OLIVER WYMAN

BEAT THE COST CURVE

Transforming the operating cost base of retail and consumer goods companies

FOREWORD

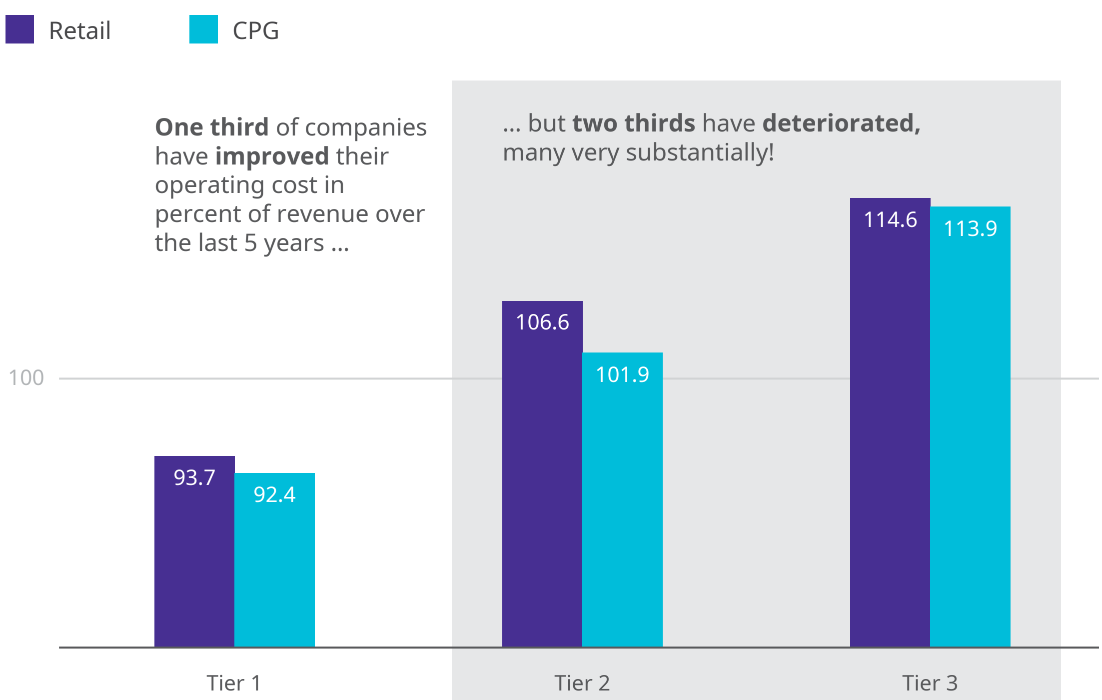
The following point-of-view was ready to go to press just as the COVID-19 pandemic began to change our world. Our original intention with this article was to argue that transforming the cost base of retail and consumer goods companies had become an absolute imperative, that traditional approaches to cost transformation were failing, and that new and bold paradigms were required. COVID-19 has not changed our conclusions, but instead given them yet greater urgency.

We argued for bold ambitions and a massive commitment to execution. The virus has forced just that. COVID-19 has driven companies to take measures that in “normal” times would have been unimaginably drastic. In many cases, boldness born of a lack of good alternatives, and a “we have to do it yesterday” attitude towards execution, has allowed for better business continuity than many or most of us could have hoped. Despite the pain of the recent weeks and months, there is much to be learnt. Companies should build upon this experience in framing their next cost transformation program.

OPERATING COSTS ARE GROWING FASTER THAN REVENUES

Traditional solutions are proving increasingly ineffective. Many retail and consumer goods companies have flourished in recent decades, helped by underlying structural demand growth, globalization, and industry consolidation. As revenues have grown, unsurprisingly so too have costs. More surprising perhaps is the fact that operating costs (excluding cost of goods sold) as a percentage of sales have increased over the last five years (2014 to 2019), both for retailers and consumer goods companies. Looking at the evolution by company tiers it becomes apparent that some seem to have found a substantially better way to keep their operating costs under control than many others.

Exhibit 1. Operating costs as a percentage of revenue have increased dramatically[1]
Indexed 2019 vs. 2014



1. This analysis is based on top 30 offline retailers in Europe and USA. Where 2019 data is not yet available, 2018 data has been used. For CPG, this analysis is based on top 50 CPG Companies in Europe and The top 50 in the USA.

