

## Consumer-value operations: An integrated approach to operational excellence

**Best-practice consumer-goods companies are focusing on commercial outcomes, enhancing their capabilities in all operations functions, and exploiting opportunities at the intersections of these functions.**

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Many executives in charge of operations at consumer-packaged-goods (CPG) companies strive to deliver value within isolated functions. For example, heads of manufacturing try to rationalize overcapacity in plant networks, procurement officers consolidate their purchasing to leverage scale, and supply-chain executives seek to centralize their scattered supply-chain organizations.

Such piecemeal efforts, however, won't make much difference unless they're part of a broader operational-improvement effort. Europe's CPG companies are battling a multitude of challenges. Growth is slow to flat in most Western European markets. Commodity inflation and volatility are at

an all-time high. Retailers, in light of slow growth and the success of discount formats, are exerting pressure on pricing and promotions and demanding more custom SKUs—not only making it hard for manufacturers to pass on higher input costs but also driving up complexity costs. And although emerging markets in Eastern Europe continue to show tremendous growth potential, competing profitably requires investing in anticipation of growth—a tall order in an era of profit warnings and budget cuts.

Against this backdrop, isolated operational improvements will have limited impact—and may even be detrimental. Because operations functions are highly interconnected, any move to



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optimize one function independently can undermine another function's performance. A drive to achieve lowest-cost material supply, for example, can at times increase manufacturing and downstream costs.

A big part of the answer for CPG companies lies in what we call “consumer-value operations”—an end-to-end approach to operations that is guided primarily by the consumer perspective and takes into account which products and activities truly drive commercial advantage. Best-practice CPG companies are basing their operations agenda on commercial outcomes, not just “four walls” operations performance. Examples of these outcomes, to which operations can make big contributions, include increasing customer satisfaction to drive share growth, delivering more new products faster, and competing cost-effectively against private labels.

To deliver such outcomes, leaders are managing operations levers holistically (exhibit). Rather than cherry-picking among functional areas or pursuing a “sum of its parts” operations program with disconnected initiatives, they are striving for excellence in all core functions. They are also working much more closely than before with the nominally commercial functions—marketing, sales, and research and development—to exploit opportunities at the intersections of the functional areas. In this article, we outline the elements of consumer-value operations and offer perspectives on how companies can begin to benefit from it.

#### Excellence in core competencies

Operational excellence requires top performance in five distinct competencies, in addition to the “table stakes” of achieving an adequate performance level in areas such as

quality, safety, service, and environmental compliance.

#### Segmented supply chain and planning

The idea of segmenting the supply chain—to serve each customer the right way, instead of serving all customers the same way—isn't new, yet only a few CPG companies have fully implemented it. A company could, for instance, prioritize customers based on profitability and strategic importance, and segment products based on volume and demand variability. This segmentation results in distinct “value streams,” or combinations of customers and products that should be measured and managed in an integrated way.<sup>1</sup> By segmenting its supply system into value streams, one CPG company reduced inventory by 20 to 30 percent and total costs by 6 percent, while significantly improving on-shelf availability at retail stores.

