



Driving sustainable enterprise cost reduction within the consumer products sector

Driving sustainable enterprise cost reduction within consumer products

With the current global financial crisis combined with volatile commodity and energy prices and increased margin pressure from retailers, it's not hard to understand why so many consumer products companies are pursuing large-scale cost reduction programs. However, given how hard they are to deliver, how do they ensure they are successful and sustainable?



70% of companies failed to improve their cost/revenue ratio year-on-year for three years after announcing a significant cost reduction program.

When we examined recent cost reduction programs we found that most failed to deliver – indeed many actually find their margins declining from their starting point.

In fact only 30% of cost reduction initiatives we looked at had improved their position by the end of year three, the rest failed. This is worrying considering that this was in a time period when markets were typically growing not declining. In a falling market it is unlikely that even this ratio will be sustained.

The answer – use both structural and tactical levers to drive down cost, sustain improvement and selectively re-invest in growth.

What is driving cost reduction?

The perfect storm seems to have hit consumer products with some force.

The instability of commodity and energy prices has affected every aspect of their business from the packaging to raw materials.¹

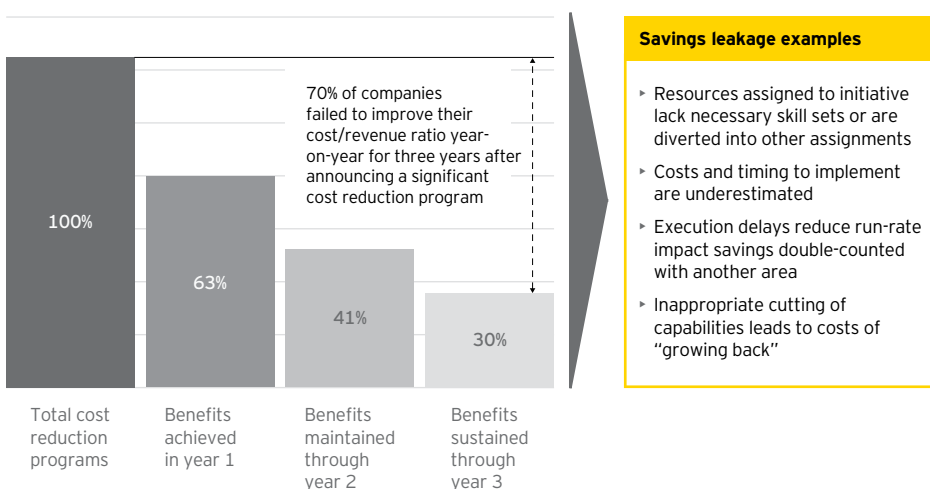
The financial crisis has left consumers unable or, at best, unwilling to pay higher costs for their market basket.

In the last few months alone, more than 12 of the leading consumer products companies in the Fortune 500 have announced cost reduction programs, from Coca Cola to Procter & Gamble. Yet while the current economic climate has cemented the focus on cost efficiency as a business imperative, many organizations come to us having attempted and failed to deliver enduring cost improvements.

Economic conditions required the company (Kraft) to “be cost-conscious day in and day out.”²

Kraft spokeswoman Renee Zahery

Sustainability of cost reduction benefits within large public companies Analysis of year-on-year performance, 2001-2006



Source: Ernst & Young Analysis

¹ Raw materials prices have increased on average 7% per year in the last three years (CAGR). Source Indexmundi.com

² Kraft to cut 400 jobs in North America by Lauren Shepherd, AP Business Writer, 6 October 2008 Associated Press Newswires



How might this recession be different from those in the past for consumer products companies? Our projection is that this recession will cause a marked and sustained shift of consumer purchasing into private label brands. Why?

First, the quality gap is closing between private label and branded products. In the US, where there has recently been an intense focus on private label, the differences in quality between branded and private label offerings are considered to be “near zero in many categories.”³ One global retailer recently conducted a formulation test to compare a private label product supplied by a global consumer products company with the manufacturers’ premium brand. On finding a quality difference the retailer insisted on, and secured, exactly the same formulation and so closed the quality gap to zero. Only a “perceived” gap remained.

