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Making Complexity Reduction Count:

How to Plan for Benefit Capture from the Start

Companies are rapidly waking up to the issues of complexity – bloated portfolios, inflated cost structures and poor service levels. However, many companies that launch complexity reduction initiatives struggle to capture the full benefits. In our work, we've seen that in order to realize benefits from complexity reduction, companies need to consider two key inseparable elements. **Removing complexity** provides the opportunity for financial and operational benefits. But **benefit capture,** as a deliberate set of actions, needs to be considered explicitly at the onset, otherwise the benefits usually fail to materialize.

A primary challenge is that existing incentives may well conflict with your complexity reduction efforts. Absent an explicit plan, the status quo will prevail. For example, managers who are financially rewarded for keeping the factory full will invariably ensure this happens, even if it is with low margin, high complexity products. This is why complexity reduction requires a holistic, "joined-up" approach where benefit capture is coupled with complexity removal.

Before undertaking a major complexity reduction program, it is important to have a specific plan for converting the reduced levels of complexity to financial benefit.

How Complexity Reduction can Translate to Benefits

Any time a company embarks on a program to remove portions of a product and service portfolio, there is the opportunity to see the following benefits:

- **Increase profits via a lower cost base (Focus Area 1)**
- **Increase profits by boosting customer willingness to pay (Focus Area 2)**

Focus Area 1: In practice, this translates to unlocking enough spare capacity to allow for fixed cost release. Companies may find the consolidation of plants to be the most dramatic way to boost their profitability. The transformation that Cadbury UK embarked upon in 2007 provides a prime example of this option. At that time the company had 8 production/feedstock plants, 18 stockholding locations, around 6,000 employees, 30 key brands, and 1,000 different SKUs. Following a massive complexity reduction campaign, Cadbury cut stock-keeping units (SKUs) by 75% and reduced the number of distribution depots from 18 to 5. The results over a 4-year period ending in 2011 where impressive: the company achieved a 15% reduction in factories, a 10% increase in margins, and revenue growth of 7% on a

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like-for-like basis.[1] This illustrates a common phenomenon: often the biggest benefit of variable cost reduction is the opportunity it affords for fixed cost release.

Focus Area 2: This translates to using spare organizational capacity to improve service levels and offerings, resulting in improved revenue and profit. Service levels and offerings can be re-aligned with customer needs around quality and delivery features such as shorter lead time, less frequent stock-outs, and augmented product options. Effectively, companies increase the focus on delivering their most attractive opportunities flawlessly and price the offerings commensurate with what the market is willing to pay for "good complexity."

As part of a turnaround in the early 2000s, Motorola Computer Group significantly reduced complexity by trimming 85% of their product portfolio and deploying the organizational capacity made available from the SKU reduction to improve quality and ratchet up on-time delivery from 70% to 90%. This increase in service levels resulted in customer satisfaction leaping from 27% to 90% over a two year period.[2] It also improved the company's cost base and helped raise operating margins from -6% to +7%.[3]

Developing the Plan for Benefit Capture

In many cases, complexity reduction can lead to benefits across both Focus Areas. Indeed, the power of complexity reduction is that it exposes many trade-offs to be false (e.g., complexity reduction can, in fact, decrease costs and improve service levels). The key here though is having the clarity from the outset as to the areas of benefit that will give the business the most lift, based on current operational and strategic gaps. For Motorola above, the focus was on increasing service levels and that became the anchor motivation. As an added benefit, they also saw their cost base decrease.

At a high-level, the identification of the plan for benefit capture occurs through 3 key steps:

- **Take an "outside-in" view to assess the areas of biggest opportunity**
- **Identify and quantify existing interdependencies and internal changes for the benefits to materialize (above and beyond the complexity reduction itself)**
- **Translate the What to the How and move to execution!**

It is important to remember when following these steps that the enemy is analysis-paralysis and victory is achieved not when theoretical benefits are identified, but when

[1] Stephen A. Wilson, Andrei Perumal. *Waging War on Complexity Costs* (New York McGraw-Hill, 2009)

