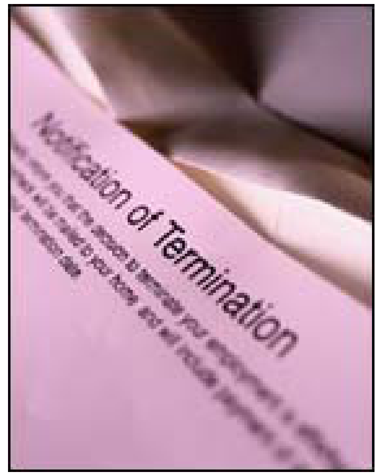
Short-Circuited: Cutting Jobs as Corporate Strategy

Published: April 04, 2007 in Knowledge@Wharton



Layoffs. Downsizing. Rightsizing. Job cuts. Separations. Terminations. Workforce reductions. Off-shoring. Outsourcing.

Whatever the term, getting rid of employees can be a necessary and beneficial strategic move for companies to make. Layoffs can signal that a company is reorganizing and moving in a more profitable direction and, as a result, give Wall Street a reason to cheer and improve the morale of remaining employees. But unless job cuts are handled and explained properly -- and are indeed necessary to achieve a thoughtful, overarching purpose -- the solution may cause as many headaches as the ailment it was meant to cure, according to Wharton faculty members and an outplacement expert.

Consider a recent move by Circuit City Stores, a big electronics retailer based in Richmond, Va. The company announced on March 28 that it cut 3,400 jobs, or 7% of its workforce, effective that day, because the salespeople were paid "well above the market-based salary range for their role." The company did not disclose specifics, but *The Baltimore Sun* reported that the laid-off workers, known as "associates," made 51 cents more per hour above what the company had set as market wages.

Circuit City also announced that it had entered into an agreement with IBM to outsource its technology infrastructure operations, which would eliminate the jobs of 130 employees. Fifty of these workers, however, were to be hired by IBM and remain on-site to serve the Circuit City contract.

These various moves, Circuit City said in a news release, were part of a "series of changes to improve financial performance largely by realigning [the company's] cost and expense structure." The decision to terminate the 3,400 employees was disclosed in the fourth paragraph of the release and described as a "wage management initiative" that led to the "separation" of the workers.

The job cuts "focused on associates who were paid well above the market-based salary range for their role," the news release added. "New associates will be hired for these positions and compensated at the current market range for the job." The company said, however, that the people who lost their jobs received severance packages and could reapply for their old jobs, at lower pay, but had to wait 10 weeks to do so. The March 28 move, coupled with a decision made in February to realign Circuit City's retail structure by reducing the number of operating regions from 10 to eight, would save $250 million over the next two years, the company noted.

Peter Cappelli, management professor and director of the Center for Human Resources at Wharton, says Circuit City may have valid reasons for having to reduce costs, but the way it treated the 3,400 workers was highly unusual. "That's the most cynical thing I've heard about in a long time," Cappelli says. "I like to think I'm cynical, but sometimes it's hard to keep up."

According to Cappelli, Circuit City's decision to replace the terminated workers with lower-paid people is like saying: "We made a mistake in compensation by paying them more than they were worth for their performance, so we're going to get rid of them." Cappelli adds that he "had never heard of that before. Companies have always done sneaky things like getting rid of higher-wage workers with two-tier wage plans, but this ... takes the cake."

A Once-Rare Occurrence

There was a time in the United States when large workforce reductions were few and far between. An employee hoped -- indeed expected -- that his or her job would last for life, and often it did. But layoffs have become so run-of-the-mill that even news editors sometimes pay them scant attention. In an April 2 column, *New York Times* writer David Carr lamented the lack of coverage of the Circuit City job cuts. His article was headlined: "Thousands Are Laid Off at Circuit City. What's New?"

