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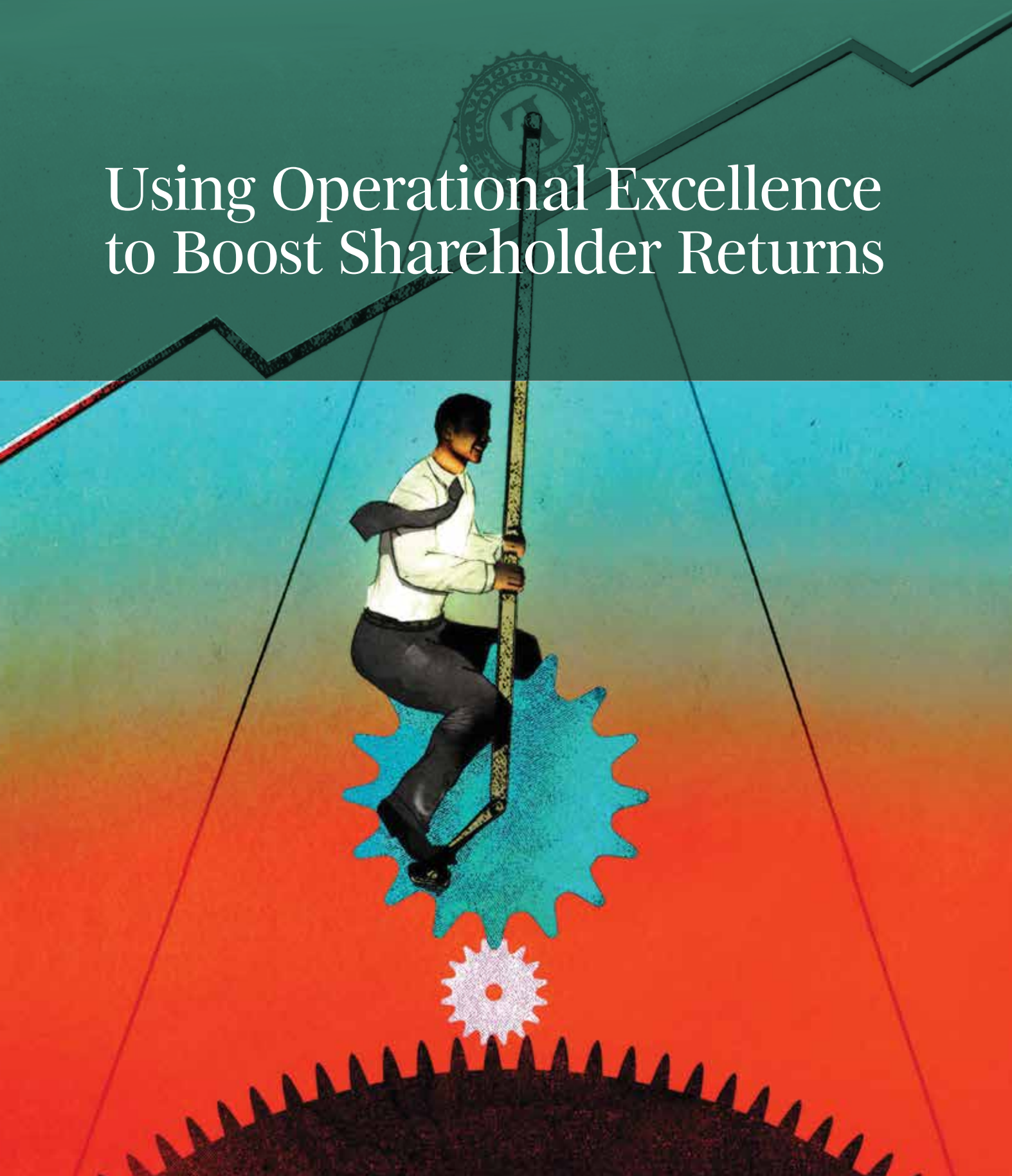
Using Operational Excellence to Boost Shareholder Returns



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Using Operational Excellence to Boost Shareholder Returns

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AT A GLANCE

Operational excellence can be a powerful way to promote sustained shareholder value, but not all efforts to improve operations result in higher total shareholder return (TSR). We examine the connection between operational improvements and TSR, and we highlight the impact of specific cross-functional initiatives.

