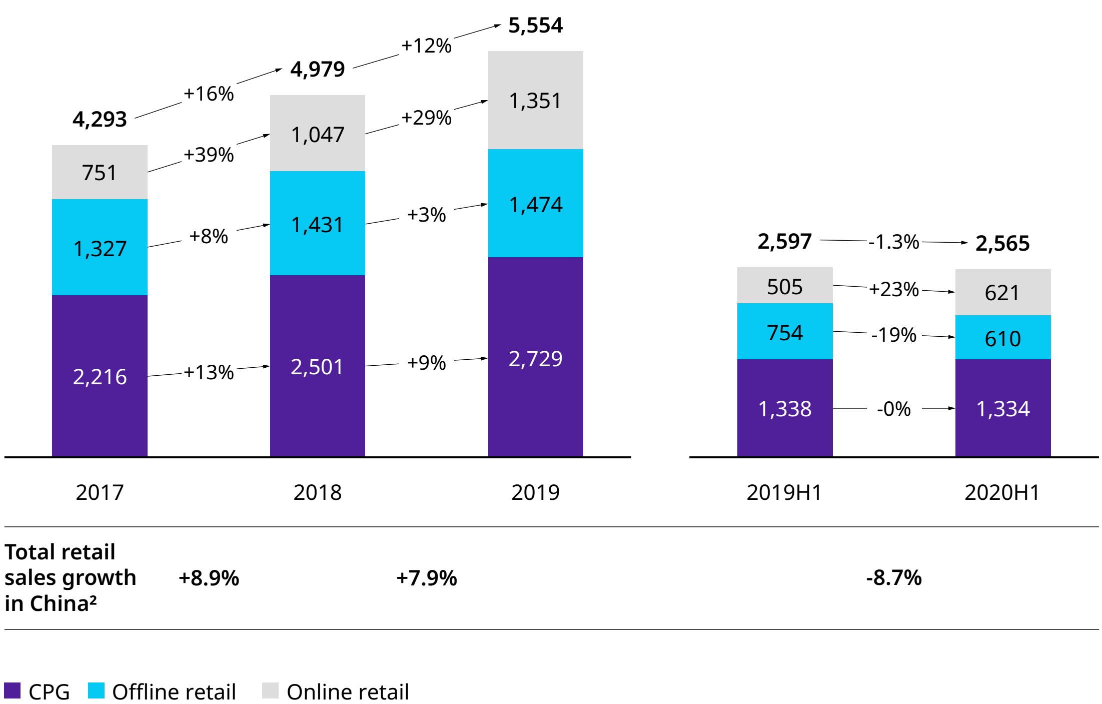
OLIVER WYMAN

TIME TO LOOK AT COSTS

COVID-19 has brought turbulence to China's retail sector, with retail sales declining by 8.7 percent in the first half of 2020. Nevertheless, the top 100 Chinese consumer goods companies managed to keep sales stable during this rocky period. The top 100 retailers also achieved stable sales overall, with the steep decline from offline retailers being negated by the strides seen among online retailers (see Exhibit 1).

Exhibit 1: Total revenue of the top consumer packaged goods (CPG) and retail companies in China[1]

2017-2019, 2019H1-2020H1, RMB in billion



1. The analysis is based on the top 100 CPG players, top 100 offline retailers and top 10 online retailers in the Greater China region of which financial information is available.

2. Year-on-year total retail sales growth compared to the previous year.

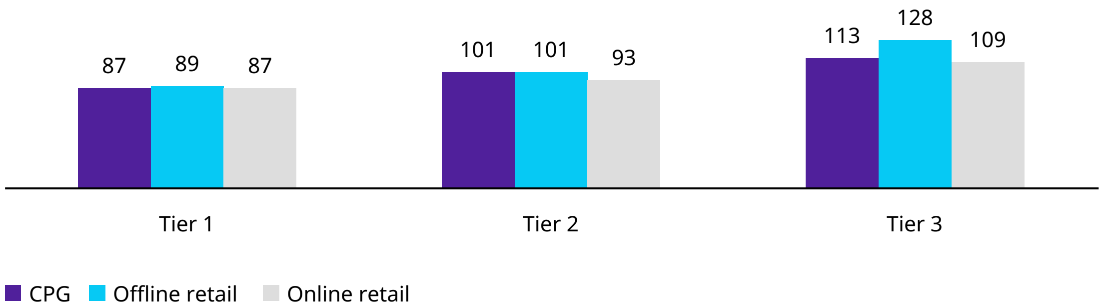
Source: CapitalIQ, National Bureau of Statistics of China, Oliver Wyman analysis

