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Unlocking Profitability in the Complex Company

When it pays to simplify for value

By Jamie Bonomo and Andy Pasternak

Whether through acquisitions, customer and channel proliferation, or tailoring of products for powerful customers, many large companies find themselves thrashing about in a sea of complexity. Not only does the enterprise become difficult to manage, but some high-maintenance customers also become hugely unprofitable. By winnowing certain products, brands, or customers, repricing others, and rationalizing manufacturing and distribution capacity, companies can simplify their way to dramatically improved profitability. The trick is determining how to “simplify for value” without jeopardizing either near-term performance or future growth prospects.

Companies today are under intense pressure to deliver growth. As internal functions mobilize to respond to this challenge, they may unwittingly make the business worse. The zeal to drive revenue growth can introduce a costly and unmanageable level of complexity, which obscures pieces of the business and drags down overall profitability.

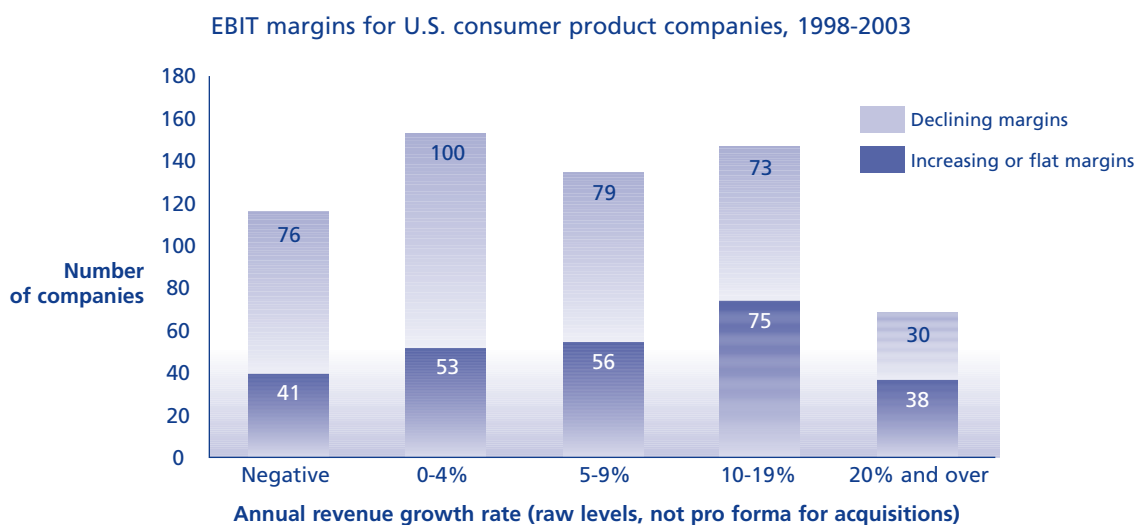
Sales, marketing, and design staff are driven to innovate, introduce new products, acquire new customers, and enter new markets in search of revenue growth and market share. Managers add products, brands, channels, and customers one at a time without regard to the cumulative impact on the business as a whole. Manufacturing personnel, who need to utilize expensive production assets, develop plans to accommodate new volume opportunities; they fill plant capacity in ways that strain their manufacturing and distribution systems. And mergers and acquisitions, although conceived to strengthen strategic position, often create large, disparate operating environments that are difficult to integrate or simplify.

This gradual proliferation and resulting complexity introduce costs across the business in ways that are not readily apparent or easily traced to their origin. They also obscure the profit contribution of any individual component, making it difficult for senior managers to make the right calls on what to offer, at what price, and to whom. Current profitability and future earnings potential both suffer.

This is why some companies with a growth orientation are actually experiencing profit stagnation or decline. Mercer Management Consulting analyzed the financial performance of more than 600 U.S. consumer products companies from 1998 through 2003. We found that fewer than half the companies with annual revenue growth rates of 5% or more also achieved increased operating margins (Exhibit 1). Over one-fifth of these firms experienced an absolute decline in operating income. While revenue growth must be part of any strategy to enhance profitability and shareholder value, it's not sufficient in itself.