How Does Operational Excellence Create Value?

Success in value creation is measured in terms of TSR relative to peers or to the overall stock market. Efforts to improve operational excellence can influence the three factors that drive higher TSR: profit growth, changes in investor expectations that affect the valuation multiple, and the cash available for distribution to investors. But these efforts must be properly designed and executed to address all three factors.

Cross-Functional Initiatives Can Drive a Step Change

Companies can apply a broad array of operational levers—both functional and cross-functional—to drive higher TSR. Based on our recent work with industrial goods manufacturers, we highlight four cross-functional initiatives that have achieved strong results: managing complexity; capturing the full potential of after-sale services; applying a world-class sales and operations planning process; and achieving excellence in support functions.

When CEOs think about creating shareholder value, they usually focus on increasing revenues—either through organic growth or M&A. However, because the growth rates in developed markets are low, companies are devoting even more attention and resources to pursuing the limited growth opportunities that exist. This focus can distract them from fully exploiting another critical lever for creating shareholder value: operational excellence.

Although many companies recognize the importance of operational excellence for improving margins and meeting asset turnover targets, often their efforts are not explicitly designed to create shareholder value. As a result, they may actually destroy value by limiting a company's growth opportunities or eroding its competitive position.

Well-designed efforts to improve operational excellence create shareholder value through a combination of growing profits, raising or sustaining investor expectations concerning the company's value, and increasing the cash available for distribution to investors. Superior operating capabilities can also help a company unlock greater value from acquired assets and thereby significantly improve the economics of acquisitions.

A critical lever that CEOs can exploit to create shareholder value is operational excellence.

Even companies that are leaders in operational excellence today cannot rest on their success. A company's stock price today reflects investor expectations for how well its operating capabilities will allow it to generate profits in the future. To raise its stock price, a company must exceed those expectations through continuous improvement.

Which approaches for achieving operational excellence will create superior and sustainable value? Some companies have exhausted levers applied to improve each function individually (such as optimizing procurement of direct and indirect materials), making it harder for them to beat investor expectations. Cross-functional initiatives, such as collaboration between the operations and marketing functions to manage complexity, offer the potential for a step change improvement in TSR.

How Does Operational Excellence Create Value?

Success in creating value is measured in terms of total shareholder return (TSR) relative to a company's peers or to the overall stock market. TSR is determined by profit growth (revenue growth multiplied by changes in margin), changes in a company's valuation multiple, and distributions of cash to investors. (See the sidebar "The Components of TSR.")

THE COMPONENTS OF TSR

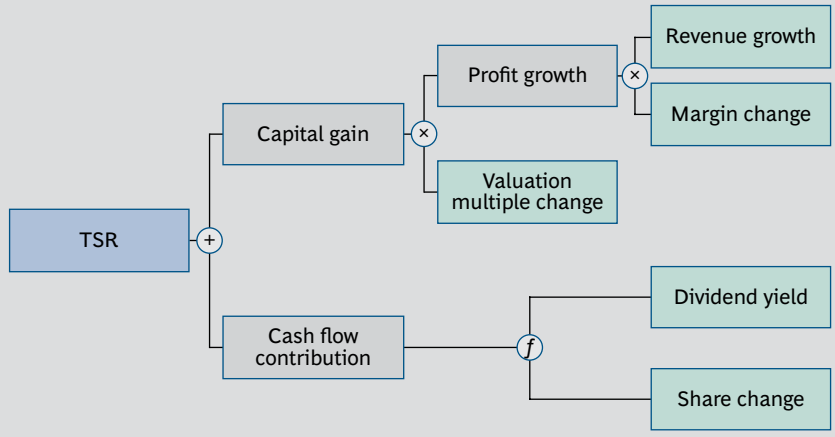
TSR is the product of three basic factors: profit growth, changes in investor expectations as expressed through the company's valuation multiple, and increases or decreases in cash payouts to investors.