Consumer attitudes are also shifting, eroding the perception of a quality gap. A recent survey reported that consumers are moving away from the view that private label brands are of lower quality than traditional brands, so providing an opportunity for retailers to differentiate themselves with high-quality, reasonably priced store brands.⁴

Looking across a broad range of consumer products cost programs, common themes emerge. We have summarized five below:

1. Sharpening operating structure

Many consumer products companies are seeking to gain economies of scale and scope. This requires making clearer distinctions between those activities that should remain close to the consumers and those that can be centralized. However, this transition, which usually requires individual countries to become focused sales and marketing organizations, involves a huge change in the level of local independence. To effect the change, compromises are made in the “purity” of the model, leading to duplicate activity between countries, clusters, regions and global. Targeting the duplicates and overlaps releases substantial costs and improves operational speed and consistency.

2. Reviewing cost of control

Most leading consumer products companies have costs of control between US\$300m and US\$700m depending on their breadth, depth and complexity of operations. These costs are driven by financial, operational, strategic, reputational or compliance requirements. Our reviews of these activities typically identify opportunities for companies to better align their control profile with their strategic requirements, in the process removing, and in a small number of cases, adding control activities. When they are then able to improve the efficiency with which these controls are delivered by streamlining and changing the types of controls used, this can yield savings of up to 20%.

3. Revising the customer tail

Divesting low- and no-profit customers is a long used margin improvement technique. The introduction of better cost allocation tools improves the targeting of true net profit including the allocations of finance, HR, IT and other support costs. This allows consumer products companies to reshape the tail in a very surgical manner. In one case, a company decided to substantially raise prices to reshape the tail. It was surprised to find that almost 50% of their consumers agreed to the price increases and stayed.

4. Sharpening the commercial resource profile

Most consumer products marketing and sales organizations have not been reshaped to reflect changes in demand or true return on sales activity. What we have seen recently is the introduction of substantially more sophisticated net profit analysis models, which measure return on sales activity far more effectively. These can assist with targeted reshaping of activity including reallocations of routes to consumer (telesales etc.), adjusting service offers/bundles and improving the effectiveness of the merchandising team.

5. Enhancing the profitability of global trading

Global trading programs are now moving far beyond the ongoing considerations of supplier lead time, quality and cost issues, to include taxes, duties and customs compliance. Proactive companies are looking at global networks optimizing factory and warehouse locations to take costs out to combat future expected rises in oil and commodity prices. Typically savings range from 10% to 20%.

³ Retailers face off with name brands in recession, Reuters News, 19 February 2009, via Dow Jones Factiva, © 2009 Reuters Limited.

⁴ J.D. Power and Associates Reports: For Private Label Grocery Brands, Organic Products Drive Gain in Prestige Among Consumers, PR Newswire (US), 25 March 2009, via Dow Jones Factiva, © 2009 PR Newswire Association LLC.

“Enterprise cost reduction should not be a one-off exercise but part of the DNA of an organization. I believe that is why Nestlé under its ‘operational efficiency’ pillar delivers continuous improvements to its earnings before income tax (EBIT) margin year after year while simultaneously driving top-line growth by 5% to 6%.”

Mike Sills, EMEA Consumer Products Leader, Ernst & Young



The pressure from retailers to discount,⁵ as well as compete against, lower-priced private label brands has meant that now the time is ripe to ensure effective and sustainable enterprise cost reduction programs in order to stay competitive. Indeed, in a survey of 250 C-suite and board-level executives worldwide carried out by the Economist Intelligence Unit on behalf of Ernst & Young, it was found that over half of companies say they are forced into cost reduction programs mainly by the pressure to stay competitive.⁶

This driver is closely followed by the pressure to maintain profitability. For consumer products companies, profitability is proving harder to maintain with the squeeze on margins, the erosion of their brands and the management of a complex global supply chain. The pressure to constantly innovate and adhere to the increased regulatory requirements is forcing them to re-evaluate their cost base.

So, as the pressure from boards, audit committees and investors mounts on companies to reduce costs in every major region where they operate, what should consumer products companies do to ensure enduring change?

So where do you find the savings?