[2] Michael L. George, James Works, Kimberly Watson-Hemphill. *Fast Innovation* (New York McGraw Hill, 2005)

[3] Even though fixed cost release and/or increasing service levels are the focal areas of this article, managers should not view these outcomes as an "all or nothing" endeavor. Companies can continually improve margins through complexity-reducing activities like standardizing raw materials, consolidating product designs, utilizing Lean tools to simplify value streams, cutting excess inventory, pricing enhancements, and refining the value proposition.

actual benefits land. General George S. Patton once said, "A good plan violently executed now is better than a perfect plan executed next week." In that same vein, the key to capturing complexity-reduction benefits is to be "principally right," move quickly, and learn as you go.

Step 1: Take an outside-in view to assess the areas of biggest opportunity

The core exercise here is to benchmark your company's performance against peer organizations using two common metrics within your industry: Asset Turnover and Operating Margin. Neatly, when the two metrics are multiplied together and compared over time, it closely approximates changes to a business's Return on Invested Capital (ROIC).

- Asset Turnover effectively incorporates elements of the company's asset intensity and efficiency of operating decisions to generate revenue. Asset Turnover helps outline whether a company is operating at capacity and fully utilizing its plant and equipment in its operations.
- Operating Margin is a measurement of a company's operating profitability taking into account the company's strategy with regard to pricing, differentiation, and utilization of costs, including costs associated with complexity. Operating Margin does not account for expenses such as interest and taxes, so it is a good measure of the profits of a company's underlying operations independent of capital structure or one-time expenses.[4]

After data collection, create a grid showing where your company falls relative to your peers on both the above metrics. The result will be an Asset-Margin Matrix like that shown in Figure 1.

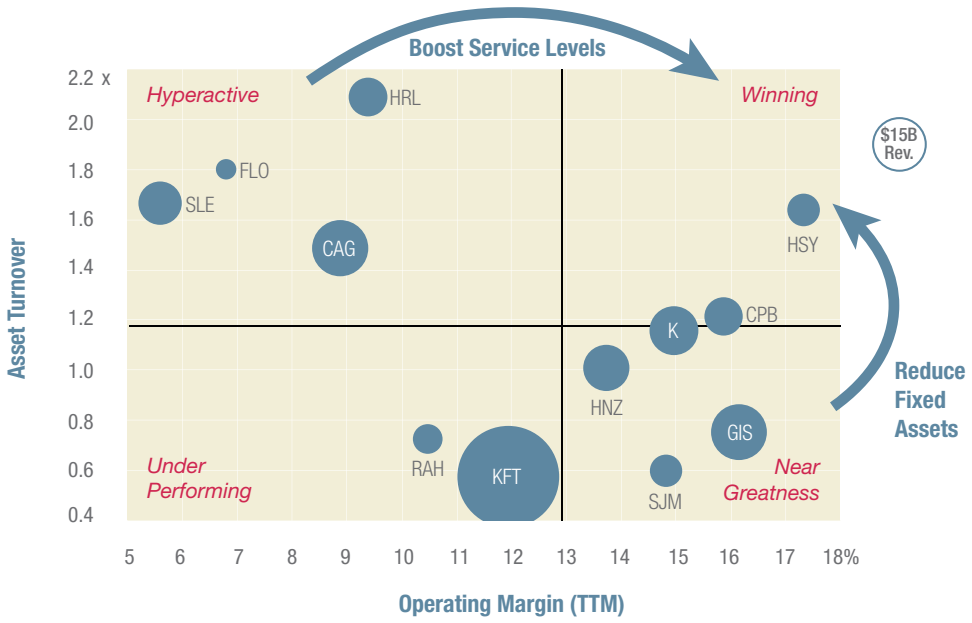

Figure 1: Example Asset-Margin Matrix Analysis of the US CPG Food Industry*

* Cross bars indicated relative performance via medians. Data includes trailing twelve months based on most recent SEC filing as of February 17th, 2012 for 12 major US CPG food companies (source: company SEC filings).