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Exhibit 1 Revenue growth is no guarantee of profits

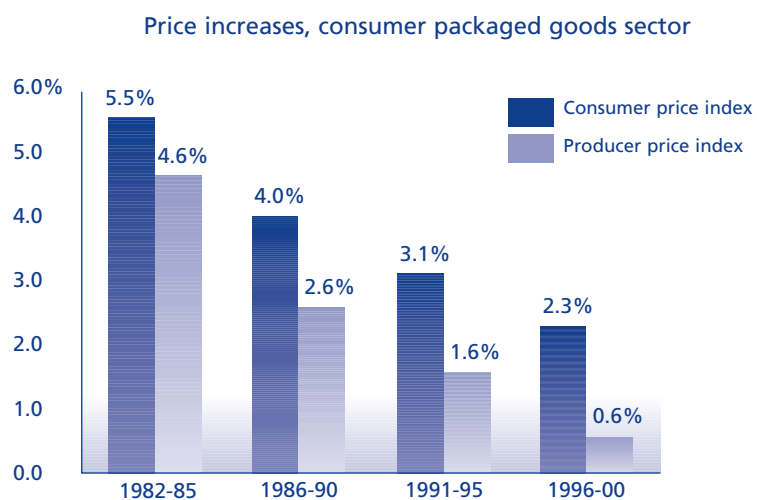


Note: The analysis covered 621 publicly traded companies.
Source: Compustat, Mercer Management Consulting analysis

This situation is increasingly a problem for consumable and durable consumer product sectors, including food, household goods, apparel, and electronics. For most suppliers of consumer products, pricing power has deteriorated over the past two decades, making the pressure to deliver revenue growth on the base business that much more intense (Exhibit 2).

Not surprisingly, most strategies in this sector are built around product innovation, designed to upgrade consumers to higher price points and gain market share. As a result, the number of new stock keeping units (SKUs) introduced annually in U.S. retail channels has nearly doubled

Exhibit 2 Suppliers' pricing has eroded



Source: U.S. Department of Commerce

over the past decade to 30,000. Annual SKU growth of 5% to 10% in a typical consumer product company's portfolio, when compared to annual volume growth in the 1% to 2% range, has eroded productivity in manufacturing, distribution, and sales and marketing. Unilever's detergent segment, for instance, has experienced a 26% decline in its revenue/SKU ratio over the past five years.

Compounding this problem has been the rise of private-label goods, which now represent one-fifth of total retail sales. Some of the fastest-growing retailers have the most ambitious private-label strategies, designed to help differentiate their value propositions; at Target, for instance, half of all SKUs carried are now private label. Expanding SKU portfolios to meet the private-label and branded requirements of retailer accounts further increases complexity for suppliers.

Finally, the quest for revenue growth has driven many consumer product companies on an acquisition binge—over the past decade, one major acquisition every other year for the average consumer product company with more than \$1 billion in revenue. Purchases of many businesses and brands such as Slim-Fast, Quaker Oats, Best Foods, and Rubbermaid have come at prices that often exceeded two times annual revenues, creating growth pressure to deliver returns on these investments. Many smaller suppliers today are roll-ups of smaller regional businesses with distinct brands, product sets, and manufacturing and distribution networks. Senior management, reluctant to force integration and risk performance disruption, often allows the acquired companies to continue operating independently, leaving the firm with redundant resources and assets.

A good example of a U.S. company in this situation is Newell Rubbermaid. Through a series of acquisitions during the 1990s in writing instruments, picture frames, cookware, and storage and cleaning products, combined with an aggressive rollout of new products, Newell created a portfolio of hundreds of brands and thousands of SKUs operating across a manufacturing and distribution network of more than 200 facilities. While Newell's revenue has grown modestly, operating margins declined from more than 13% in 2000 to 9% in 2003. Other factors such as raw material pricing and the overall economic environment no doubt contributed to Newell's poor performance, but the complexity of its networks and proliferation of marginal components clearly have constrained profitable growth.