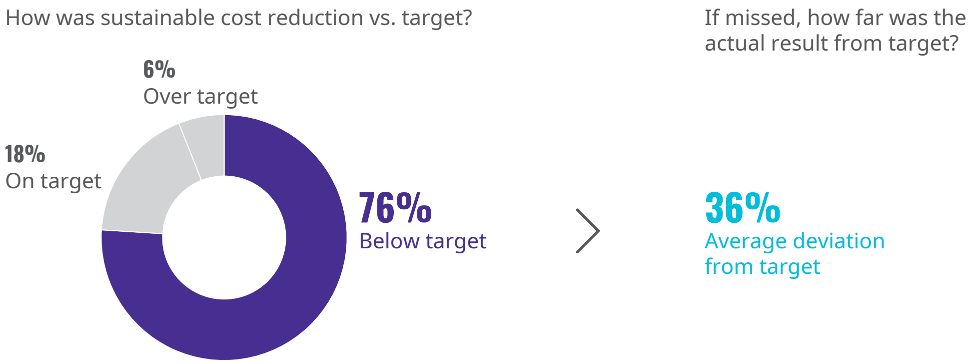
Tiering based on evolution of operating cost, equal number of companies by tier.

Source: Oliver Wyman Research and Analysis

Depending on the industry segment, the share of these operating costs can be as high as 50 percent. The evolution of cost as a percentage of revenue over the last five years can explain more than 500 basis points of EBIT decline.

In 2019, Oliver Wyman conducted an extensive international survey of the company leaders in European and North American retail and consumer goods companies who had recently conducted significant cost reduction programs — the results were sobering.

Exhibit 2. Was the program successful?



Source: Survey among 50 retail and consumer goods company executives in North America and Europe, with past responsiblity for a comprehensive cost reduction program (only completed programs)

Fully three quarters of the respondents reported that their cost transformation programs had failed to deliver the expected value, and only six percent indicated that they obtained higher than expected results. For those programs that failed to achieve targets, the scale of underachievement was substantial. On average companies missed their targets by 36 percent vis-à-vis expected cost savings.

There is a clear mismatch between intention and reality. Why? Our analysis points to a clear culprit — traditional approaches to cost management and transformation are proving increasingly inadequate. The tools which executives have used to address cost in the past are no longer able to produce the results needed. Getting results in the future will require new thinking and fresh approaches. Fortunately, highly effective new models are emerging, driving dramatic improvements for those willing to view cost in a fundamentally different and more holistic way. The rewards can be enormous.

Exhibit 3. Transformational savings potential

		Scope examples	Savings potential	Main levers
Operations and supply chain	**Manufacturing**	• Shop floor operations • Capacity • Site network/footprint	10-15%	Lean processes, plant network redesign, automation
	Logistics	• Warehousing • Distribution • Inventory	5-10%	Lean processes, DC network redesign, S&OP/ forecast improvement
	Store operations	• Store labor • Store fittings • Store support functions	10-20%	Process redesign, digitization and automation, optimized labor scheduling
Overhead functions	**Business functions**	• R&D • Buying/trading • Manufacturing • Marketing • Sales	15-20%	Reorganization, refocus on strategic minimum, digitization
	Support functions	• HR • IT • Finance • Indirect sourcing	20-25%	Service level redesign, flexible/agile business model, shared services
Indirect spend	**OPEX**	• Marketing • Facility management • Transportation • HR services	10-20%	Systematically "cheaper, better, less", tight spend control
	CAPEX	• Machines • Warehouse and store equipment • Fleet	15-20%	Systematically "cheaper, better, less", tight spend control
	Real estate	• Lease/rent • Service fees	2-5%	Consolidation/ re-location/WFH, systematic renegotiation, indexation

Holistic transformation can yield up to 15-20% sustainable cost savings

RECIPES FOR SUCCESS

1. ACT NOW AND THINK BIG, BROAD, BOLD!

Many of our clients tell us that cutting cost in a big way is uncomfortable and risky, and therefore not something easy to embark upon. Executives fear the risk of endangering sales and the negative impact such cost reduction programs can have on employee morale. As a result, the tendency has been to postpone substantial cost programs until the market or competition makes it unavoidable — when it can be too late.

Even when they move ahead, companies often define very conservative targets. Half of the executives surveyed reported setting an ex ante cost reduction target in the single-digits or low double-digits — a recipe for disappointment. In our experience, a lack of ambition at the outset ranks high amongst the biggest impediments to success. Conversely, establishing "unreasonable" goals early on, goals which require fundamental business transformation, is a central driver of ultimate success, alongside others:

Timing counts! Choose your own starting point. Don't have it chosen for you. Any cost program will be more effective and sustainable if it is self-initiated and focuses on specific long-term outcomes. It takes away the "we have to do it and are all in the same boat" argument and instead signals a CEO/CFO agenda focused on transforming the business.