Even so, prior to the COVID-19 outbreak, the leading Chinese retail and consumer goods companies had already seen a steady slowdown in revenue growth, from 16 percent in 2018 to 12 percent in 2019. Despite the slowdown in revenue growth, most of these companies managed to improve their operating cost during this time.

Alarmingly, for one third of the top 100 consumer goods companies and top 100 retailers, costs significantly outpaced the growth of revenue (see Exhibit 2). The bottom third of consumer goods companies averagely experienced a 1.1x increase in the operating costs to revenue ratio. Meanwhile, the bottom third of offline retail companies suffered the most, with a 1.3x increase in this ratio on average.

Exhibit 2: Comparison of operating cost ratio as a percentage of revenue

Indexed 2019 vs. 2018, %



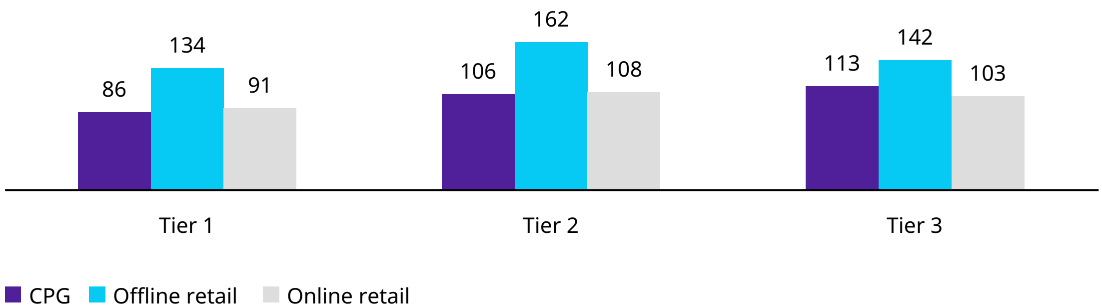
Note: The analysis is based on the top 100 CPG players, top 100 offline retailers, and top 10 online retailers in the Greater China region of which financial information is available.

Sources: CapitalIQ, Oliver Wyman analysis

As expected, operating costs further deteriorated due to the pandemic (see Exhibit 3). While the top third of consumer goods companies and online retailers still managed to reduce their operating cost base amid the pandemic, all offline retailers took a hard hit. The combined impact of the reduced foot traffic during the lockdown, lower consumer willingness to spend amid the economic uncertainty, and inflexibility to adjust operating costs due to a higher fixed-cost base created higher cost ratios and thereby severely challenged the ability of many offline retailers to survive.

Exhibit 3: Comparison of operating cost ratio as a percentage of revenue

Indexed 2020H1 vs. 2019H1, %



Note: The analysis is based on the top 100 CPG players, top 100 offline retailers, and top 10 online retailers in the Greater China region of which financial information is available.

Source: CapitalIQ, Oliver Wyman analysis

Costs have historically been overshadowed by a faster-growing top line. With the market downturn caused by the COVID-19 outbreak, the associated risks of a growing cost base have surfaced and the need to look at costs has become more vital.

General merchandising stores, department stores, and apparel retailers have been the most impacted. The drastic drop in the top line due to store closures and decreasing spending power during the outbreak, combined with the high fixed costs associated with large stores and/or a vast store network, could hardly be remedied with any flexible operational adjustment. Hypermarkets and food retailers, on the other hand, have benefited from the increased spending on food and household products, and food retailers have even managed to decrease their operating expense ratio in 2020.

Exhibit 4: Percentage of retail companies with increased operating cost ratio[1]

% of companies by sub-categories	2018-2019	2019H1-2020H1	Average index of companies with increased operating cost ratio: **2018-2019** (Index 2018=100)	Average index of companies with increased operating cost ratio: **2019H1-2020H1** (Index 2019H1=100)
General merchandise stores	83	100	123	177
Department stores	53	82	166	210
Apparel retail	73	79	149	136
Hypermarkets and super centers	57	57	110	132
Food retail	53	53	142	112
Internet and direct marketing retail	47	40	136	195
Computer and electronics retail	50	33	187	167
Home furnishing retail	33	33	101	124

■ 2018-2019 ■ 2019H1-2020H1

N = 125, for selected companies with available financial data for 2018-2020H1.