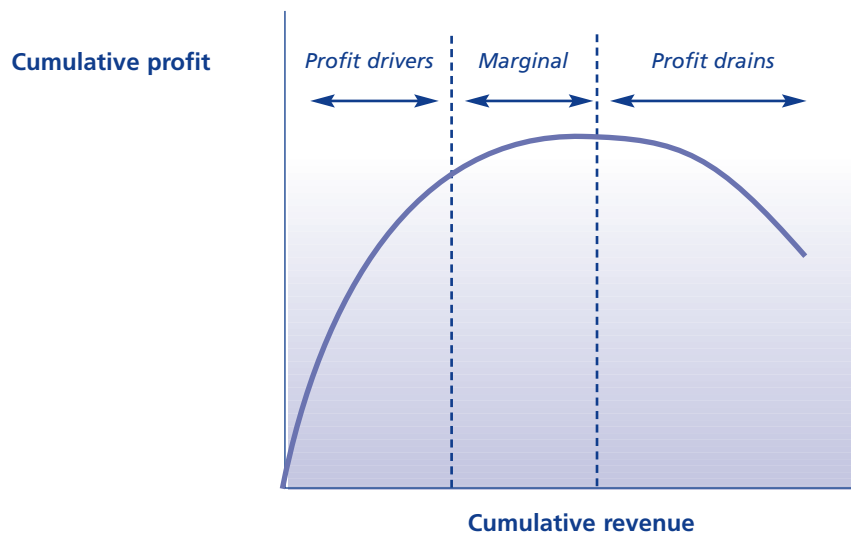
Where profits really come from

Within the large, complex company a more profitable entity is waiting to emerge. Conceptually, the profitability profile of the total enterprise looks like Exhibit 3. A subset of any individual business component, whether that component is brands, products, channels, or customers, constitutes the vast majority of profits. Other, marginal subsets contribute little to profitability as currently configured and likely do not justify invested or potential capital. The remaining subsets destroy value for the enterprise based on their actual direct contribution or their impact on systemwide economics.

How can companies in this situation unlock profitability in their core businesses? Our work with one multi-billion-dollar consumer products company with operations in the U.S. and Europe, which we will call Milo, suggests how to proceed.

Milo operates several businesses serving retail and institutional channels. Milo's revenues doubled in the late 1990s, mostly through a regional roll-up of mid-size companies operating

Exhibit 3 The profit concentration curve



in relatively distinct geographies. Decisions about product introduction, brand management, and network operations remained largely local, with an incentive system and culture focused on revenue growth and local economic performance. The company's private-label programs also were becoming a larger share of the overall business mix.

This growth strategy created a complex company that was difficult to manage. By 2002, Milo had roughly 50 manufacturing facilities, 600 distribution centers, over 10,000 SKUs under 100 brands, and thousands of retail and institutional accounts representing numerous channels and methods of distribution. Moreover, the business mix had deteriorated, moving from higher-margin areas—defined as high volume per SKU with favorable pricing and manufacturing/distribution dynamics—to lower-margin areas. Operating margins declined from 10% in the late 1990s to 2% by 2003.

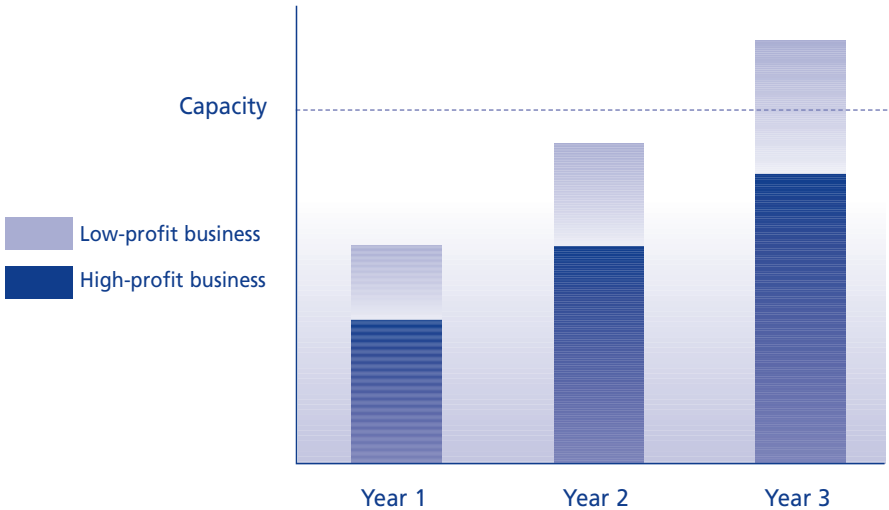
The first requirement was to gain a better understanding of where Milo made and lost money. This task was more difficult than anticipated because Milo lacked consistent information and systems across its many businesses and geographies, and because its “shared costs”—those which could not be directly attributed to individual components—represented nearly half of the total cost structure. The analysis revealed large profit disparities in Milo's lines of business, brands, products, and customers. The company's private-label business had especially unfavorable economics, with contribution margins of -14%.

One case in point was a customer we will call MacGuffin. A long-time, large account, MacGuffin was seen by Milo's managers as one of the two most important customers in a particular geography. For Milo, however, pricing was unfavorable and the complexity of serving MacGuffin was staggering, owing to nearly 30 product SKUs developed specifically for this customer. Milo used four manufacturing facilities to produce these SKUs and operated a “mixing center” to aggregate orders across plants, primarily for MacGuffin. All totaled, MacGuffin generated \$5 million in annual sales for Milo but, when properly analyzed, lowered the bottom line by \$700,000.