The TSR framework illustrated in the exhibit below uses the combination of revenue growth and change in margins (measured as return on sales) as an indicator of a company's improvement in fundamental value. It then uses the change in the company's valuation multiple to determine the impact of investor expectations on TSR. Together, these two factors determine the change in a company's market capitalization and the capital gain (or loss) to investors. Finally, the model also tracks the distribution of free cash flow to investors in the form of dividends and/or share repurchases in order to determine the contribution of free-cash-flow payouts to a company's TSR.

The important thing to remember is that these factors all interact—sometimes in unexpected ways. A company may grow its earnings per share by reducing selling, general, and administrative expenses, but doing so might not significantly affect its valuation multiple. In contrast, growing earnings per share by raising gross margins might materially improve the valuation multiple. A company can increase its free cash flow by accepting lower prices in an effort to improve asset turnover, but doing so could erode the valuation multiple. Alternatively, the company could improve the valuation multiple by raising prices and accepting lower asset turnover.

Because of these interactions, we recommend that companies take a holistic approach that uses TSR as the metric for assessing how operational improvements will affect value creation.

TSR Is the Product of Multiple Factors



Source: BCG analysis.
Note: "Share change" refers to the change in the number of shares outstanding, not to the change in share price.

The reduced opportunities for revenue growth in today's business environment are taking a toll on investors' TSR expectations. Investors anticipate that low GDP growth around the world will reduce the prospects for organic revenue growth and put pressure on margins, as companies compete for smaller pools of demand for their products and fewer new growth opportunities. BCG's 2013 Investor Survey found that investors think the low-growth environment will persist for the next five years and that the average market TSR during this period will be approximately 8 percent, in contrast to the long-term average TSR of 10 percent. (See "Investors Look to the Long Term," BCG article, May 2013.)

Given that revenue growth will likely contribute less to TSR for most companies during the next five years, operational excellence becomes a much more important lever for creating shareholder value. It can help a company improve three of the key factors in determining TSR:

- By improving operating margins, operational excellence can drive *profit growth*—helping to offset low revenue growth.
- By improving operating margins and/or asset turnover, operational excellence can help companies sustain or improve their *valuation multiple.*
- By helping companies to realize these improvements, operational excellence also frees up *cash for distribution* to investors.

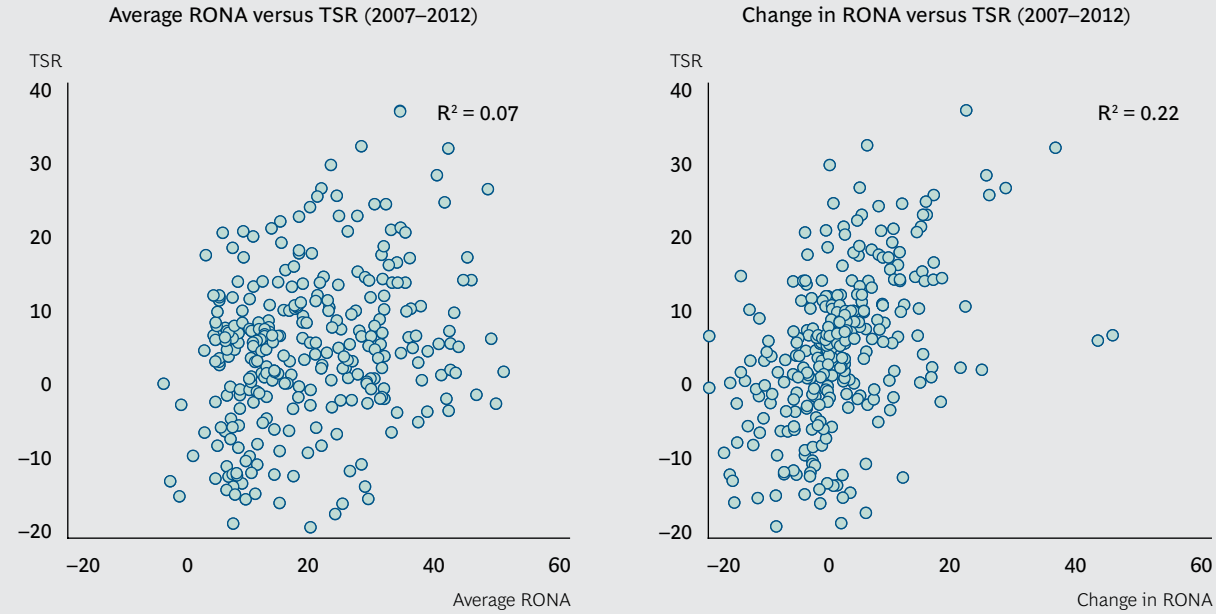
However, companies must recognize that not all efforts to improve operational excellence will result in higher TSR. For example, our analysis of the performance of nonfinancial companies in the S&P 500 from 2007 through 2012 found virtually no correlation between TSR and return on net assets (RONA). (See the exhibit "A Greater RONA Does Not Directly Correlate with a Higher TSR.") We found the same to be true when we assessed the correlation between TSR and return on equity (ROE).