Ernst & Young's cost initiatives typically deliver between 15% and 34% net run-rate reductions, often in settings where organizations have been through recent cost reductions.

Our experience, based on working with a number of leading companies in the sector, suggests that the likelihood of achieving the savings can be enhanced through three techniques.

The first, that we refer to as “handbraking,” should deliver savings in the financial quarter in which it is performed. The second, we refer to as “net profitability analysis,” should deliver savings within six months. The third, improved operational efficiency, should deliver savings within six months to two and a half years.

1. “Handbraking” current discretionary costs

In a declining market, we typically find that most organizations are unable to curb costs to keep in line with falls in revenue. At one company, we recently reduced selling, general and administrative expenses (SG&A) related costs by 8% by reviewing cost run rates against projected revenue for non-personnel categories and adjusted marketing, legal, travel and entertainment as well as provisions to reflect the new projected outturn. The policy changes related to travel and entertainment could be sustained for an extended period of time, the others could be adjusted appropriately as growth returned.

2. Net profitability analysis

We see many organizations that make budgeting decisions on the basis of assumed rather than true net margin. Recently, for a client, we identified opportunities to reduce costs by 22% after a short piece of analysis. We accomplished this by conducting a staff survey which allowed us to develop a robust understanding of how people were spending their time. We used this information to analyze the organization's revenue by brand, line of business, geography and type of activity. This allowed us to understand the true costs of generating each area of revenue and to highlight where true profitability was adrift of assumed profitability.

3. Improved operational efficiency

In one recent situation, we identified 28% in savings in the SG&A cost base, improving finance, HR, and sales and marketing. We used external benchmarks and evaluated best internal performance in the company. Together with process reviews, this analysis allowed the company to save money through centralizing marketing, improving average revenue per sales person, reducing the variation in HR support, and creating a leaner finance function through more targeted reporting and better integrating planning and budgeting.

To help deliver this level of savings, and to do it at speed, we work through an initial set of hypotheses and rapidly test them with our clients. We find that this helps to build consensus and support for the results. It also prevents us from missing any major areas of potential opportunity.

⁵ Increasingly, international retailers and buying groups negotiate international deals with consumer products producers

⁶ Survey details for some of the research in this article, the Economist Intelligence Unit, the research arm of *The Economist* magazine, surveyed 250 senior executives and board members. Respondents were drawn from Asia Pacific (33%), North America (31%) and Western Europe (28%) with the remaining responses from the rest of the world. All executives polled worked for businesses with revenues in excess of US\$1 billion.



The drive for value, pace and sustainability underpin the three cost levers

Value is identifying and driving out savings. *Pace* is accomplishing the expected savings rate with the right momentum. Finally, *sustainability* is driving out the right costs and creating an appropriate cost consciousness across the organization.

Value can be realized by *carefully examining key elements of addressable spend*.

- ▶ Has a clear vision of success been created and defined? Are the implications of this clear? Usually we have seen this done by reference to external or internal benchmarks, although it can be done through a “bottom-up build” of the capabilities required to deliver the strategy.
- ▶ Have baseline costs been established?
- ▶ Is the cost base targeted for reduction well-defined and understood?

- ▶ Have all addressable spend areas been examined?
- ▶ Are a full range of cost reduction techniques deployed?
- ▶ Is the cost reduction opportunity qualification and prioritization process effective?
- ▶ Have target savings estimates been established and budgeted?

Pace comes from a careful balance of short- and longer-term savings. Pace can be improved by having *effective project management and appropriate project focus*.

- ▶ Are the processes, decision-making and progress tracking mechanisms in place to drive “action, not talk”?
- ▶ Have appropriate quick wins been identified to create the necessary momentum and demonstration of management commitment?
- ▶ Are quick wins and tactical programs followed by significant longer-term initiatives?