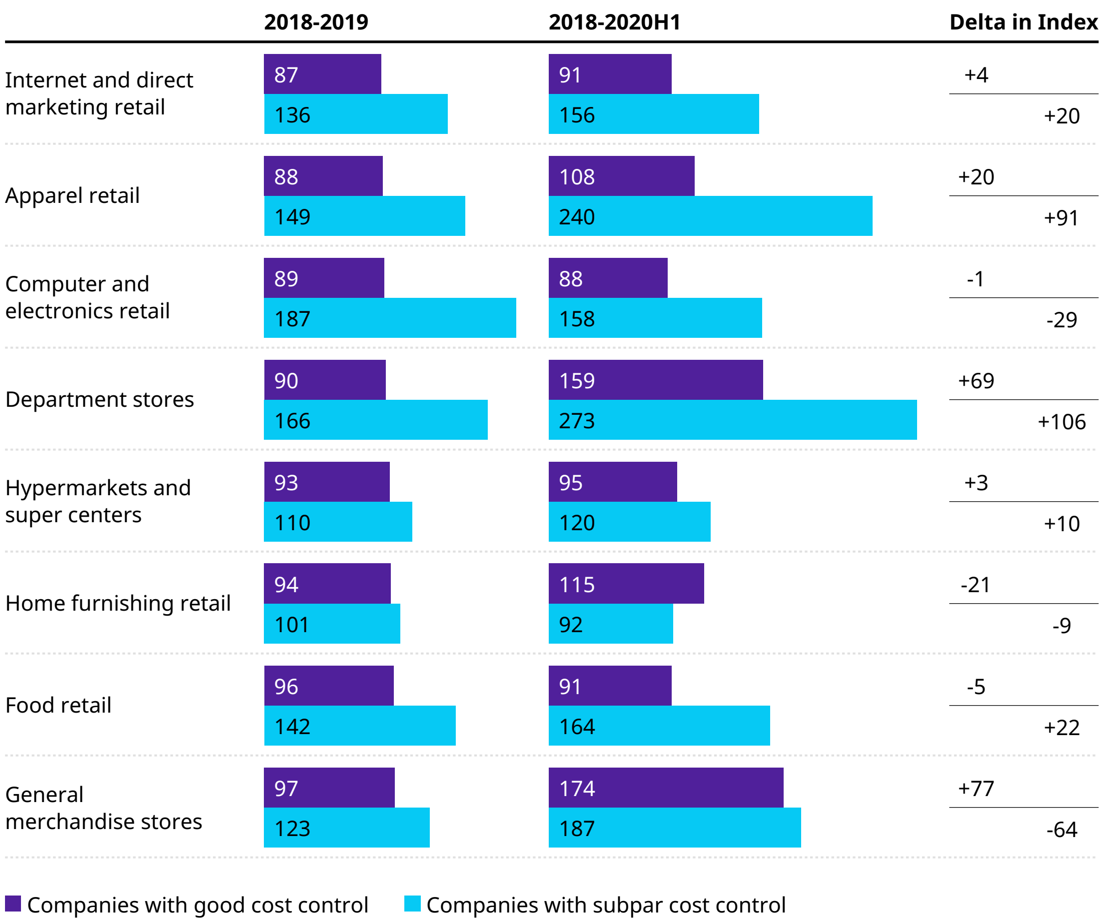
1. Increased cost is defined as index for the operating cost as percentage of revenue is larger than 100.

Source: CapitalIQ, Oliver Wyman analysis

The success of individual retailer in reducing operating costs has also played a significant role in how many of them have survived the pandemic better. Despite the sales disruption that has occurred in 2020, many retailers who managed to lower their operating cost ratios in 2019 also managed to keep their cost ratios in the first half of 2020 below their 2018 levels (see Exhibit 5). Well-optimized cost structures have not only helped retailers limit their losses during the COVID-19 outbreak, but they have also provided them more room to offer post-pandemic discounts during various shopping festivals to capture the retaliatory shopping opportunities that have occurred.