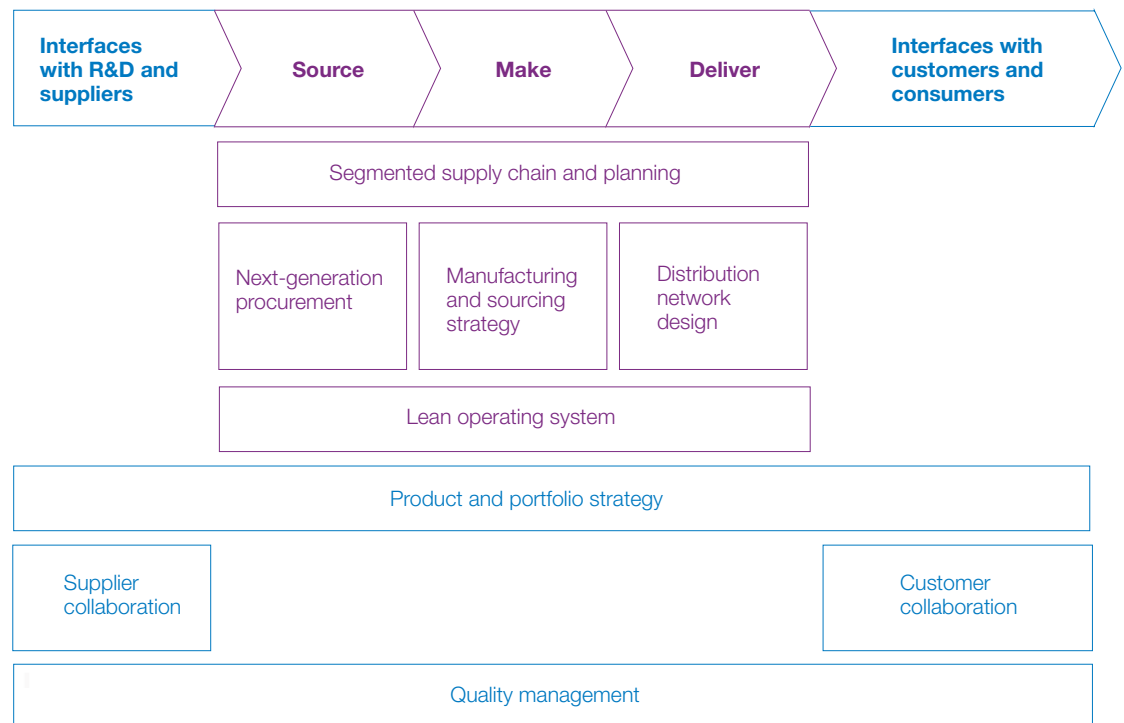
#### Next-generation procurement

Most CPG companies are already building procurement scale, consolidating suppliers, and developing centralized procurement functions. But to offset the volatile commodity environment, leading companies are making more assertive moves. They're pursuing more opportunities to capture scale benefits, such as by joining buying consortia for indirect procurement. They're developing commodity strategies based on distinctive knowledge of upstream supply economics and “clean sheet” or “should cost” models. And they're building risk-management capabilities to mitigate ongoing volatility. By taking these steps, best-in-class companies realize more than 10 percent reductions in direct spend and more than 15 percent reductions in indirect spend, with 80 percent of these improvements achievable in the first two years.

<sup>1</sup>See Yogesh Malik, Alex Niemeyer, and Brian Ruwadi, “Building the supply chain of the future,” *mckinseyquarterly.com*, January 2011.

## Exhibit

### Leading CPG companies strive for excellence in the core functions and at the intersections between functions.



#### Manufacturing and sourcing strategy

Leading CPG companies distinguish between highly efficient “volume” and highly agile “innovation” factories or lines within their manufacturing networks, and manage them with different metrics. They use contract manufacturing in a deliberate way—not so much to manage the balance sheet but rather to provide flexible low-cost capacity or technology expertise not available in-house. They take a long-term view of network investments and build the capabilities needed to refresh their strategies when market and input costs shift. Well-designed networks typically result in 10 to 20 percent lower conversion costs and increased flexibility and

responsiveness. In addition, strict business-case requirements, careful design optimization, and sophisticated project-management approaches can deliver capital-expenditure savings of 20 to 30 percent and improve return on invested capital by as much as 4 percent.

#### Distribution-network design

Given soaring transport costs, CPG companies can’t afford to ignore inefficiencies in their logistics operations. A company should design its network based on precise knowledge of what customers need and which activities add value. In Western Europe, for example, our analysis shows that 14 to 18 strategically located distribution

centers (DCs) can make overnight deliveries to most large retail stores, 9 are sufficient for deliveries within 24 hours, and 6 can handle two-day deliveries. Concentrating inventories in fewer DCs leads to inventory savings; on the other hand, centralization increases transport costs due to longer distances and underutilized capacity. To correctly measure the inverse cost effects, companies must build a sophisticated model that covers all relevant factors. In our experience, companies can typically reduce logistics costs by up to 10 percent while maintaining or even raising service levels.

#### Lean operating system

Leading CPG companies are not only reinvigorating their lean programs in the manufacturing environment—typically achieving 15 to 25 percent reductions in conversion costs as well as improvements in capacity, flexibility, and responsiveness—but also applying lean philosophies across the entire value chain. A CPG company, for example, undertook a three-year lean transformation that started in one manufacturing plant in one business unit, then expanded to other locations, business units, and processes in a carefully sequenced rollout. The

company subsequently introduced lean techniques in planning, procurement, and transportation and warehousing.