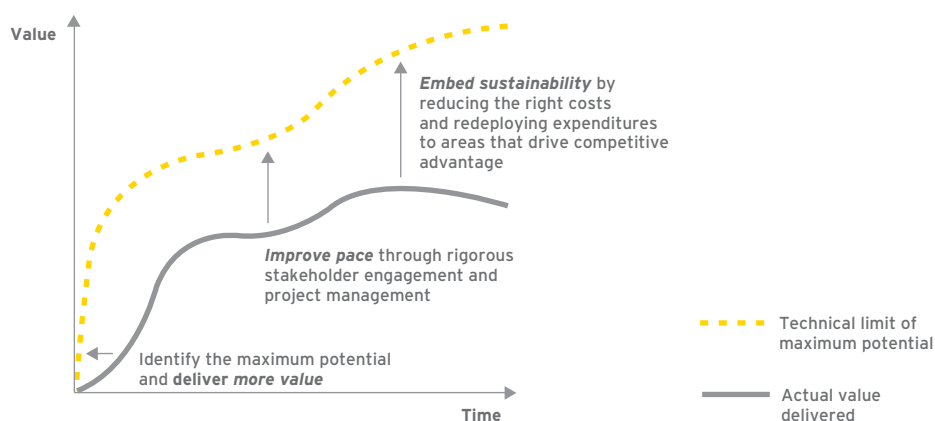
- ▶ Have resources with appropriate skills been put in place to support the program?
- ▶ Does the program have clear governance and a fixed scope?
- ▶ Are financial business cases adequate to support action?

Sustainability results from changing the “balance of expenditures” toward those activities that are central to organizational performance. Using a structured approach to do this helps *maintain savings results over time*.

- ▶ Are cost reduction initiatives aligned to company strategy and capabilities?
- ▶ Does the organization understand what is truly important to its success compared with those areas where it only needs to be effective?
- ▶ Is there strong and consistent executive support and transparency?
- ▶ Has a collaborative approach been used to garner sufficient user involvement and support?
- ▶ Is there continuity among the cost reduction program and project staff?
- ▶ Is there a structured approach for engaging with key stakeholders and monitoring cost metrics over time?
- ▶ Have links to performance management been embedded in reward and compensation systems?

By focusing on value, pace and sustainability, companies can overcome the challenges typically seen in cost reduction programs.

Improving cost reduction program performance



“Personalizing the benefits of cost reduction are important. For one company, we described savings as ‘the equivalent of one third of current R&D spend.’ In another, savings were equivalent to the profit generated in China. For another client, we worked out the cost of not implementing cost cutting recommendations – in this instance US\$1,500 per minute.”
 Oliver Wright, Global Enterprise Cost Reduction Leader, Ernst & Young



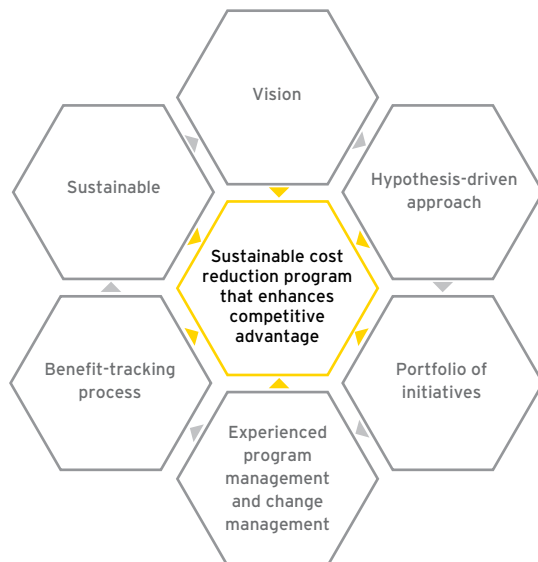
How do leading companies design and manage their enterprise cost reduction programs to improve results?

Ernst & Young’s experience shows that successful cost reduction efforts are based on the following six critical program elements.

Six elements of an effective cost reduction program

A vision which is aligned with corporate strategy and supported by executives, facilitates selection of appropriate cost reduction opportunities. The organizational resistance to large-scale cost reduction programs can be formidable. Leading companies are successful only when executives set a clear vision for success and visibly engage in unwavering support of the program. In this context, vision can be an overly grand word. What we mean is alignment on how things should work.

Six elements of an effective cost reduction program



Two consumer products companies we worked with saw duplicated costs caused by lack of clarity in strategy. This emerged in overlaps in capabilities between global, regional and country teams. Costs were incurred as people sought to maintain the ability to deliver at different levels in the organization. In one of the situations, we created a simple summary that outlined how activities could be streamlined. The potential saving? Tens of millions of dollars.