Set ambitious targets and push for radical solutions. Any target at 10 percent or below will have teams focused on incremental savings actions rather than looking for a truly creative step-change on how each respective function is run.

Allow broad thinking. The goal of cost transformation programs should be margin improvement. While the initial focus must be on the cost side, there should be no artificial limits once analyses reveal margin opportunities beyond the pure cost scope. For example, analytically looking into sales force efficiency may reveal levers for much greater effectiveness, such as driving higher margins by better customer selection and pricing, rather than cutting back on the workforce.

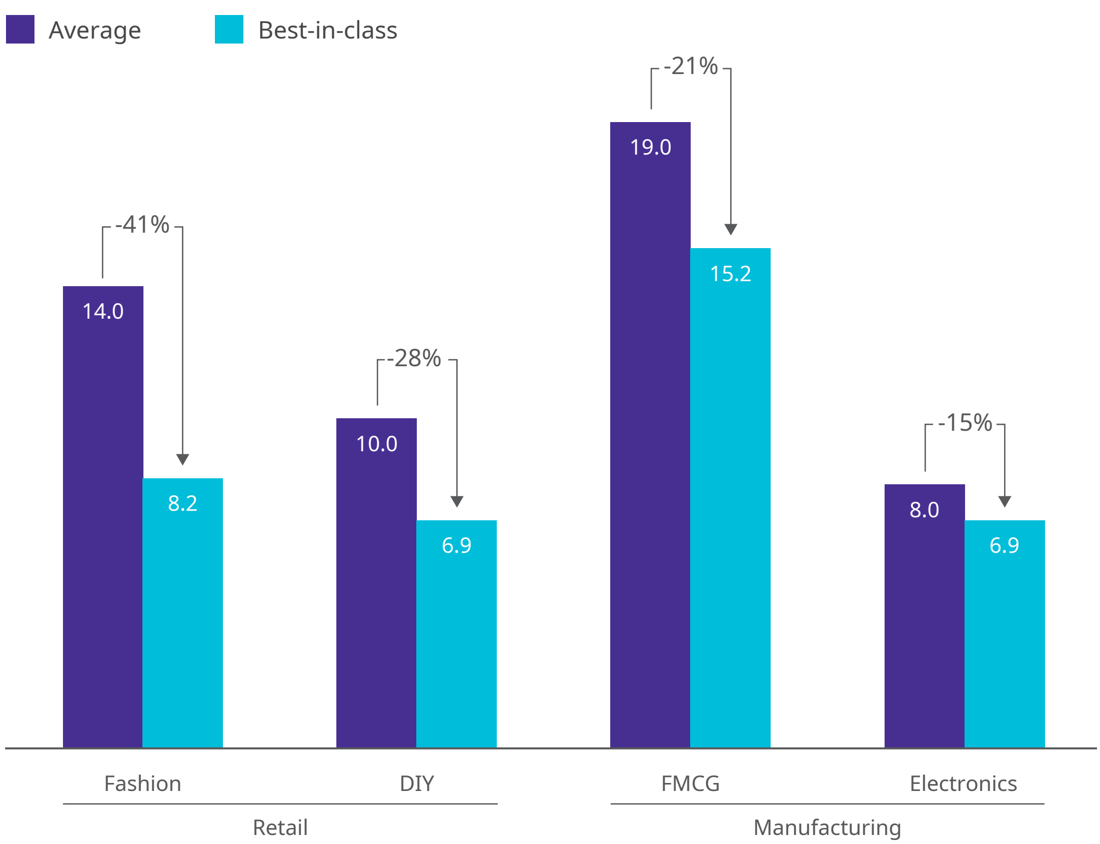
Be customer-driven. Albeit contradictory at first glance, customer focus remains paramount even in the most extreme cost reduction programs. The "customer lens assessment" can serve as an important input for prioritizing and redesigning the company's services, both internal and external. Customers' preferences for simple products and services, a declining interest in hardcopy marketing brochures, or the openness for smart compromises such as callback buttons instead of hotline waiting times are just a few examples where factoring in the customer angle can accelerate cost optimization rather than slowing it down.