What explains the lack of correlation? In some cases, operational improvements that drive higher RONA or ROE may undermine future growth opportunities or harm a company's ability to sustain its market share or competitive advantage. For example, by cutting costs relating to, say, marketing or R&D, companies may grow profits and thereby improve earnings in the short run. However, excessive cost cutting may also reduce the valuation multiple investors assign to those earnings if they believe the cuts will not be sustainable or will erode the company's competitive advantage and longer-term revenue-growth potential. Similarly, reducing working capital can ultimately reduce customer satisfaction, and deferring capital expenditures for maintenance can harm quality. In other cases, the shortcomings of these metrics prevent them from being true measures of operational improvements—for example, high goodwill or high debt can distort the comparability of RONA among companies as well as the metric's link to value creation.

Operational excellence can help improve three of the key factors that determine TSR.

To ensure that operational improvements create value, companies need to apply a strategic and comprehensive approach to designing and implementing their efforts. When they reduce costs, companies should be aware that cutting some costs may

A Greater RONA Does Not Directly Correlate with a Higher TSR



Sources: Compustat; BCG ValueScience Center.
Note: RONA = return on net assets, defined as the product of operating margin and asset turnover. R^2 stands for regression correlation coefficient. The analysis covers the nonfinancial companies in the S&P 500. We removed extreme values.

have a larger positive impact on their valuation multiple. For example, reductions in cost of goods sold can have a greater impact than reductions in administrative costs, because high gross margins are viewed favorably by investors. High gross margins signal to investors that a company has differentiated products and/or a cost advantage, giving it more cash to spend on R&D, marketing, and other long-term investments that sustain competitive advantage. In addition, companies must apply a strategic mindset to deploying the cash generated by performance improvements. Reinvesting the cash in brand building or future growth can create tangible value but must be weighed against the alternative to return cash to investors when appropriate (through share buybacks or dividends).

Continuous improvement is also critical because investors have already priced the anticipated levels of a company's growth, margins, and asset productivity into its stock price. In doing so, capital markets level the playing field for companies. Regardless of the operational excellence it has achieved, each company must exceed expectations in order to drive an above-average TSR. Today's leaders in operational excellence must, therefore, continuously pursue a higher level of performance in order to achieve a higher TSR relative to their peers.

Operational excellence is an especially powerful lever for creating shareholder value because improvements can often contribute to beating expectations in more than one TSR driver. For example, by improving gross margins, a company can increase earnings per share, its valuation multiple, and the cash available for dividends or share repurchases or for funding growth initiatives. Likewise, improving working

capital can increase both the company's valuation multiple and its available cash. In contrast, beating revenue growth expectations only affects one TSR driver.