[4] Operating Margin and Asset Turnover tend to vary inversely. Companies with high margins tend to have low asset turns and vice versa. This is due to low margin companies typically not adding much value to products and thus requiring high turns to generate profit (e.g., grocery stores). However, it should be the goal of companies to achieve high levels on both metrics. Best-in-class organizations are able to do this and thus have corresponding high returns on invested capital.

ROIC and the Asset Margin Matrix

Many investment professionals have championed ROIC as one of the best measures of a firm's ability to generate superior returns. Praise for ROIC's virtues appears in popular pieces ranging from Joel Greenblatt's value investing books, to investment white papers, to advice from renowned strategist Michael Porter who advocates:

> *"ROIC is the appropriate measure of profitability for strategy formulation, not to mention for equity investors."* [5]

While many nuances can be applied to the ROIC equation, it is commonly calculated as:

$$\text{Return on Invested Capital (ROIC)} = \frac{\textit{Operating Income* (1 - tax rate)}}{\textit{Debt + Book Value of Equity}}$$

Asset Turnover and Operating Margin are typically calculated as:

$$\text{Asset Turnover} = \frac{\textit{Revenue}}{\textit{Assets – Cash and Cash Equivalents}}$$

$$\text{Operating Margin} = \frac{\textit{Operating Income}}{\textit{Revenue}}$$

For Asset Turnover x Operating Margin compared over time to closely approximate changes to ROIC over time, the following justifications are required:

Ⓐ (1- tax rate) expression found in the numerator of ROIC must be accounted for

Ⓑ Assets - Cash and Cash equivalents, the denominator of Asset Turnover, must approximately equal Debt + Book Value of Equity (i.e., Invested Capital), the denominator of ROIC

Regarding Ⓐ, (1-tax rate) is relatively constant over a short period of time. Therefore, comparing changes to a company's Asset Turnover x Operating Margin over time will closely approximate ROIC changes over time.

Regarding Ⓑ, from a balance sheet perspective, Invested Capital can be computed as follows:

$$\text{Invested Capital} = \textit{Fixed Assets + Current Assets – Current Liabilities – Cash Equivalents}$$

So long as Current Liabilities are minimal compared to Assets, Assets - Cash and Cash equivalents will approximately equal Debt + Book Value of Equity. For most companies, this is true.[6]

Given that Operating Margin and Asset Turnover are the two key components of the Asset-Margin Matrix it is logical that those companies that are able to move to the top right – effectively improving their ROIC – will be those that are most successful.

[5] Porter, Michael. "*The Five Competitive Forces That Shape Strategy,*" Harvard Business Review, January 2008

[6] This relationship generally holds true but there are balance sheet exceptions whereby Fixed Assets + Non-Cash Working Capital do not equal Debt + Book Value of Equity. One such example is when a company has minority holdings in other companies that are classified as assets on the balance sheet.

Figure 2: Interpretation of Matrix Locations

Companies in each quadrant exhibit different characteristics and will benefit from various uses of the spare capacity created by complexity reduction. If you look behind the numbers, there are clear patterns in how companies in each quadrant are using their resources and the resulting business challenges they face. There are four categories, as shown in Figure 2.

Under Performing

Characterized by both lower Asset Turnover and lower Operating Margin than competitors, 'Under Performing' companies also have the greatest opportunity and urgency, for dramatic improvements. They will need to consider a broad range of operational and market-facing improvements to reduce complexity and better their competitive stance.

The focal point will be a meaningful improvement in the business model, both in terms of service levels/differentiated offerings and costs. The company's leaders must drive a return to focusing on their customers, understanding what drives their satisfaction, and conduct a robust review of complexity, both good and bad (note: customers value and are willing to pay for "good complexity"). They can then make better decisions about right-sizing operations to profitably deliver the good complexity and eliminating bad complexity.

Hyperactive

Characterized by high Asset Turnover but low on Operating Margins, these companies are either working too hard for their results or, as is less often the case, they are concentrating on relatively high revenue but low margin products.

Companies that are 'Hyperactive' often focus on operational metrics without fully understanding the implications for customers and profitability. For example, in an effort to keep inventory costs low, these companies might frequently stock out of items that customers demand. Alternatively, a company might focus on high machine utilization and fill spare capacity with low margin products and/or entice customers to buy additional volume at a discount. This increases revenue to cover fixed costs, often an incentive, but destroys profit and long-term competitiveness.