When timing, bold ambitions, broad scope, and customer focus come together, results can be truly impressive. Oliver Wyman worked with the CFO of an international multi-billion retailer who, after several waves of cost optimization in the past, was bold enough to set a new target: reducing overhead functions and indirect spend by 20 percent. After the initial shock, the "unreasonable" demand drove innovation and creativity, from rigorously prioritizing centrally provided services through a customer lens, substantially increased spans of control to tightly organized, technology-enabled expert networks allowing for much more effective procurement decisions across the entire company. And for seemingly minor cost buckets such as gift card fees, broader perspectives allowed for a step-change in overall margin: in this case strategic partnerships with international vendors, with an incentive to improve total returns rather than just cutting back on the commission fees. Overall, the ambitious target was fully achieved and marked a real turning point in the company's profit and loss (P&L).

It pays to be bold, even when it seems impossible. Even in an area such as indirect spend, where leading companies often claim to have "already cut all spend back to the bone," best-in-class benchmarks reveal different stories.

Exhibit 4. Selected indirect spend benchmarks

Indirect spend to revenue ratio for selected sectors in retail and consumer goods

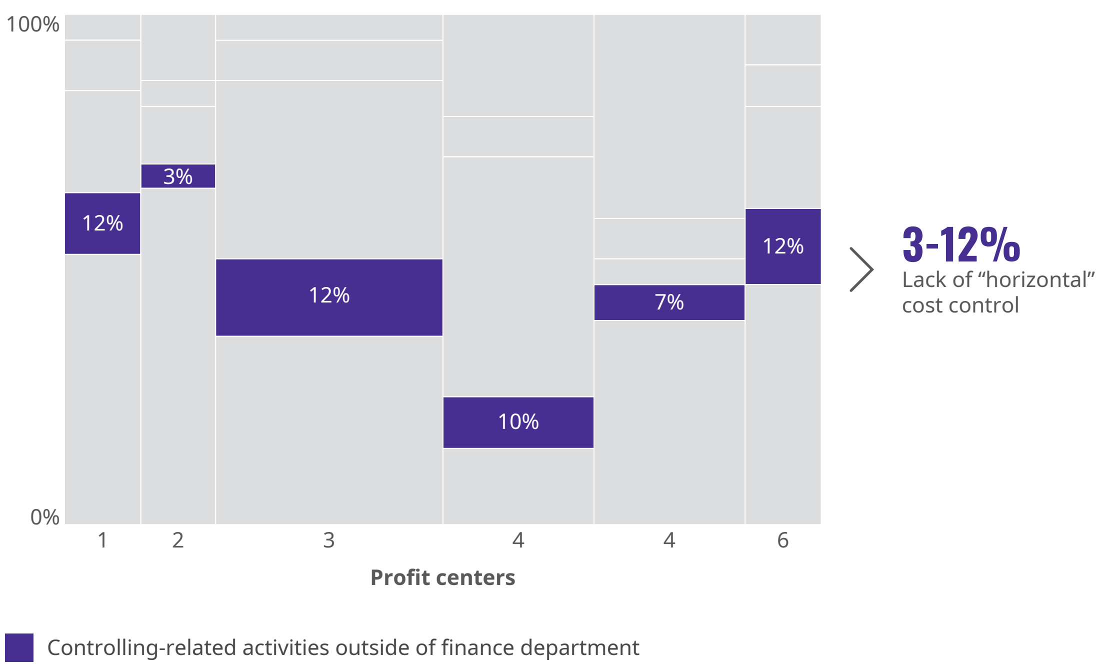


Source: Oliver Wyman analysis, representative industry players selected based on Oliver Wyman experience

2. PUSH FOR A MORE HORIZONTAL PERSPECTIVE ON COST

In our experience, many companies still work in highly "siloed" organizations. Looking at these organizations from an activity and cost-type perspective we find highly decentralized approaches, making it very hard to realize otherwise readily achievable economies of scale. Even after centralization and efficiency programs, we often observe the emergence of "shadow services." If for example, the finance department reduces its reporting activities, functional leaders in sales or procurement will task one of their resources for report continuation. Similarly, on indirect spend, the central sourcing team/function may have negotiated frame contracts with temp labor such as maintenance or cleaning service providers, but the actual spend on these services remains at the discretion of each profit center operator, and is only reported upward as part of miscellaneous general expenses. We have seen many companies where master frame agreements for cleaning and other services have been highly competitive, yet total spend levels had been miles off best-in class. These examples illustrate how a lack of transparency or horizontal grip on cost can undermine cost effective cost reduction.