Exhibit 5: Comparison of operating cost ratio as percentage of revenue[1]

Indexed 2018 operating cost ratio = 100



N = 125, for selected companies with available financial data for 2018-2020H1.

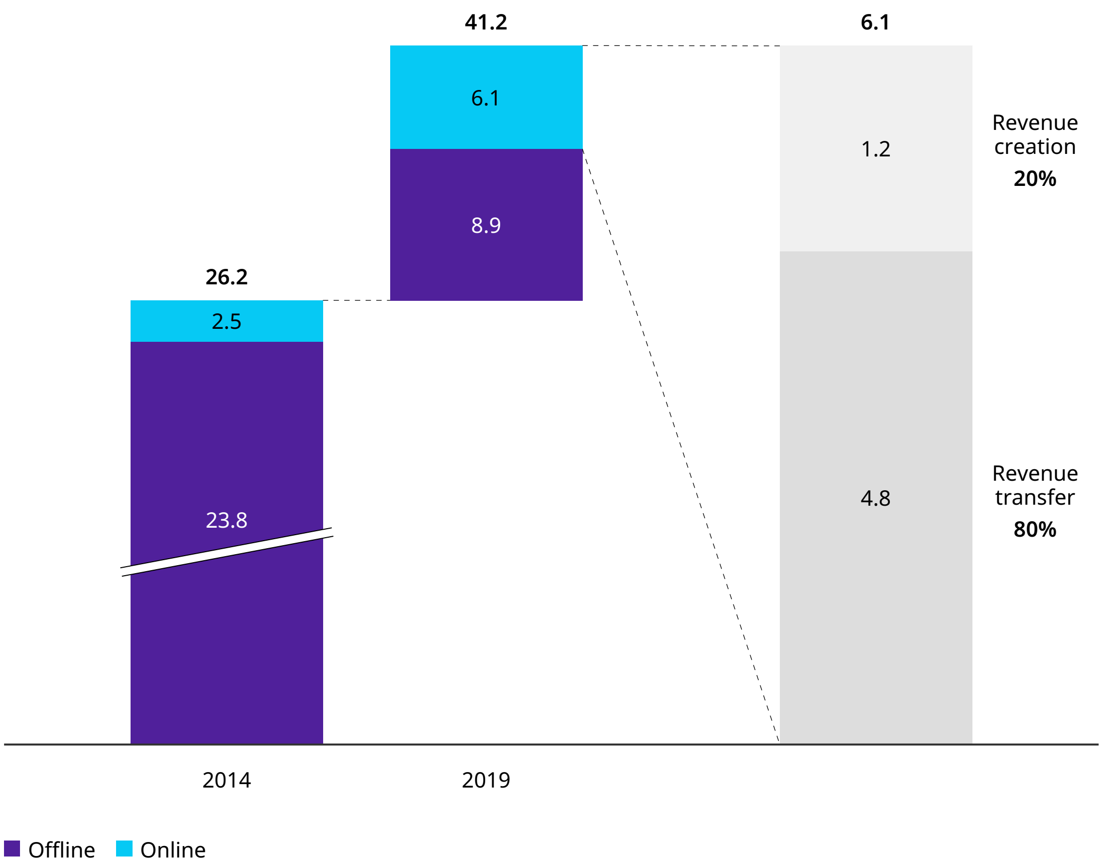
1. Increased cost is defined as the index for the operating cost as a percentage of revenue is larger than 100.

Source: CapitalIQ, Oliver Wyman analysis

The outbreak has accelerated another trend that has long haunted offline retailers, namely, the growing share of the online channel. Between 2014 and 2019, offline retailers had already seen much of their value being captured by e-commerce players. We estimate that about 80 percent of the e-commerce players' growth in the past five years was as a result of revenue transferral from offline retailers, with only 20 percent as a result of revenue creation (see Exhibit 6).