At the micro level, the benefits can also be very substantial; consider the improvement opportunities offered through better alignment in risk management. For another global consumer products company, we asked the leadership team to gauge the level of risk they were willing to take on a range of their key business issues. We plotted separately the feedback from each member of the leadership team.

Four interesting themes emerged. First, many of them believed they were taking a different level of risk vs. their peers than they truly were. Second, in some areas, they agreed that they were “over controlled” but had never put the changes into place that would reduce their costs. Third, there were some areas where there were wide variations in perceptions of the appropriate level of risk – a lack of alignment that is “trapping” costs. In one recent situation a review of controls identified US\$5.9m in savings opportunities out of a cost base of US\$ 80m.

Finally, we did identify some areas that were under controlled where we could immediately take steps to help the company manage the level of risk incurred and reduce the potential financial downside.



A hypothesis-driven approach based on experience helps focus efforts on areas with highest benefit potential.

Leading companies are most successful at identifying opportunities for improvement when they aggressively challenge the status quo and utilize external and internal benchmarking to encourage new thinking. One consumer products company created a series of standard monthly reports comparing simple internal benchmarks across operational units globally. It then conducted regular discussions with the relevant leaders to highlight areas of opportunity to confirm how they could be rapidly and cost effectively put in place. Because the ideas were predominantly internal there was little push back that they could not be accomplished.

Most leading organizations identify a set of themes that can deliver value across functions and business units, and attack each element of the cost base. These focus analysis and resources and ensure that the entire cost base is adequately targeted. Initiatives are typically grouped under these themes, sorted by timing of payback, size of payback and level of effort to implement.

A portfolio of initiatives helps drive an integrated roadmap for change.

A portfolio approach assists in managing opportunities and initiatives throughout the organizations project lifecycle.

A successful cost reduction program typically consists of a portfolio of near-term quick wins and longer-term transformational programs. A balanced portfolio may help create a “self-funding” program, using early savings to potentially help fund longer-term initiatives with higher returns.

We have found that the delivery of early results is a particularly important driver of success. Our research indicates that very few programs that focused purely on medium- to long-term benefits were successful. Think of a runner in a race; very few who fall over at the start are able to pick themselves up and overtake the opposition. We found that many successful programs put a solid balance of effort on reviewing the highly variable elements of the cost base to examine and deliver non current headcount related opportunities.

Experienced program management and change management equipped with an established methodology and supporting tools that drive execution.


Many companies struggle with the implementation of cost reduction programs because these initiatives are typically executed in challenging times and require significant effort in addition to the “day jobs” of managers and staff. Effective program management is essential to keep projects on track.

Change management issues are a common theme across many cost reduction programs. In spite of increased understanding of the issue, we continue to find examples of insufficient thoughtful engagement within organizations that will build sufficient commitment to the change. On one program we observed, a small highly analytical external team identified US\$280m worth of savings across the organization. However, when seeking sign-off, it rapidly became clear that the necessary support for the ideas within the leadership team did not exist. There was indeed a strong resistance to being presented with a “fait accompli.” The program was stopped, the team stood down, a new team was put in place and strong support was built through a heavily consultative process. This ultimately delivered US\$400m of savings.

Our message to cost program leaders? If you are spending more time on the details of the program than on actively managing your stakeholders, reassess how you can better use your, and your team’s time to allow you the space to build the required consensus for change.

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Oliver Wright, Global Enterprise Cost Reduction Leader, Ernst & Young



“Many of the best managed cost reduction programs thoughtfully blend cost reduction, growth and customer experience.”

Oliver Wright, Global Enterprise Cost Reduction Leader, Ernst & Young



A robust **benefit-tracking process** embedded within existing processes helps drive accountability and realization.

Tracking benefits by defining clear improvement measures to create accountability, and then measuring and monitoring benefits help to drive results. Many companies fail to deliver results in cost reduction programs because the day-to-day reporting systems of many companies will not track net reductions in cost structure related to one-time initiatives. Accurate benefits tracking is essential to enforce accountability and determine whether financial value is ultimately achieved.