According to Michael Useem, management professor and director of the Center for Leadership and Change Management at Wharton, "After waves of large-scale layoffs among American companies, most notably in the early 1990s, but again in the early 2000s in the wake of the dotcom bust, we have learned a lot about good practices and bad practices [in eliminating jobs] by watching companies in action."

Research has shown that if a company announces a downsizing without a broader reference to a strategic plan, its stock price will, on average, drop 5% to 6% over the next several days, according to Useem. By contrast, if large-scale job cuts are announced as part of a broader restructuring, and a strategic plan is laid out, the firm's stock will rise some 4%, on average, in the days following the announcement. Useem says the research shows that, contrary to popular wisdom, Wall Street does not always welcome job cuts for their own sake.

"The tough-minded, big institutional equity market is actually skittish and worried about downsizings that are simply short-term cost-cutting measures without a broader plan described behind them," Useem notes. "Investors are not beating the drum for downsizing as much as it is sometimes said they are. It really is the restructuring they are applauding, not the particular method within it. It's helpful to think about downsizing as restoration -- cutting costs as a move to restore luster and performance."

Cappelli says, however, that Wall Street does sometimes support layoffs for their own sake. "If we define layoffs as being necessary because it makes sense to keep financial analysts happy, then it may make sense for companies to lay off people because analysts have a bias toward layoffs," he says. "They love layoffs because they immediately improve the bottom line. They can't easily assess what the long-term prospects of layoffs will be, but they can see immediate benefits."

Academic research, according to Cappelli, shows that layoffs usually have negative effects on a company's performance after the cuts take place. "But in fairness to companies that feel they have to cut jobs, part of the problem with the research is how the research is done," Cappelli adds. "Companies laying off people are, by definition, already in trouble. So it's not surprising that if you select companies already in trouble [for a research study], they look in worse trouble later." It typically makes sense for a company to lay off workers only "when it has a particular problem -- excess capacity. When you don't have excess capacity and you're cutting, you're cutting muscle."

Sending Signals

Wharton management professor Lawrence Hrebiniak says layoffs that are part of a restructuring can send a signal that a company is "refocusing its use of scarce resources." He likens such a move to investors who reallocate assets in their portfolios to move from poorly performing securities to more promising investments.

Downsizing can also send an important signal to customers, competitors, suppliers and Wall Street. "Years ago, Procter & Gamble cut thousands of jobs," Hrebiniak recalls. "They called it 'cost savings,' but the CEO also said P&G was sending a signal that this was a sign of a cultural revolution at P&G: to eliminate inertia, to wake people up to the focus on new markets and products and innovation, to get rid of dead wood. So layoffs can represent a refocusing."

Robert E. Mittelstaedt, dean of the W.P. Carey School of Business at Arizona State University, notes that the stock market "has more respect for [job cuts] if they are part of a broader plan. Just signaling that you're going to cut costs and not saying anything else about what you're going to do doesn't impress people a whole lot."

In fact, Wall Street respects companies for divesting themselves entirely of unprofitable or barely profitable businesses rather than trying to strengthen them through large job cuts, because jettisoning unwanted businesses can make better strategic sense, according to Mittelstaedt. "There are times companies have to say that they believe exiting a business is right," Mittelstaedt says. "That gives a better signal to the market, as opposed to trying just to cut costs."

A March 26 story in *The Wall Street Journal* that Citigroup was in the process of finishing up a restructuring plan that will result in the elimination of some 15,000 jobs appears designed to achieve both short- and longer-term goals -- to juice up the company's lagging stock price and to refocus the firm, according to Hrebiniak. Citigroup reportedly wants to put more emphasis on its international operations and consolidate back-office functions.

"He's getting pressure from shareholders," Hrebiniak says of Charles Prince, Citigroup's chief executive. "He's feeling no love. He's got to show he's doing something to cut costs, improve margins, make some more money. So it may not primarily be a move to restructure at all; it could be a move to get critics off his back." If Citigroup does decide to cut 15,000 jobs, it would represent nearly 5% of its workforce of about 327,000.