Exhibit 6: Total retail sales by channel in China

2014-2019, RMB in trillion



Source: National Bureau of Statistics of China, Oliver Wyman analysis

The shift has led to a rapid slowdown in revenue growth for the offline retailers and is bringing many of them into negative territory this year (24 of the top 100 offline retailers experienced a loss in the first half of 2020). With e-commerce players continuing to gain ground, offline retailers have also had to start engaging in promotion wars to combat the online players' heavy discounting offered during shopping festivals such as the 6.18 and 11.11 ones. Margins have been redistributed across the value chain to pass on the price savings expected by consumers, and this has only become worse this year with the most aggressive promotions to date to motivate Chinese consumers to start shopping again.

The attempt to fend off the online shift by investing in online-to-offline options has further resulted in a shift in margins. While a greater online coverage could create savings in terms of store expansion and operating costs, such as rental and staffing costs, additional costs are incurred with last-mile delivery and online marketing investments to acquire online traffic.

With increasing top-line pressure, as well as rising property costs and wages, retailers have attempted to pass the burden to their distributors and suppliers, namely consumer goods companies, who in turn are squeezing out margins from sourcing and production to maintain their margin share (see Exhibit 7).

Exhibit 7: Margin redistribution through the growth of online (as a percentage of retail price)
Selected benchmarks

The old world		
Direct costs	50%	Manufacturer margin **69%**
Indirect costs	14%	
Manufacturer profit margin	5.4%	
Marketing costs	2%	Retailer margin **31%**
Store & labor costs[2]	16%	
Logistics costs	4%	
Indirect costs	2%	
Retailer profit margin	7.3%	

The new world	Offline	Online	
Direct costs	47%		Manufacturer margin **68%**
Indirect costs	14%		
Manufacturer profit margin[1]	7.1%		
Marketing costs	2%	-	Retailer margin **31%**
Store & labor costs[2]	16%	-	
E-commerce operating costs[2]	-	16%	
Logistics costs[3]	4%	8%	Retailer profit margin dropped by 1-2 percentage points
Indirect costs	2%	2%	
Retailer profit margin	6.6%	4.0%	
Consumer savings[4]	**1%**		

1. CPG companies avoided margin erosion through reducing direct costs related to production.
2. Store operating costs include rent, labor, and store level expenses and depreciation; e-commerce operating costs include online promotions, such as keyword search and banners, and labor costs.
3. Logistics cost ratios substantially vary across retailers, ranging from c. 2% for lightweight durable goods such as apparel, up to low double-digit for fresh produce, significant impacting the online/offline profitability mix.
4. Margin leakage to consumers as retailers are forced to follow e-commerce giants in heavy discounting.

Source: CapitalIQ, Oliver Wyman analysis

However, once there is no further room to squeeze out margins upstream, both retailers and consumer goods companies will be forced to look into additional cost reduction initiatives. Consumers will only demand more value, not less, and e-commerce will only continue to gain share in the coming years, especially with the acceleration that has come about as a result of the COVID-19 outbreak.

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 we 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.

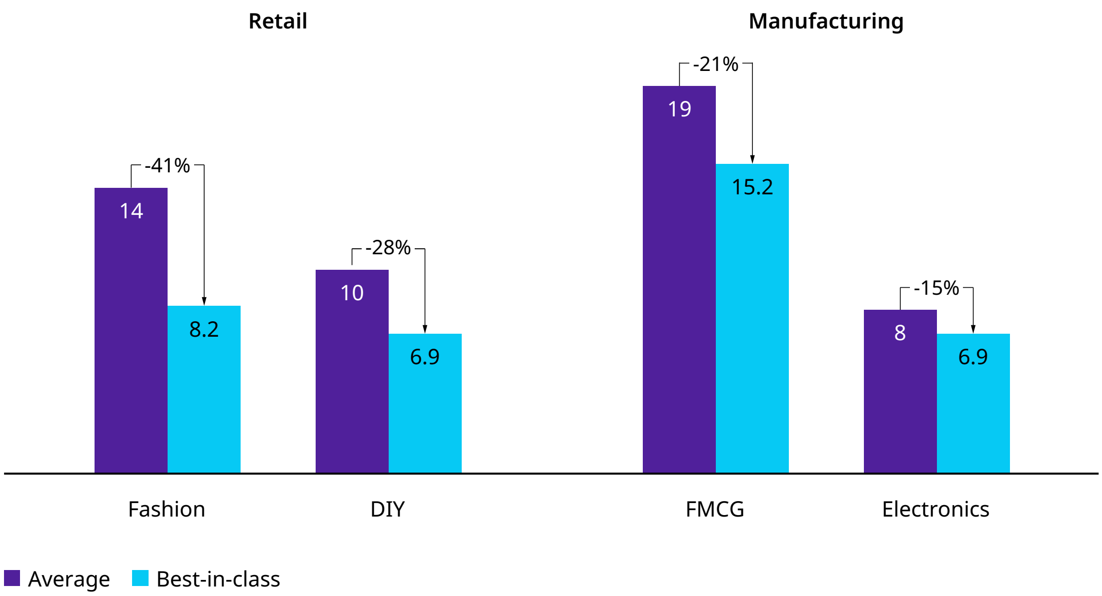
Be customer-driven. Albeit contradictory at first glance, customer focus remains paramount even in the most extreme cost reduction programs. The “customer lens assessment” can serve as an important input for prioritizing and redesigning the company’s services, both internal and external. Customers’ preferences 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 8: Selected indirect spend benchmarks