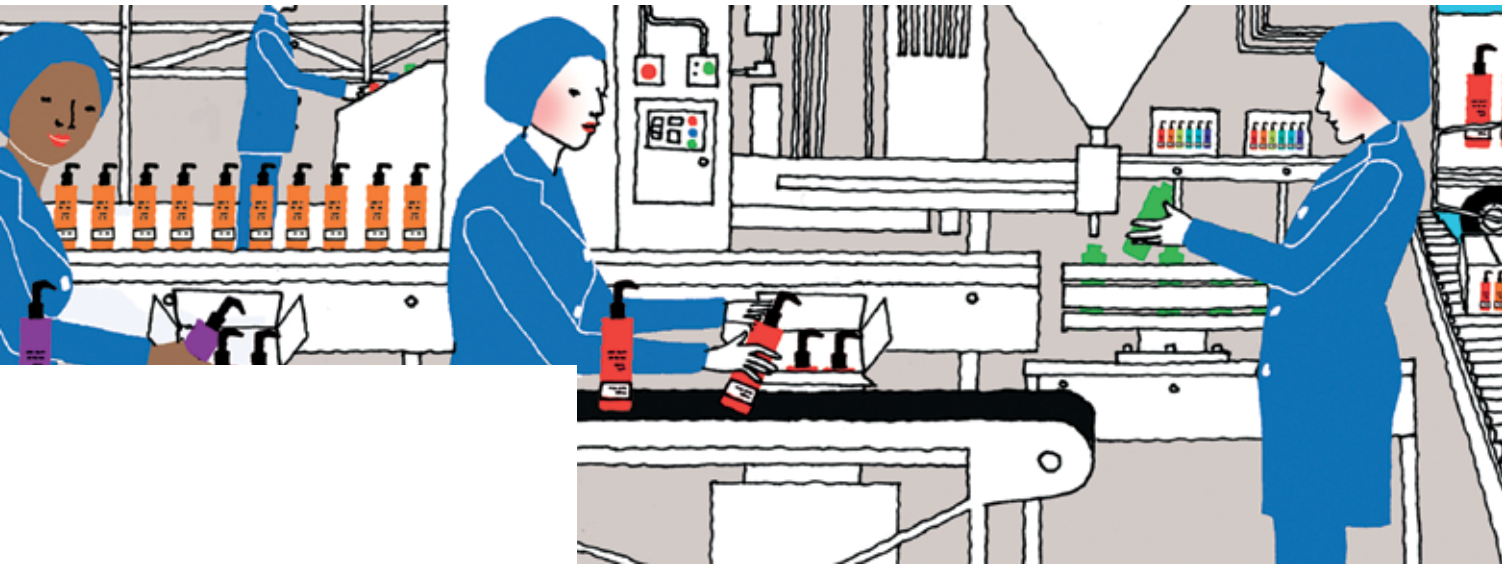
#### Winning at the intersections

The most successful companies don't make trade-offs among functional competencies. Instead, they aspire to best-in-class performance across—and at the intersections of—all functions, as well as in their interactions with suppliers and customers. They develop and execute operations strategies in close cooperation with the R&D and commercial functions. We see four intersections between functions, and between a company and its customers and suppliers, where improvement initiatives can deliver outsize rewards.

#### Product and portfolio strategy

CPG companies face the conflicting priorities of speeding more new products to market on the one hand, and improving gross margins and reducing portfolio complexity on the other. Leading companies break through the inherent trade-offs by developing three institutional capabilities: assortment optimization, “design to value” (DTV), and complexity management.





*Assortment optimization* consists of defining the ideal assortment from a consumer perspective. Leading companies assemble an assortment that covers all consumption occasions and consumer needs without duplication, methodically dropping non-value-adding SKUs that don't serve a strategic purpose and rigorously filling relevant gaps.

Leading companies also apply a cross-functional *DTV* approach to all new and existing products, designing and redesigning products to deliver greater consumer and customer value while lowering cost of goods sold (COGS) by as much as 200 to 300 basis points. They optimize specifications, recipes, and packaging designs

based on both consumer research and a detailed understanding of competitive products' cost structures.<sup>2</sup>

Finally, leading CPG companies excel in *complexity management*, having moved from sporadic SKU-rationalization exercises to a structured product-platforming approach similar to the automotive industry's. They harmonize products and specifications to create a small number of platforms (recipes, material standards, and packaging formats) based on consumer preferences, optimal assortments, manufacturing efficiencies, and other COGS drivers.<sup>3</sup> They drive these platforms aggressively throughout the portfolio and set up their supply chain for

<sup>2</sup>See Ananth Narayanan, Asutosh Padhi, and Jim Williams, "Designing products for value," *mckinseyquarterly.com*, October 2012.

<sup>3</sup>See Jim Brennan, Philip Christiani, Frank Sanger, and David Spiller, "When less is more: How to manage portfolio complexity in consumer goods," *csi.mckinsey.com*, January 2011.

late-stage differentiation to enable faster launch times and multimarket launches.

#### Supplier collaboration

In an industry where supplier-related costs account for approximately 70 percent of COGS, more CPG companies are realizing the need to go above and beyond standard procurement practices. Sophisticated supplier collaboration and development efforts enable companies to create value through reduced packaging, ingredient, and processing costs; greater innovation; and meaningful improvements in quality, service, and sustainability.

A leading food-and-beverage manufacturer used a clean-sheet-based negotiation approach—comparing its current suppliers' costs to best-case scenarios achieved by the most efficient companies—to identify areas in which its packaging suppliers could substantially reduce costs through leaner production methods. It worked with its suppliers to set production-improvement targets, established joint teams to optimize material specifications, and improved data sharing for timelier and more accurate forecasts. Combined, these efforts delivered

15 to 25 percent reductions in packaging-material costs.