Exhibit 5. Horizontal perspective on cost



In our work we have found common patterns for success:

Specify the relevant cost and activity types upfront. Rather than trying to achieve "total transparency" through overly granular bottom-up analyses, step-change should be built on a strong set of initial hypotheses, such as which cost and activity types need to become more transparent "across the silos." As mentioned before, examples typically include controlling activities or spend on external services such as maintenance, cleaning, or temp labor. It should also be defined, where decoupling of spend may be required, for example in case of full-service-contracts for machinery or fleets where product and maintenance cost should be separated for further analysis.

Track and trace drivers. The efforts on creating transparency should not be limited to understanding the details of spend; it must also include the key cost drivers. Cleaning costs should, for example, be linked to floor space and relevant characteristics (such as type of floor), or research and development prototype cost to the number of projects or training cost to headcount numbers. Transparency of this kind allows for internal benchmarking and tight control over "new cost levels" in the future, by creating and sharing largely automated KPI dashboards such as total training cost per head or total cleaning cost as a function of space.

Redesign the operating model. Often, creating transparency is seen as a one-off effort done in project mode. This short term view can, and often does, undermine the sustainability of a cost reduction program. We have observed that companies with a clear view on the future "transparency operating model" from the onset of the program — covering systems, processes, and people — have not only been able to sustain cost reductions over time, but also build upon such foundations to generate more reductions in future. For cost management leaders, the new transparency is often directly reflected in the current company environment, for example embedded in enterprise resource planning (ERP) with explicit ownership in the controlling department. If this is not immediately feasible, best practice examples have defined the future solution and defined clear milestones for going forward: If not in the ERP, where then? What will the future maintenance process be, to keep definitions up to date? Who is responsible for quality control and report distribution? Who answers which questions?

An international company has recently been very successful in moving from limited ERP transparency to a new setup with dedicated spend transparency responsibility, reporting to the existing controlling team. This has allowed continuous output on monthly cost evolution and dynamics report by country, as well as quarterly cost updates for every profit center including a driver analysis — both reports including a broad set of internal benchmarks. Cost efficiencies in the 10 to 15 percent range were realized, driven by tighter control and more consequent best practice implementation by cost and activity type across profit centers (who remained fully responsible for their P&L).

3. NOMINATE LEADERS NOT CONTROLLERS TO RUN THE PROGRAM

Often, cost programs are a required “reset” to allow for substantial investment in future programs. At the same time, however, there is an inherent risk that cost programs are perceived as negative and backward-looking. In our experience, the right people, messages, and tools are needed to overcome successfully these challenges, creating sustainable momentum and impact. Leadership, communication, and governance make the difference here.

Select leading program drivers rather than controlling project managers. Leaders for cost programs are often selected based on their functional expertise. However, in our experience, soft skills and leadership potential are more important for the overall success of the program. One of our clients, a leading, stock-listed multinational selected an emerging high-potential regional sales manager to lead the cost program instead of a more traditional internal project manager with a controlling background. She was chosen for her deep understanding of the business, her empathetic style, and her communication — factors which more than outweighed her lack of project management and controlling experience. These qualities allowed her to become “the face” of the program and the principal driver of a highly successfully cost reduction transformation.

Communicate the hard truth from day one. Cost programs not accompanied by thoughtful and professional communication fail. Honest and transparent communication about the objectives, milestones and governance of the project all are essential. One example with which we are very familiar involves a company which has conducted two major cost programs over the last five years. The first initiative was positioned as a performance improvement program, initially not mentioning any predefined agenda to cut jobs. The later job-cutting announcement provoked massive protest and substantially limited the overall benefits achieved. A subsequent program — then under new company leadership — chose transparent communication from the beginning and received much broader and enduring support.

Celebrate progress and reward leaders. Selected “quick wins” should be identified early in the project and implemented right away, supported by strong communication and explicit top management feedback to the project leaders.

Retain project management office (PMO) longer. Unlike some other project types, for cost transformation the PMO should be kept well beyond the “project phase” as there is always a strong reflex of the organization to push back to comfort zones where possible. One of our clients kept a PMO in place for 12 months after project end. Doing so not only secured the P&L benefits of the program but also delivered additional incremental savings measures and impact on top of the initial project contributions.

Orchestrate shift from project to business as usual. There should be an overinvestment at the end of the "project phase" in handing over project responsibilities to the respective line managers. This process needs to be fully transparent to top management and closely interlinked with finance (budgeting and progress reports) and HR (role description and, incentive structures). One of our clients — the CFO of a European multinational — had insisted that all relevant project metrics be fully translated into the regular finance environment. The effort proved to be a great success and allowed for measurable cost impact far greater than in any project before.