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

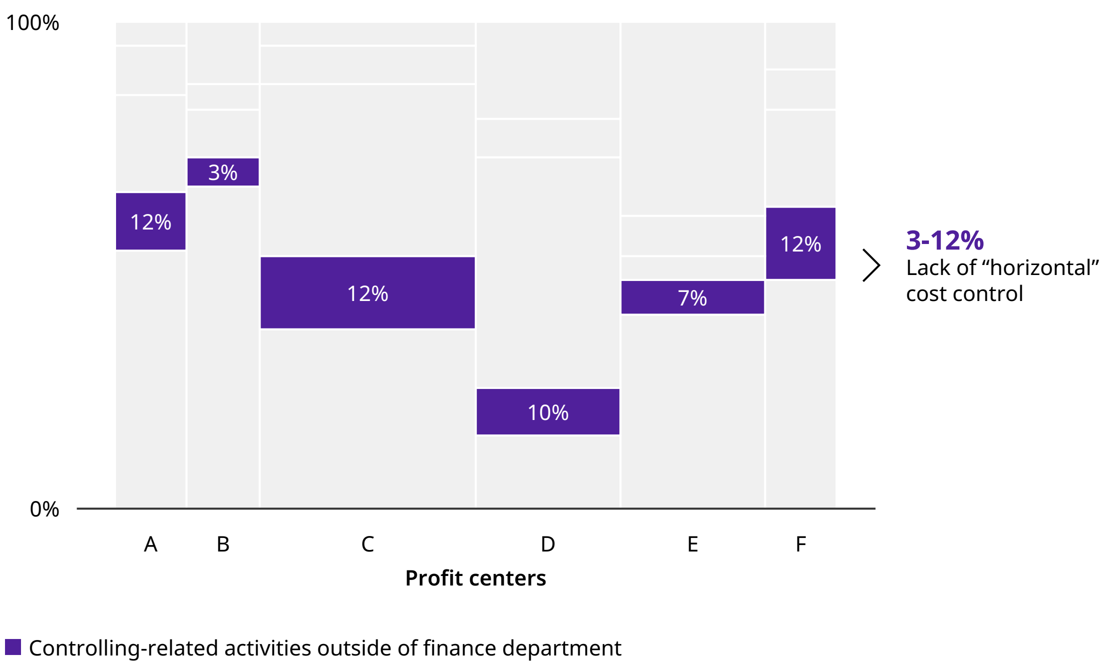


Source: Oliver Wyman analysis, representative industry players selected based on Oliver Wyman experience

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 9: Horizontal perspective on cost



Source: Oliver Wyman analysis

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).

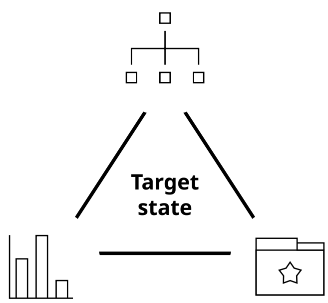
3. ADOPT A ZERO-BASED APPROACH TO ORGANIZATIONAL REDESIGN

A zero-based organization (ZBO) approach emphasizes focusing on the most productive resources by assessing what needs to be done and why. This method incorporates both employee understanding of the required input and understanding of the output desired by customers when making decisions on how to reorganize. This approach is quite unlike other, older techniques: think “cost optimization” rather than mere cost reduction. ZBO reorients people, operations, and organizations, from the head office to the individual stores, to the most productive activities. Those activities that fail to produce real value are reduced or eliminated, while those that pass the value test are likely to be increased — if this is what achieving the strategic priorities demands.

