reduced from 5% per million naira transaction to a maximum of 2% per million naira transaction and the ATM charge is completely removed. High T-bills rates which have provided a lucrative haven for banks to make good returns at no risk whatsoever have been falling. The strategic intent is to ensure that banks can focus more on doing the real business – financial intermediation, especially to the small medium scale enterprises. The industry will become more competitive, especially when customers are requesting for more innovative products, competitive pricing, seamless processes and excellent customer service.

A more critical way to estimate the opportunity banks have to improve their efficiency ratio is to benchmark with competitors operating in the same market. According to an empirical study by Beccalli, Casu, Giradone, 2006, there is room for improvements for a bank’s CIR by **15% -25%** in comparison to best-in-class bank in the industry. Currently, GTBank has the best CIR performance in the industry, hence other banks can improve their CIR level to match or even surpass GTBank. Diamond bank showed this by improving its CIR performance over the past years from 62.7% in 2010 to 44.3% in 2012.

As shown in Figure 4 below, there is huge potential for banks to improve their profitability level by (1) efficiently utilizing their assets and (2) keep operating expenses very low. The Figure below shows a comparative analysis between the bank’s productivity and cost efficiency levels. GTBank emerges as the most cost effective bank while Fidelity bank is the most productive (based on assets utilization). Only Fidelity and Diamond bank clearly emerge in

the superlative quadrant although there is more room for improvement in cost efficiency. Similarly, other banks can do better to improve their asset utilization and cost position.

Figure 4: Productivity/Efficiency Performance of Selected Nigerian Banks



**The assets used for calculating asset turnover in the above analysis are stripped of the deposits from customers and other banks in order to put the banks all on the same level-playing field and appropriately measure their true productivities.*

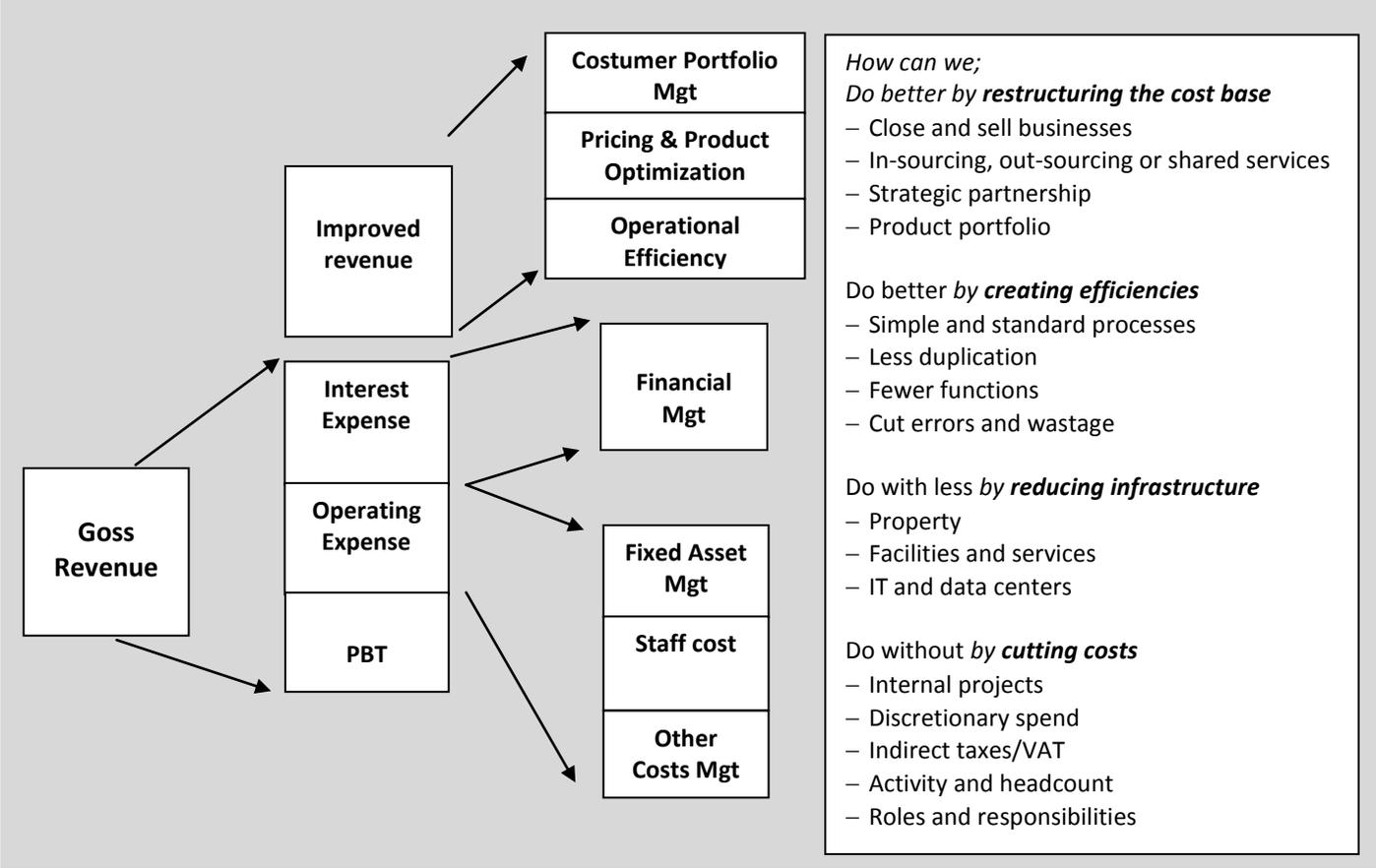
Cost-reduction initiatives may create their own problems or fall short of their goals unless managers first address a few key questions. These include:

1. Which initiatives have the most potential?
2. Will these initiatives generate savings quickly?
3. Can we pursue these initiatives without disrupting our company?

There are strategies that companies can use that often achieve real and rapid cost reduction without interfering with their day-to-day operations. While these vary by industry, a study by Boston Consulting Group (BCG) shows that initiatives that combine cost-cutting and revenue enhancement can deliver 4-6% improvement in earnings before interest, taxes, depreciation, and amortization (EBITDA) in 3 months. The firm can generate 10-15% improvement in EBITDA in six months and up to 50% in 12 months.

When considering improving the cost position, the firm must take a holistic approach to dissecting the opportunities available within its system. For example, a more efficient approach to reducing interest expense will likely have an impact on revenue generation if not managed well. Similarly a decision to reduce staff cost by laying off can have a short to medium term impact on revenue. Understanding intra and interconnectedness of expense generating elements with revenue generating elements becomes very critical. See figure 5 for a broad break-down of revenue enhancement and cost saving elements.

Figure 5: Break down of revenue enhancement and cost saving elements



Our team at Index did some estimation, and our findings revealed interesting numbers based on the potential opportunities for Nigerian banks to harness cost reduction and revenue enhancement as a strategy to gain competitive advantage. See figure 6 & 7.

Figure 6: Actual 2012FYE Results of Some Selected Banks

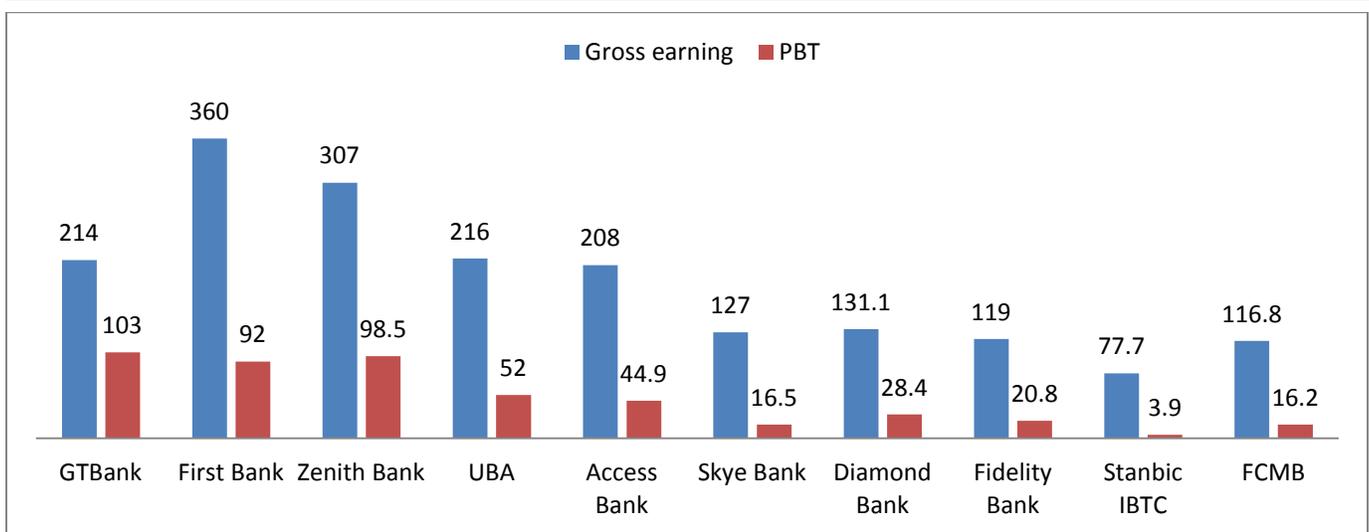
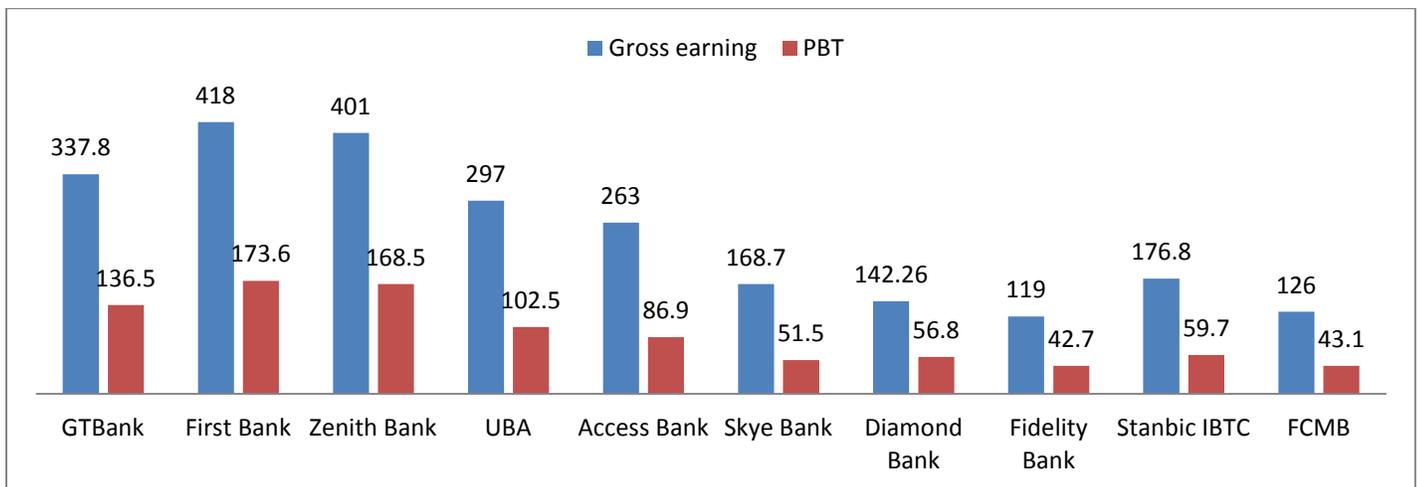


Figure 7: Estimated 2012FYE Financials of Selected Banks based on Optimized Productivity and Efficiency Parameters