Adrian Tschoegl, a Wharton management lecturer who follows the banking sector closely, says the planned Citigroup layoffs have a strategic purpose: consolidating various functions that have grown redundant over the years and have become costly and difficult to manage. He calls a 5% workforce reduction far from draconian.

"Citigroup has built up lots of bits and pieces over time, and it's a culture that tends to be combative," Tschoegl says. "Clients have been known to remark that Citibank's most tenacious competitors have been other Citibank units. So this is a case of having a lot of bits and pieces and tidying things." But cost-savings also play a big role in Citigroup's restructuring. Tschoegl says the company could benefit, for example, by moving back-office functions from high-cost locations like New York to lower-cost operations in South Dakota and India.

In general, Tschoegl says, cutting jobs makes sense when a company is not only trying to reduce costs but also complexity. One common way to achieve both goals is to outsource functions -- such as security and janitorial services -- to firms that specialize in such services. In these cases, outsourcing can actually benefit janitors and security guards because they will be employed by firms that can offer them an upward career path in ways that a big corporation never could.

"Where you get into trouble is if you simply cut heads across the board," Tschoegl warns. "Then you're not being sensible; you're not getting rid of things that could be done better by somebody else ....No company has ever gotten good by simply cutting."

Another risk is that a downsizing company can get rid of people whose knowledge and experience are vital. Wharton management professor Daniel A. Levinthal points out that Circuit City's decision to cut 3,400 veteran sales people "sounds like a massive de-skilling" of the company. Since the people who will be hired to replace the laid-off workers probably will not know the merchandise as well as the workers who were dismissed, customers who want to know how to set up a high-definition TV or why one music player is better than another might not receive the best advice.

If this is the case, Circuit City might have a hard time differentiating itself from its competitors. "These new people will be order takers and have less knowledge [about the merchandise]," says Levinthal. "Circuit City would now be competing against e-commerce because it's become similar to e-commerce and lost its differentiation as a bricks and mortar store."

As for the financial benefits associated with layoffs, Wharton accounting professor Wayne Guay says eliminating jobs can help a company financially in several ways. One benefit is that labor expenses are lower and cash flow is higher in the current and following years simply because the firm does not have to pay as many people. But layoffs do not necessarily allow a company to take a large write-off that can sharply reduce its tax liability for the year in which the job cuts take place.

Bad News in One Big Dose

Typically, it is best for a company that is downsizing to announce all the bad news "in one fell swoop" rather than in a "series of smaller, separate, sequential layoff announcements," Useem notes. "Employees don't like the sequential approach -- they don't like any downsizing, of course -- but they like least the suffering of a thousand cuts. The same thing is true for the stock market."

The way people are treated during a downsizing is a "testament of the values and soul of a company," according to Useem, and firms should follow several steps that demonstrate to employees and the world at large that the firms practice good management principles. First, companies should engage in as much transparency as possible, revealing as much financial information as they can to show the need for job reductions and help laid-off workers obtain retraining, outplacement assistance and resume-writing guidance.

Second, firms should work intensively with the employees who remain on the job because these people "will be shell-shocked and fearful that they could be next," Useem says. "Gloom and anxiety are exactly the opposite of what companies need when they go through downsizing because they need to get more work done with fewer people. Good morale is essential. If top and middle management works with the people who remain, it can be a vital formula for ensuring that the people who are survivors get behind the new, leaner company, and achieve the results top management wants to achieve."

Regardless of the motivation behind, and execution of, layoffs, it is clear that they will continue to occur with almost drumbeat regularity. "The use of layoffs as a management tool to cut costs is widespread," says John Challenger, chief executive of Challenger, Gray & Christmas, a Chicago-based outplacement firm. "Virtually every Fortune 500 company has done it. Only the absolutely most successful companies, [whose] profits have been consistently up, may have [avoided] them. Layoffs have come to be expected by shareholders, and we are more and more in an environment where shareholders drive company actions."