'Hyperactive' companies should aim to utilize complexity reduction and spare capacity to improve service levels/ differentiate offerings to their customers. For example, by using freed up capacity to have more changeovers in a production environment, companies are able to keep work-in-process (WIP) and inventory costs low but increase service levels via shorter lead times.

Near Greatness

Characterized by high Operating Margins but low Asset Turnover, companies in this category have the right focus on their customers and product offerings. But compared to the competition, they require more assets to produce each dollar of revenue. 'Near Greatness' companies would benefit by reviewing their asset portfolio and potentially achieving fixed cost release.

Often, profitable companies are reluctant to take cost cutting measures that remove options. Examples include divestiture of infrequently used equipment or consolidation of under-utilized assets. Though this is understandable due to a general desire for operational flexibility, 'Near Greatness' companies often like to keep options open and desire more flexibility than is required based on forecasted demand. Maintaining lean operating discipline will benefit these companies, as complexity will have fewer places to hide and the costs associated with complexity will thus be kept at bay.

Winning

Characterized by a Strong Capability in Optimizing Complexity, companies in this category will still benefit from performing ongoing reviews of their product portfolio, proactively preventing complexity from creeping back into their business, and utilizing tools to drive profitable growth. Be wary of a focus on a singular metric as they typically give only a partial answer. Complexity creeps in over time, so even the best run organizations need to guard against gradual product proliferation, erosion of service levels and inflation of costs. A key leading question for 'Winning' companies may be: is the complexity of your portfolio growing faster than your revenues over time? If so, take action promptly to preserve the good fundamentals of your business.

Step 2: Identify and quantify existing interdependencies and internal changes for the benefits to materialize

Once you've established an outside-in view, the management team will have a strong sense for what needs to be the "anchor" goal for driving benefit: fixed cost release, or focus on service levels, or potentially both. Step 2 clarifies the end state through analysis, accounting for interdependencies and changes required for benefit capture.

Embarking on Step 2 is where many management teams stumble as uncertainty takes hold and teams find themselves in a state of analysis paralysis.

The reason paralysis sets in is that identifying and accounting for interdependencies can be dizzying! Take, for example, a recent manufacturing company client in the 'Near Greatness' quadrant aiming to improve service levels and, correspondingly, revenues. To do so, a determination was required as to how increased service levels would equate to increased customer willingness to pay. Operationally, increasing service levels required smaller batch sizes and freed up capacity to allow for more product line changeovers. More changeovers resulted in higher scrap costs, but reduced WIP and associated working capital. From a commercial perspective, training was required to augment sales force skills. Customer call centers required refined service-oriented processes. And so on…

It is important to consider interdependencies such as those mentioned above in advance. For Focus Areas 1 and 2, you will need to consider areas such as:

- Product profitability after correcting for complexity costs. This is a critical facet for identifying the optimal portfolio. The key is to make the link between products and their fully-loaded profitability, taking into account both the fixed and variable costs required. From our experience, low-volume products as well as those with high variation in demand are almost always under-costed using traditional costing techniques. Conversely, high-volume products and those with low variation in demand are over-costed. It is crucial to correct for imprecise cost allocation techniques.
- Cost and Service Breakpoints. This will tell you how much capacity is required to achieve Focus Areas 1 and/or 2. With respect to fixed cost release, you need to explicitly define the cost-level breakpoints at which assets can be released by either cutting products or moving their production to alternate facilities. Regarding service level increases, you need to conduct customer research and competitor analysis or leverage current management understanding to ascertain customer willingness to pay corresponding to augmented service levels.
- Migration paths and one-time costs. This will detail the costs associated with transitioning the business to the desired future state, which may include costs associated with closing facilities, discontinuing or moving production. Moreover, this will highlight the "choreography" required to execute on the SKU reduction plan and adjacent initiatives. To make complexity reduction count, there are nearly always a set of "before" processes and "after" processes, which need to be planned and executed.