#### Customer integration and collaboration

Collaboration efforts between manufacturers and retailers have proliferated in recent years. Many CPG companies, for example, are partnering with retailers to tailor the supply chain and planning approach for new products. Successful retailer collaboration is neither quick nor simple, but the effort pays off. Deeper supply-chain collaboration—on optimizing processes, sharing data, and building logistics networks—delivers a return equivalent to a profit uplift of 4 to 6 percent through a combination of increased sales from better on-shelf availability and reduced costs.

#### Quality management

Quality costs—both direct (such as warranties and replacements) and indirect (including rework and scrap)—are an often-overlooked pool of costs that can be turned into ready cash in the short term and profit-improvement opportunities in the medium term. A comprehensive quality-improvement program can not only reduce quality costs by 10 to 15

**Best-practice companies develop a clear understanding of consumers' quality expectations and perceptions.**



### One CPG company's experience

A global CPG company launched an operations transformation program that focused initially on manufacturing and procurement—the areas in which the company initially perceived the greatest opportunities. But strong transformation results in those areas, along with broader business pressures, compelled the leadership team to expand the scope of the transformation to cross-functional topics such as supply-chain and portfolio management.

Given the scope of change, the company adhered to two guiding principles. The first was to start small, prove the solution, and then deploy. For example, when the company designed new production-planning and scheduling processes and tools, it first piloted them in one country

before rolling them out more broadly. The second guiding principle was to focus on capability building: the company matched capabilities to the initiatives and built capabilities to fill any gaps. It sequenced the implementation of initiatives in waves, employing “train the trainer” approaches and establishing stringent performance metrics and structured performance dialogues. It also built a team of internal continuous-improvement experts to drive higher and more sustainable impact and to encourage widespread changes in mind-sets and behaviors.

The results included 300 to 400 basis points margin improvement, 20 to 30 percent cash savings, and increased operations capabilities.

percent but also spur sales increases of as much as 5 percent due to greater customer demand for the new, higher-quality products.

Best-practice companies first develop a clear understanding of consumers' quality expectations and perceptions—for example, through consumer surveys, third-party rating systems, analysis of social-media mentions, and focus groups. They ensure that their quality strategy and targets reflect these expectations when it comes to the product concept, the product itself (for example, its trustworthiness or health benefits), and the shopping and service experiences. They then translate these quality targets into metrics and key performance indicators (KPIs) for each functional department. One KPI for a manufacturing plant might be the number of

customer complaints per million units; a KPI for a distribution center might be the rate of “perfect” (on-time and accurate) deliveries.

### Executing a holistic operations strategy

Companies intent on implementing consumer-value operations understand that it requires a multiyear transformation. They set high aspirations and dedicate their best people to lead the change (see sidebar, “One CPG company's experience”). And they make deliberate choices about their operating model and IT, both of which are critical to success.

Many CPG companies have moved from country-specific to regional—or, in some cases, global—operating models to capture economies of scale and deploy more highly skilled talent. However, in

so doing they limit their flexibility to meet local demand requirements, which is essential to support growth in emerging markets. Companies that strike the right balance between operating-model centralization and flexibility make choices based on business characteristics, differentiating as needed among markets.<sup>4</sup> They ensure alignment between the operating model and the commercial model by instituting cross-functional processes with joint accountability, especially with respect to sales and operations planning, financial planning, new-product introduction, capital-expenditure strategy, and product-portfolio management.

IT is another crucial enabler of consumer-value operations. Most CPG companies make major investments in enterprise-resource-planning and supply-chain-management systems to support the analytics, integrated information flows, and data harmonization required to deliver on operations transformation. But such systems won't automatically yield results. To capture the anticipated value through IT capabilities, leaders must define their operations strategy, operating model, and sources of value up front, and then

tailor their IT solutions accordingly. They must establish governance bodies encompassing IT as well as business units, and these governance bodies should determine IT-enablement priorities, firmly rejecting IT-related requests that don't align with the strategy. They must also develop a business-driven (not IT-driven) road map that delivers quick wins while ensuring that personnel are trained in new ways of working.



A transformational operations effort can begin with an objective, fact-based maturity assessment, in which the company compares its current processes to best practices in each element of consumer-value operations. This assessment should include an analysis of key gaps and potential roadblocks, as well as a quantification of the opportunity. Such an exercise—if it takes into account the perspectives of stakeholders across functions and regions—can energize and motivate the entire organization, making it an important first step in the journey toward operational excellence. ○

<sup>4</sup>See Martin Dewhurst, Jonathan Harris, and Suzanne Heywood, "The global company's challenge," *mckinseyquarterly.com*, June 2012.