**Assumption: Optimized financial performance of each banks to meet up with best in class for Asset Turnover(Fidelity Bank) and Cost Efficiency (GTBank)*

Cost reduction is a difficult task, and too many of such efforts fail to deliver their targets. Even when they seem successful, executives are apprehensive. When done rightly, especially with revenue enhancement part of the strategy, the cost reduction effort can free up resources for strategic initiatives, position the firm for better growth and reinforce the firm to compete effectively. To win with cost reduction, executives must look externally, tailor their efforts to their strategy, get the metrics right and focus on value that can be created from the interconnectedness of the various units, processes and activities in the bank. The results the bank will achieve will not only be remarkable but also lasting.

Below are some tips executives should consider when embarking on a cost reduction project.

- A) Determine the time frame. Decide how soon you need to produce results. Is it in three or six months? Then, clarify your priorities.

- B) Analyze your shortlist of quick-hit prospects. Review your top- and bottom-line opportunities for possible bottlenecks. Avoid time-consuming, comprehensive, activity-based assessments.
- C) Prioritize initiatives. Look for efforts that will produce the quickest results, but make sure that there are no operational constraints.
- D) Revisit past cost-cutting and revenue-enhancing programs and measure their success. Often, potentially successful programs are curtailed before they've had a chance to deliver full benefits. Restarting programs undertaken in recent years can often yield quicker results with fewer resources than an entirely new set of programs.
- E) Establish mechanisms for rapid decision-making and communication. Meet at least once a week with senior managers and set up an efficient communication system that provides both direction and feedback.

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