Exhibit 10: Components of a ZBO approach

Target state triangulation

Current organization
(HR database, spans, layers)
Consideration of current organization as a baseline



Benchmarks and external data
Top-down assessment of appropriate staffing targets for teams based on comparable organizations

ZBO bottom-up
(Routines, projects, talent)
Bottom-up staffing targets based on actual activities teams need to perform

The three essential components of a ZBO approach are assessing, benchmarking, and evaluating from the bottom-up.

Assess the current organizational state and review in-store operations: The initial focus lies on establishing the organization’s baseline state and juxtaposing it against organizational-design best practices. The analysis is carried out by tapping into human resources data, supported by interviews with leadership of the organization to establish the “state of departure.” The process identifies and maps the current organizational design in terms of reporting spans, managerial layers, and number of direct reports. From our experience, most organizations develop anomalies in their organizational structure over time. These quirks tend to arise from leadership changes and the evolution of individual departmental reporting structures. By applying standard organizational design principles, the analysis produces a preliminary list of areas at the corporate and individual store level that can achieve improved efficiency. At this point, many traditional efforts would move straight to implementation, but the ZBO approach does not. It is first important to establish what impact such changes might have on the entire business.

A review of in-store operations is also needed for retailers to identify points of inefficiency within each retail process and determine optimization opportunities. These retail processes include ordering and planning, goods reception and restocking, shelving and checkout, and finally cleaning. Once the status quo of the operation is understood, the ZBO approach entails establishing potential solutions to address the inefficiencies, such as poor on-shelf availability, manual labor scheduling, and ineffective training programs.

Benchmark against leading practices: Our approach to ZBO exploits benchmarking while remaining cognizant of the fact that a given organization varies along different dimensions, such as sector, scale, areas of business, mix of products and services, culture, and geographical location. Such a wide variation produces challenges in creating a relevant data yardstick against which one can make useful measurements. Crude benchmarking ignores such nuances, seeking to imagine uniformity where there is none. In contrast, the ZBO approach introduces a point of comparison that highlights glaring discrepancies, while also stimulating further thinking and examination more often than not. We believe that an organization knows to which peers it is more comparable. In cases where the organization can acquire tailored data from comparable organizations, such data is likely to have greater weight in the ZBO triangulation and be more effective in establishing best practices.

Evaluate the ZBO approach from the bottom-up: A bottom-up evaluation is at the heart of the ZBO methodology. The objective is to establish the right organization for the company based on its ways of working and culture. The database for this exercise comes from employees. This approach brings the employees within the “circle of trust”: instead of the ZBO approach being “done to them”, they are an integral part of the process, helping determine its outcomes. In addition to focusing on people at the head-office level, the ZBO approach addresses the people within the company’s stores. By identifying areas of inefficiency within store operations, and developing solutions to address these issues and streamline in-store processes, the ZBO approach ensures a comprehensive reorganization throughout the entire company.

The bottom-up evaluation analyzes all current routines (recurring tasks completed by employees) and projects (non-recurring tasks addressing one-off needs) to establish exactly what is done and by whom. What comes next differs from top-down approaches to cost reduction: the ZBO approach asks why activities are done the way they are and evaluates the value they create. By leveraging industry expertise and specialist knowledge, this process distinguishes between activities that add real value from those that represent low value. As a result, some activities can be eliminated altogether, while others require further investment to better align with strategic priorities.

The ZBO approach is not simply to right-size an organization, but to right-shape it too. By comparing data from the bottom-up evaluation with the appropriate benchmark, a company can identify where employees are producing real value and where they are not. Discrepancies between current and actual staffing needs reveal opportunities for cost-reduction and efficiency.

Essentially, our ZBO approach focuses on making people at all levels of the organization more productive — and this fuels growth. Performance is improved on average by 20 percent, without harming the underlying culture and its ability to stay in touch with the market environment.

4. 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.

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

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