A global retailer completed a holistic cost transformation which resulted in 500 basis points effective profit improvement. The retailer had created a formal transformation program which guided the implementation over a period of three program. Many of the learnings illustrated above applied to this situation. Clearly in the first year the company recognized the need for strong leaders to steer and drive the program. Sustaining the program for "as long" as three years paid back in full as it ensured that the changed sustained. Almost symbolically — the PMO as disbanded after three years on the day to demonstrate it was now business-as-usual.

COST TRANSFORMATION AND COVID-19

Covid-19 has challenged businesses as never before. For months, companies have been working to cope with unprecedented upheaval focusing on employee protection, business continuity, and financial survival. In doing so, companies have had to make hard decisions and act in ways previously unthinkable or unachievable in the normal course of business:

- Food retailers have in some cases radically reduced their active SKU ranges to allow for a more effective management of store and supply chain operations
- Fashion and consumer electronics retailers have negotiated dramatically revised payment terms with suppliers and landlords
- Many companies have switched their head-office to 50/50-shifts, having 50 percent of employees work from home. Also, they have eliminated face-to-face activities with third parties, shifting to fully digital interaction
- Wholesalers have changed their delivery schemes to allow for stock-ups: reduced delivery frequencies, increasing drop sizes, and premium fees for small orders
- Further examples include the massive cutback or complete stop on discretionary spend such as events, travel, or marketing materials

At this moment it remains largely unknown how and when companies will be able to get back to normal. However, one thing seems clear already: despite the hardships for people and companies, the crisis is currently teaching valuable lessons for cost management in the future. On the one hand, it may pave the road for bolder, more radical decisions in the near future as many companies have learned how well their business can cope in crisis mode. On the other hand, some of the changes which companies have made to address the crisis may be changes they want to keep, from reduced retail ranges to more efficient distribution schedules to more closely managed cash expenditures.

An important part of learning business lessons from the pandemic will in our view be a systematic evaluation of what happened, what was done, what worked. and what did not. It is already possible to begin building a catalog of COVID-19 inspired cost reduction and mitigation approaches (see exhibit 7), one which is likely to grow dramatically over the coming months.

Exhibit 6. An emerging COVID-19 cost learnings checklist

	Operations and supply chain	Overhead functions	Indirect spend
Crisis action examples	• More digital collaboration E2E • More flexible capacity utilization • Adjusted service levels and SLA tolerance (e.g. transportation) • Increase supply alternatives/redundancy for critical items	• Remote/digital service delivery from HR to procurement • Work from home • Project reprioritization	• Budget cuts/freeze of spend • Cancellation of travel and events • Payment term adjustments • Lease renegotiations
Post-crisis cost checklist	☐ Redefine required business complexity (e.g. product range) ☐ Systematic redesign of digital E2E collaboration and data sharing ☐ Re-balancing of flexibility and cost (manufacturing, supply, …) ☐ Labor schedule flexibility (advance notice, shifts, etc.) ☐ Rebalance transportation schedules (frequency, sizes) ☐ Next generation forecasting/ S&OP optimization ☐ Retain cross-site connectivity and global best practice sharing	☐ Use COVID-19 time as reference for service levels, reports, meetings, … and systematically challenge the need to go back ☐ Link business changes to effort drivers and respective resource sizing (e.g. less promo activity) ☐ Define new normal for remote/ digital services instead of physical check-in (IT, HR, etc.) ☐ Define future workspace need in light of permanent WFH percentages, potentially even question HQ structure entirely	☐ Retain elements of tighter spend controlling and cash management ☐ Optimize procurement operating model for spend control, risk management, crisis sourcing ☐ Redesign future event and travel requirements (zero-based budgeting, literally) ☐ Systematically review make-or-buy decisions by category, based on crisis experience ☐ Streamline and optimize payment terms across the supplier base ☐ Renegotiate lease agreements

ABOUT OLIVER WYMAN

Oliver Wyman is a global leader in management consulting that combines deep industry knowledge with specialized expertise in strategy, operations, risk management, and organization transformation.

In the Retail & Consumer Goods Practice, we draw on unrivaled customer and strategic insight and state-of-the-art analytical techniques to deliver better results for our clients. We understand what it takes to win in retail: an obsession with serving the customer, constant dedication to better execution, and a relentless drive to improve capabilities. We believe our hands-on approach to making change happen is truly unique — and over the past 20 years, we've built our business by helping retailers build theirs.

For more information, please visit www.oliverwyman.com

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