Step 3: Translate the What to the How and Move to Execution!

Step 3 is robust project planning, translating what in Step 2 to how by layeringin deliverables, activities, timing and responsibilities. While volumes have been written on the topic, a few complexity reduction best practices will greatly increase your odds of capturing full benefits:

- Invest sufficient time educating the team on how complexity reduction will benefit the business. Any time you change peoples'

jobs, you'll encounter resistance. Also it's not uncommon for the internal team to become attached to the idea that a particular asset or product category is critical, and should not be touched, no matter what the data says. It's essential to keep reinforcing the messages around the business case.

- Sustain project momentum through the right cadence and right team structure. Ensure the team includes "doers" (analysts/line management) and "thinkers" (senior people that can make decisions), and includes key representatives from major functions involved. Appoint a senior project sponsor to quickly remove roadblocks and make final decisions. This person should be capable of holding the line, the point of elevation for dealing with the (almost inevitable) set of issues that crop up. Use weekly Steering Group meetings to keep urgency high, elevate issues and ensure tight deadlines.
- Actively manage customers' expectations and commercial risk. One common barrier to complexity reduction is the perceived fear of losing a customer with a portfolio change. However, this is often overstated, particularly if communication with customers is handled well. Bring out the positive messages. Promote the benefits of complexity reduction (e.g., improved response time, sales force focus, etc.) and if necessary, offer meaningful assistance transitioning customers from one product to another, such as a promotional price break.

The 5% profit uplift

Many executives know that their business is too complex and want to affect change to make their business simpler to operate and more profitable. From our experience, their instincts and judgment are right: many companies achieve a bottom-line boost of 5% or higher by attacking complexity.[7] Complexity reduction is not easy; it often requires companies and people to work differently, and may require a direct engagement with customers. Given the arduous nature of the task, companies need to be confident of realizing the benefits at the end of the day. With the approaches and mindsets described in this article, companies can more confidently attain the rewards from their complexity reduction initiatives.

From our experience, low-volume products as well as those with high variation in demand are almost always under-costed using traditional costing techniques.

[7] Wilson Perumal & Company project experience

Key Takeaways

- Complexity removal provides the opportunity for financial and operational benefits. But benefit capture, as a deliberate set of actions, needs to be considered explicitly at the outset; otherwise the benefits usually fail to materialize.
- Complexity reduction can expose perceived trade-offs – the notion that you can have either cost improvement or service-level improvements. Complexity reduction often yields both.
- Complexity reduction efforts that fail to identify where the benefits will come from tend to falter in the face of concerns about the impact of revenue loss. Conversely, complexity reduction is most likely to succeed when it is simply an enabler to reaching a significant and meaningful benefit (such as fixed cost release).
- Identifying and executing the best option requires the following 3 steps:
  - Take an "outside-in" view, utilizing the Asset-Margin Matrix to assess the areas of biggest opportunity.
  - Identify and quantify existing interdependencies and internal changes for the benefits to materialize (above and beyond the complexity reduction itself).
  - Translate the What to the How and move to execution!

Starbucks Turnaround

Since the start of their turnaround in January 2008, Starbuck's share price has more than doubled, outperforming an index of its peers by 50%. To achieve this relative outperformance, Starbucks launched an aggressive, effective, and well chronicled turnaround that serves as a model for companies moving from the 'Under Performing' to the 'Winning' quadrant.

Starbucks' stock price declined more than 40% in 2007 with dire prospects as the recession took hold. Operating Margins were in freefall and the company seemed burdened by overexpansion, rising competition in the premium coffee market, and an increasing "commoditization" of the brand. It was not merely an issue of cyclical forces at play because many of Starbucks' competitors were profiting, as shown by the modest gain in the Dow Jones Restaurant and Bar index or McDonalds' near 40% gain in 2007.