Identifying the brands, products, and customers that constrained profitability highlighted two underlying issues. First, it's important to identify and evaluate the cost impact of a given component on the total system from the sales front end to the operations back end. In the case of MacGuffin, the cost to Milo of reduced manufacturing line productivity because of SKU complexity, transportation to the mixing center, the operation of the mixing center itself, and sales resources to serve this high-maintenance customer had not been attributed to this account, but rather was spread across all accounts in the region. So Milo had been overstating the profitability of its business with MacGuffin, while understating the profitability of and, therefore, the imperative to grow its business with other customers in the region.

The second issue illuminated by Milo's situation is that decisions about pricing and selection of products, brands, customers, and channels should not be made on the margin—that is, assuming that the cost of infrastructure is fixed and that existing excess capacity is essentially free. This is an easy logic trap to fall into when managers figure “the plant is there anyway.” However, this logic only applies to the very near term and leads to problems over a longer-term horizon. As illustrated by Exhibit 4, a company that thinks it is expanding capacity in order to grow the profitable components of the business may unwittingly be accommodating the marginal or unprofitable components.

Exhibit 4 **What's really triggering the need for new capacity?**



Integrating the parts

The key to unlocking profitability in complex businesses is creating integrated strategies that address the economic and strategic implications of key decisions across the entire value chain. Developing this understanding requires an evaluation of how individual components impact key performance drivers at each step in the value chain, whether that be promotional effectiveness in marketing, sales force productivity, or waste, utilization, and labor intensity in manufacturing. These drivers will be specific to the business, of course. Additionally, costs and assets often assumed to be fixed in nature should be considered at least somewhat variable.

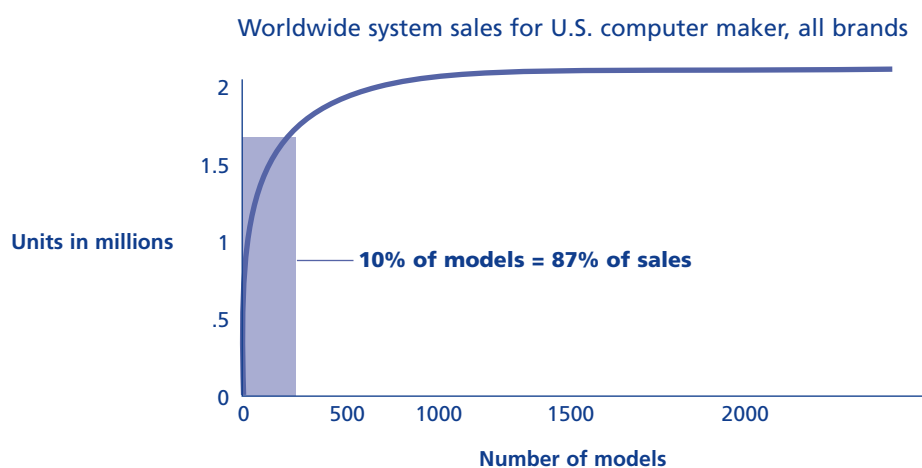
This approach can be applied across the spectrum of decisions, from those that are highly strategic and long term in nature to others that are quite tactical and quickly implementable.

Consider a few integrated initiatives that were developed at Milo and other clients:

- **Rationalizing brands and SKUs.** Most complex companies will find that they have brand or SKU revenue concentration curves with “long tails.” Lower-volume brands or SKUs at the end of the tail need to be evaluated along several front-end and back-end dimensions, including customer imperative (the additional customer reach relative to base brands or SKUs); customer loyalty, satisfaction, and relevance; base economics (revenue and gross margin contribution); and systemwide operational impact (the added burden on manufacturing and distribution productivity and asset efficiency).

As shown in Exhibit 5, a U.S. computer maker discovered that many low-volume brands and SKUs offered little additional customer reach, had low absolute levels of revenue and gross margin, and added significant complexity to its system. As a consequence, manufacturing and distribution productivity were reduced by 10% to 20%, meaning the company was employing up to 20% of its assets to support marginal brands and products.