Consistency in beating expectations year after year is challenging, but doing so by modest amounts can produce top-quartile results. Based on our historical analysis of S&P 500 companies over the past 60 years, to achieve a top-quartile TSR in any given three-year period, a company must beat the average annual TSR by 8 percentage points each year—but over a ten-year period, achieving top-quartile TSR only requires beating the average by 4 percentage points each year. It is unlikely that most large, established companies can drive top-quartile TSR solely by continuously raising their revenue growth rates by 8 percentage points, or even 4 percentage points, annually. A better route to success would be to complement growth programs by pursuing operational-excellence programs that achieve modest but continuous increases in the three factors that drive higher TSR—and then reinvesting the profits into future growth opportunities.

Cross-Functional Initiatives Can Drive a Step Change

Companies can apply a broad array of operational levers to help in beating expectations for TSR. For industrial goods manufacturers, for instance, these levers include "contemporary classics," such as lean manufacturing and optimizing direct and indirect procurement spending.

Cross-functional initiatives can achieve step changes in operational performance—and TSR.

For some companies, focusing on these functional areas is the right way to improve their TSR in the short term. However, based on our client work and experience, we have found that many companies today apply cross-functional initiatives to achieve true step changes in operational performance—and consequently in TSR.

A cross-functional approach entails broadening the scope of operational excellence beyond the traditional operations function. This means actively including other corporate functions (such as marketing and sales) in the design and implementation of operational initiatives. It can also mean applying operational-excellence principles in other organizational areas (for example, employing lean manufacturing principles in the area of corporate support functions). Instead of simply seeking each other's input in shaping a value proposition, members of various corporate functions collaborate on operations-related decision making and initiatives geared toward winning in the market at the lowest cost.

Levers for operational excellence—whether contemporary classics or cross-functional approaches—differ among industries. For example, a financial services company applies a different approach to optimizing its internal workflows than an automotive OEM uses to improve its discrete manufacturing processes. To gain a better understanding of successful cross-functional initiatives for a specific sector, we examined the practices of industrial goods manufacturers. Operational excellence is a key strategic lever for most of these companies, making them ideal candidates for an analysis that would yield insights into best practices. By delving into their recent practices, we have identified a range of cross-functional initiatives that can increase TSR by simultaneously improving operating margins and asset turnover.

Below, we highlight four of the levers that leading companies in the industrial goods space have applied to achieve strong results: managing complexity, capturing the full potential of after-sale services, applying a world-class sales and operations planning (S&OP) process, and achieving excellence in support functions. This set of cross-functional levers is not exhaustive, however. Others include, for example, applying design-for-value principles and optimizing the management of large capital-expenditure projects.

Managing Complexity

Complexity has its costs. In a product portfolio, the cost of complexity arises from the need to combine multiple operational resources (such as equipment, production lines, technology, and people) in order to provide the variety of products customers demand. Some manufacturers view reduction in complexity as simply a matter of cutting back on the variety of SKUs in order to create a more manageable product portfolio. To manage complexity effectively, however, companies must find the optimal balance between the cost of complexity and the value of variety.

Leading manufacturers have increasingly sought to strike this balance by applying the perspectives of operations and marketing and sales in combination. These functions collaborate in order to identify products and unique configurations that add incremental value from a customer's perspective, while also looking for ways to reduce complexity without sacrificing sales or growth. To achieve this objective, they apply customer insights to a range of operational decisions and apply operational considerations to efforts to shape demand. Marketers seek to better understand both customer needs and willingness to pay, and they work closely with their colleagues in operations in order to identify ways to standardize offerings and design products to optimize costs.

Various companies have applied this cross-functional approach in order to manage complexity. For example, Volkswagen Group has developed a modular platform strategy that allows it to maintain a broad product portfolio with fewer modular parts. Through close collaboration among product design, manufacturing, and marketing and sales, the automaker has continuously improved its platform strategy since introducing it in the 1990s.