Many cost programs anticipate “benefits leakage” of up to 40% of the savings identified. In one situation a client identified US\$700m worth of savings to feel confident that they could achieve a US\$500m target. The leakage usually comes from poor baselining, cloudiness over whether the savings are included in current or future budgets, multiple departments claiming the same savings, or lack of deep commitment by business owners to the savings that have been identified.

In addition, many companies fail to adequately capture the “tail costs” that go with changes in employment, this includes computer leases, mobile phones etc. that can otherwise sit on the P&L for an extended period of time. A detailed benefits – tracking process that is tied into ongoing reporting and baked firmly into budgets, is therefore critical.

An effective transition of the initial program into a **sustainable**, ongoing function.

Establishing a sustainable program governance structure, aligning performance management systems, transferring knowledge to embed a cost reduction culture into the company and driving a focus on change management, all help to sustain results over time. Cost reduction programs which are run simply as one-time initiatives are destined to be repeated.

Conclusion

Done properly, in other words, embedded into the DNA of the organization, companies should be able to harness cost cutting programs to reduce their operating and overhead costs in such a way that they are sustainable. At the same time, they can increase revenues from ongoing activities and so improve margins. The result is a potential for lower ratio of costs to revenues year-on-year and substantial savings.

The business challenges facing companies today are considerable. Companies that implement a program which effectively addresses the common cost reduction challenges should experience much better results with their programs both in the short and long-term.

Successfully executed cost reduction programs are essential for companies who want to maintain or achieve market leadership in the current economic climate.



“Leading practice enterprise cost reduction programs should look for improvement opportunities that simultaneously re-invest bottom-line savings into top-line growth.”

Mark Beischel, Americas Consumer Products Leader, Ernst & Young



Why Ernst & Young?

Ernst & Young has experience in many aspects of cost reduction programs to assist companies cut to the heart of the issue. We have the capability to identify, diagnose, design, manage the delivery and help ensure that each cost reduction program is sustainable.

Questions to ask yourself

- ▶ Why do most consumer products companies fail to implement effective cost reduction strategies?
- ▶ How do we ensure maximum impact from our cost reduction programs?
- ▶ Which areas of our business are likely to yield the greatest efficiency savings?
- ▶ How should we align cost reduction programs with our growth strategy?
- ▶ Who needs to run a cost reduction program in order for it to be effective? What level of support and commitment is necessary?
- ▶ How can we ensure cost reduction doesn't affect the consumer experience or impede revenue growth?
- ▶ What are the critical success factors for an effective cost cutting program based on prior experience?

Industry/subject matter knowledge and team

In choosing Ernst & Young, you can be confident that we have the industry and subject matter knowledge and a team of professionals to recommend an enterprise wide cost reduction program. Our depth of global experience, including extensive research and analysis, provides strong subject matter resources and insights to our clients. Our team integrates advisory capabilities across our multidisciplinary service lines to deliver the full range of services to address your needs.

Methodical execution and delivery

We harness leading-edge program management techniques and tracked results delivery, supported by a clear change realization methodology. Our integrated program delivery framework focuses on performance improvement and sustainable benefits.

Rapid and efficient approach

We are able to advise on rapid savings initiatives that can fund the assessment, rationalization, review and realization phases of the transformation. We work closely with client leadership to agree on a common vision of success and shape a program which is commercially compelling and realizable.

Drive sustainability

We understand the psychology of cost – sustainability is the key focus from the outset, engraining cost optimization behaviors in the organization. We frame cost improvement in terms of a desirable end-state encouraging clear motivation to “take the pain of change” out of the process.

In short, Ernst & Young will help you to ask the right questions to help your programs bring you long-term sustainable business benefits.

To find out more about the work we have been doing with companies in this area, please visit www.ey.com

Survey details

For some of the research in this article, the Economist Intelligence Unit, the research arm of *The Economist* magazine, surveyed 250 senior executives and board members. Respondents were drawn from Asia Pacific (33%), North America (31%) and Western Europe (28%) with the remaining responses from the rest of the world. All executives polled worked for businesses with revenues in excess of US\$1 billion.



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