Exhibit 5 **It takes just a few**



Source: Mercer Management Consulting client example

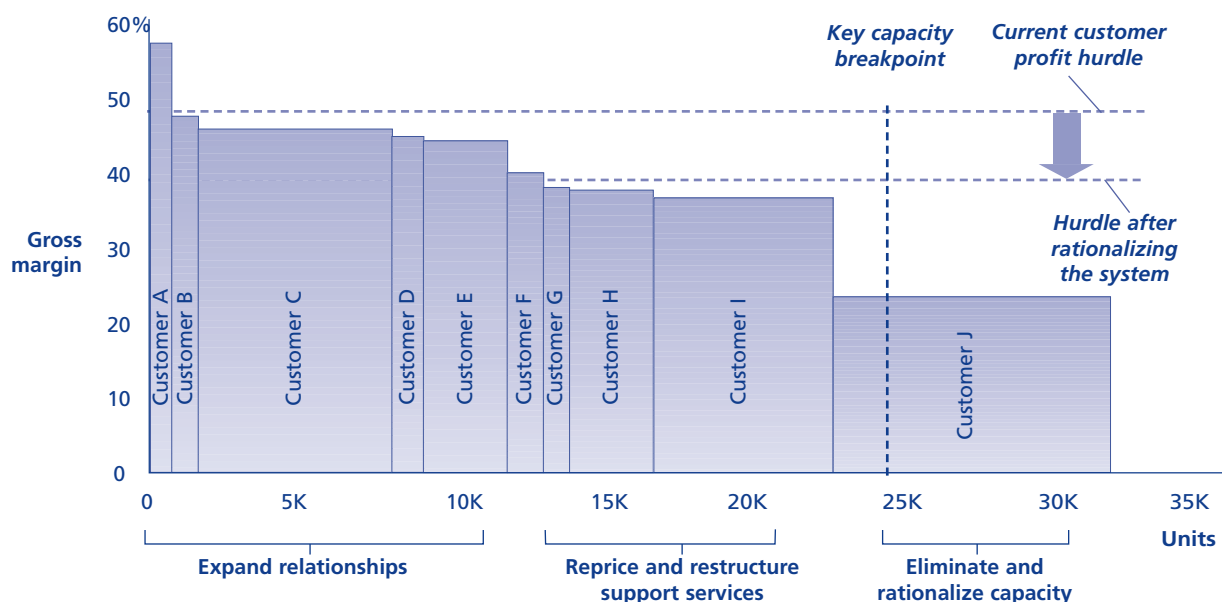
By carefully targeting the right brands and SKUs (anywhere from 10% to 30% of the total, depending on the line of business), the computer maker was able to free up significant capacity with negligible loss of revenue and volume. This was not a purely operations-driven effort, however, because customer considerations were paramount. The company used a methodology from the field of discrete choice modeling to estimate demand for its various brands and SKUs and to know exactly how and why customers chose those products. Managers could evaluate tradeoffs among changes in volume, pricing, and systemwide costs, thereby creating an integrated perspective on their options.

- **Realigning customers and networks.** In several geographies, Milo had a number of unprofitable customers as well as opportunities to improve the mix of low-cost and high-cost manufacturing capacity. While eliminating or cutting back on a single account would have reduced overhead absorption, addressing sufficiently large groups of accounts allowed the firm to consolidate facilities and close the highest-cost manufacturing lines.

Armed with this alternative, Milo was in a far better position to renegotiate pricing with its high-cost accounts. Ultimately, this iterative approach, shown in Exhibit 6 for one market, resulted in the closing of a high-cost factory, ending relationships with several poor-performing customers, and repricing terms with other customers. The approach often can lead to dramatically improved profitability (up to 500 basis points in operating margin improvement) and to a sharper focus of selling resources on the profitable accounts with high growth potential.

- **Setting long-term strategy.** An integrated perspective is a prerequisite for senior executives to establish and communicate their strategic priorities. For Milo, we worked with the leadership team to create an Interactive Strategy Model, or ISM®, which is a highly structured, graphical representation of the company’s business model. An ISM quantitatively represents the key performance drivers at each step in the value chain and then evaluates the systemwide impact of different strategies. This rolls up into an integrated financial picture of the business, so the leadership team can challenge its assumptions around performance drivers, choose the most favorable strategies, and set organizational goals. At Milo, the ISM helped the leadership team understand the long-term economics of different growth and pricing strategies across key segments and channels.

Exhibit 6 **Reconciling accounts, profitability, and capacity**



Source: Mercer Management Consulting client example

Note that each initiative incorporates an awareness of the economic implications of various strategies across activities from front end to back end. And in each case, the decisions are grounded in fact-based, rigorous analysis. Even formerly “soft” areas such as brand equity and future customer demand now have the benefit of scientific tools to quantify potential effects, rather than having to rely on extrapolation from the past or on plain instinct. Two elements distinguish this approach from the extensive work conducted in the late 1980s and early 1990s on de-averaged profitability and activity-based costing: an integrated understanding across the value chain and a dynamic perspective on potential strategies and tactics, as opposed to the static one generated by a simple allocation of costs.