Managing complexity effectively requires balancing the cost of complexity and the value of variety.

Building upon its expertise in this field, Volkswagen Group is rolling out one of its largest modular platform strategies to date for its portfolio of small to midsize cars. This new modular toolkit will eventually cover several dozen models of small and midsize cars. The objective is to standardize critical parts that constitute up to 60 percent of a car's cost, allowing the automaker to use the same transmission, front axle, steering, and heating, air conditioning, and ventilation system for each of the covered models. While continuing to standardize critical parts of a vehicle, the guidelines provide flexibility in order to account for changing dimensions, regional variations, and alternative power train concepts. In addition to reducing unit costs, the modular platform strategy significantly lowers capital expenditures, enables flexible scheduling for plants, and reduces the time spent on production and engineering for each model. Volkswagen Group has also rolled out a similar modular concept for larger models with longitudinal engines.

Capturing the Full Potential of After-Sale Services

Leading manufacturers maximize value from a full set of after-sale service offerings. Companies that earn a significant share of their revenues and profits from services go beyond traditional product-related services, such as installation, training, MRO (maintenance, repair, and overhaul), aftermarket spare parts, and troubleshooting. They provide enhanced technical services—including upgrades, retrofits, and end-of-life disposal—and extend their service offerings to competitors' products. What's more, they complement these traditional and enhanced services with business services, such as consulting and operational-process outsourcing, in order to manage equipment and guarantee performance over the product's and customer's life cycle.

Companies that excel at these types of services typically develop a strong services organization, standardize service offerings, and set prices based on the value delivered. To enable delivery of maximum value, many companies integrate services into the product development process by applying "design-to-service" principles. They also include services in setting a product's price. Moreover, they usually redesign their go-to-market approach and sales force incentives to promote the selling of service agreements.

Kone, a leading manufacturer of elevators and escalators, emphasizes the importance of services for its own installed base as well as competitors' products. In fact, services generate more than half of Kone's revenues—and of that amount almost 50 percent comes from servicing competitors' installations. To achieve this level of revenues from servicing competitors' installations, the company has reengineered competitors' products and offers appropriately priced repair-and-maintenance service packages to competitors' customers.

Applying a World-Class S&OP Process

The S&OP process can be thought of as a company's "hidden supply-chain engine." (See *The Hidden Supply-Chain Engine: Sales and Operations Planning,* BCG Focus, August 2011.) It determines how many units of each product will be made by each plant, based on demand forecasts from marketing and sales, cost factors, risks, and strategic objectives. Based on our experience, however, many companies overlook the importance of designing the process to capture the full value of cross-functional coordination.

Companies should consider three key success factors in designing a world-class S&OP process. First, information should be sufficiently clear and readily available in order to support strategic, operational, and transactional decision making. Second, a company can significantly improve the accuracy of forecasts by segmenting products, channels, and customers on the basis of variables such as volume, predictability of demand, and a product's life-cycle stage. Third, the active engagement of C-level executives in the decision-making process—especially in high-stakes areas such as pricing and capacity planning—can be a source of competitive advantage.

Toyota has set the standard in applying lean principles and cross-functional excellence to S&OP processes. The success of the Toyota Production System arises from its ability to produce vehicles according to a stable production schedule. To achieve this discipline, Toyota applies its fundamental principles of continuous improve-

Toyota set the standard in applying lean principles and cross-functional excellence to S&OP processes.

ment and teamwork in a structured, cross-functional planning process that brings people in sales and manufacturing together under a common set of guidelines. These guidelines aim to increase the horizon for planning—for example, by freezing sales commitments over a period of time, which in turn is managed by adjusting sales incentives—and to support rapid action in handling exceptions. To ensure that senior managers apply their expertise in a timely manner, the company sets the cadence for senior team involvement in approving plans and resolving conflicts that arise in the process.