Starbucks recognized the need to take on both fixed costs and boost service levels. During the turnaround the company closed more than 900 stores, reined in expansion and associated capital expenditures, and eliminated more than 1700 non-store support and management positions and 6000 associate jobs. On the service

side, Starbucks invested in new technologies, training, and processes to improve the customer experience. Some of the renewed quality practices moved the store-front operations away from previous efficiency-oriented practices. For example, the baristas "returned to the practice of grinding whole beans" and brewed "smaller batches with a hold time of no more than 30 minutes." These changes paid off as indicated in the 2009 improvement in YOY same-store sales, growing cash balance, elevated 2010 forecast [8], and significantly increased ROIC.

Jan 2008: Announce return of Schultz as CEO with plan to: ① improve customer experience, ② slow store openings and close under-performing stores, ③ realign organization and management, and ④ accelerate growth abroad

July 2008: Announce closing of 600 stores and reduction of 1000 non-store positions at a cost of ~$340M

Sept 2009: Reduced store openings cut Capex by 50% from $985M in 2008 to $450M in 2009.

Mar 2010: Gains continue with cash surplus enabling first cash dividend and authorization for additional share buyback

May 2008: Investments in tools and training to boost quality and consistency of in-store experience including changes to brewing methods and introduction of newly acquired brewing tech

Jan 2009: Announce closing of 300 additional stores and 6000 associated positions plus the elimination of 700 non-store positions

H2 2009: Cost reduction targets ahead of forecast; EPS improves 50% yr-over-yr and operating. margin moves from (0.8%) to 8.5%. Growing cash balance enables payoff of all short-term debt.

General

Fixed Assets Focus

Service Focus

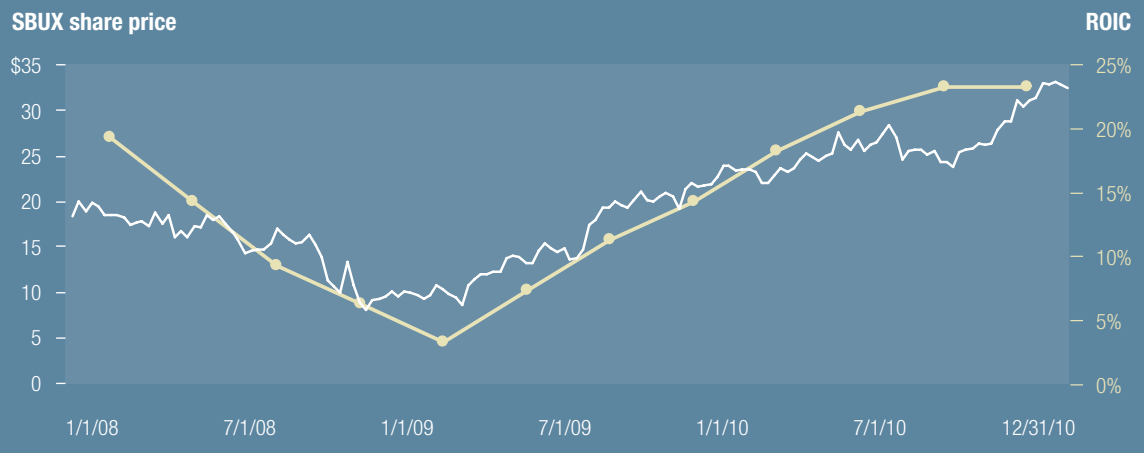

Figure 3: Bold changes made by Starbucks from 2008-2010 and the correlation between ROIC improvement and stock price

[8] Starbucks annual reports, 10-K and 10-Q filings, Investor Conference Call Transcripts 2007-2010

This article was authored by:

Stephen Wilson, Managing Partner with Wilson Perumal & Company, Inc. Contact Stephen at swilson@wilsonperumal.com.

Craig Foos, Manager with Wilson Perumal & Company, Inc. Contact Craig at cfoos@wilsonperumal.com.

Gabriel Wilmoth, Consultant with Wilson Perumal & Company, Inc. Contact Gabriel at gwilmoth@wilsonperumal.com.

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Wilson Perumal & Company, Inc.

Two Galleria Tower
13455 Noel Road, Suite 1000
Dallas, TX 75240

contact@wilsonperumal.com

www.wilsonperumal.com

Wilson Perumal & Company, Ltd.

100 Pall Mall
London SW1Y 5NQ
United Kingdom