■ Unlocking profitability in business-to-business markets

Companies that sell to other businesses often face the same level of complexity as suppliers of consumer products. Large manufacturers find themselves chasing volume to fill up plants, only to find that price breaks have eroded any profit from the additional volume. During lean times, managers pursue unprofitable customers for “strategic” reasons, and that business becomes part of the core. When the economy rebounds, capacity utilization rises and managers spend additional capital to build new plants, which then must be filled again.

The “simplify for value” approach can unlock profits in these B2B companies. For example, one major manufacturing firm has facilities around the world and serves industries as diverse as automotive and telecommunications. Mercer’s due diligence of the company’s profitability identified significant opportunities. In one region, one-third of customers accounted for 100% of gross margin. In another, certain customers had been acquired incrementally several years back and were still being served at a loss of several million dollars. And in one business line, managers were planning to expand capacity when half the current volume produced did not meet the company’s own rate-of-return hurdle.

Based on this analysis, Mercer took several steps to help the company generate immediate and sustainable profitability improvements:

- In markets with excess demand, we identified several million dollars worth of unprofitable or underperforming customers where the company could renegotiate pricing or terminate the relationship.
- We created tools with which managers could identify and monitor products and customers at both ends of the profitability spectrum and take action accordingly.
- We worked with supply chain, customer support, and R&D teams to align their efforts with the most lucrative areas of the business.
- Finally, we identified longer-term opportunities to realign capacity and support functions around high-profit segments, customers, and regions.

To institutionalize this new way of thinking across the organization, Mercer is now working with a cross-functional team on workshops for key managers in the organization. ❖

Exhibit 7 Signs of overcomplexity

Business characteristics	Performance indicators
<ul style="list-style-type: none">• Significant merger activity<ul style="list-style-type: none">– Particularly regional roll-ups• Consumer-oriented industry• Many overlapping brands and SKUs• Sales and marketing rarely coordinate with operations• Privat-label provider	<ul style="list-style-type: none">• Declining or stagnant operating profit margins despite revenue growth• 25%+ reduction in SKU or brand velocity (sales per unit)• Declining manufacturing productivity<ul style="list-style-type: none">– Negative variances to standard

Shifting the mindset

Unlocking profitability in the complex company is not straightforward. With the sales function making pricing decisions, marketing designing the products, operations staff managing capacity, and so on, all of the relevant functions must join the effort. The CEO, general manager, or business unit head has to become the arbiter who makes the tradeoffs that will be best for the company as a whole.

This will stress the day-to-day decision-making processes in most organizations. Not every decision can involve a cross-functional team; indeed, in a business environment that requires speed and agility, nothing would get done if that were the rule.

It's helpful to view the effort to unlock profitability at two different levels. First, enhancing integrated performance is a one-off effort targeted at "cleaning up" the business. It involves non-standard decision-making and cross-functional teams with executive sponsorship. The second level involves continuous improvement of processes and execution. Managers should ask: What can we learn through the completion of the one-off exercise to influence how day-to-day decisions are made? Can these learnings change what we do to prevent (or at least slow down) the creep of complexity into our business?

The organization likely has rules of thumb that guide how people make decisions, so transforming a revenue culture into a profit culture is no small task. Basing the firm's processes and metrics on an integrated perspective is the first step toward a more simple and profitable business. ❖

■ Questions for managers

- Do we know which of our customers make or lose money for the business? Which brands? Which product lines?
- Is our profitability modeling static or dynamic? Do we consider large categories of cost to be "fixed"?
- Does our organization chase volume to drive down fixed costs? Do we think of large, aggressively priced customers as "base load" capacity?
- Is our capacity filled, but returns are still low?
- Is our organization focused on market share?
- How do we address old, inefficient capacity? Do we consider rationalizing volume to reduce capacity but increase profits?
- If a new and highly profitable opportunity came along and we did not have enough capacity to address it, what would we do?
- Do we have local or regional profit centers? How are their objectives balanced against the broader network economics?
- Do support functions such as R&D, Sales, and Marketing set their own agendas, or do they collaborate closely with other groups across the enterprise? Are performance metrics designed to optimize overall profitability?
- Are the functions attuned to systemwide economics?