The planning process, which occurs twice a year, is driven by a "collaborative tension"—sales teams submit their plans to maximize sales, while manufacturing teams submit plans to meet demand within available capacity and other constraints. The company uses this healthy teaming process to identify the optimal plant configuration for meeting sales requirements, including the mix of vehicle models produced at plants and plans for new investments.

Achieving Excellence in Support Functions

For many years, companies have applied lean principles in order to reduce waste in manufacturing processes. More recently, though, they have also applied these principles throughout support functions in order to enable smoother collaboration between different parts of the business and achieve significant cost improvements. BCG's experience shows that applying lean principles beyond manufacturing remains a largely untapped source of value. Cross-functional lean initiatives can improve productivity and capacity utilization, as well as reduce operating expenses, such as selling, general, and administrative expenses.

Applying lean principles beyond manufacturing remains a largely untapped source of value.

Leading companies have leveraged lean tools in sales, HR, finance, and other support functions. The objective is to eliminate waste within these functions based on an end-to-end analysis of the processes and information required to deliver a product or service. They have been simplifying their organizations by introducing standards for structural design and increasing the pooling of resources (for example, creating a flexible talent pool). Work standards have been created to track and reduce deviations, including applying lean techniques in order to reduce errors. Top performers have also designed efficient workplaces in which floor layouts are optimized and targets and achievements are clearly displayed.

A leading mining company sought to achieve excellence in support functions when it introduced a new operating model. At the beginning of the transformation, employees in all parts of the organization regarded the support functions as requiring long lead times for decisions, lacking clear roles, and having limited empowerment and low levels of collaboration.

In addition to benchmarking and performing structural analyses of organizational logic and spans of control, the company applied tools such as "activity-based optimization" to identify pockets of inefficiency. It identified redundancies and inefficiencies in how people were allocated across various support functions within the corporate center. The company validated these findings through benchmarking and beliefs audits. The findings informed a complete redesign of the operating model, organizational setup, and processes. This effort included redefining the roles of the

support functions by applying a clear understanding of what would create the most value from an operations perspective. As part of this exercise, the company also identified the opportunity to reduce headcount by approximately 25 percent.

Getting Started

During the next decade, improving operational excellence relative to peers will be essential to delivering superior TSR. Companies can achieve this goal directly (by improving margins, asset productivity, and valuation multiples) as well as indirectly (by establishing competitive operating advantages that can translate into superior rates of revenue growth). Some companies that seek to outgrow their peers in the current low-growth environment will likely achieve only limited success—perhaps increasing profit growth but not the other critical elements of TSR. Pursuing higher margins and asset productivity through superior operational excellence will be a much more powerful approach to addressing each TSR component.

Improving operational excellence relative to peers is essential to delivering superior TSR.

To increase TSR through operational excellence, companies must develop approaches that foster collaboration among departments, such as promoting the proverbial "handshake" between operations and the marketing and sales function in order to manage complexity. Although reaping the full rewards will ultimately require a multiyear effort, we often see significant improvements in terms of operating margins and/or asset turnover in less than one year.

Executives who want to assess their starting point for this effort should consider the following questions:

- What is your company's TSR performance relative to its peers? What is your overall goal for TSR? What level of TSR performance will your current plans allow you to achieve—and how will you close the remaining gap to achieve your goal?
- Do your current plans to improve TSR include improving operational performance through function-specific levers, such as lean manufacturing, procurement of indirect and direct materials, and supply chain management?
- Has your company sought to improve margins and asset turnover by adopting the cross-functional approaches discussed above—managing complexity, capturing the full-potential of after-sale services, applying a world-class S&OP process, and achieving excellence in support functions—or others (including design-for-value principles and optimizing the management of large capital-expenditure projects)?
- If your company hasn't pursued any cross-functional initiatives, what have been the barriers to change? Skills? Focus? Organizational responsibilities? How can these barriers be overcome?

For many companies, the answers to these questions will point to opportunities to make significant improvements in their approaches to creating value through operational excellence. The resulting improvements will not only help to drive higher TSR—they may also help the executives to pursue and fund initiatives that lead to a sustained competitive advantage.

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