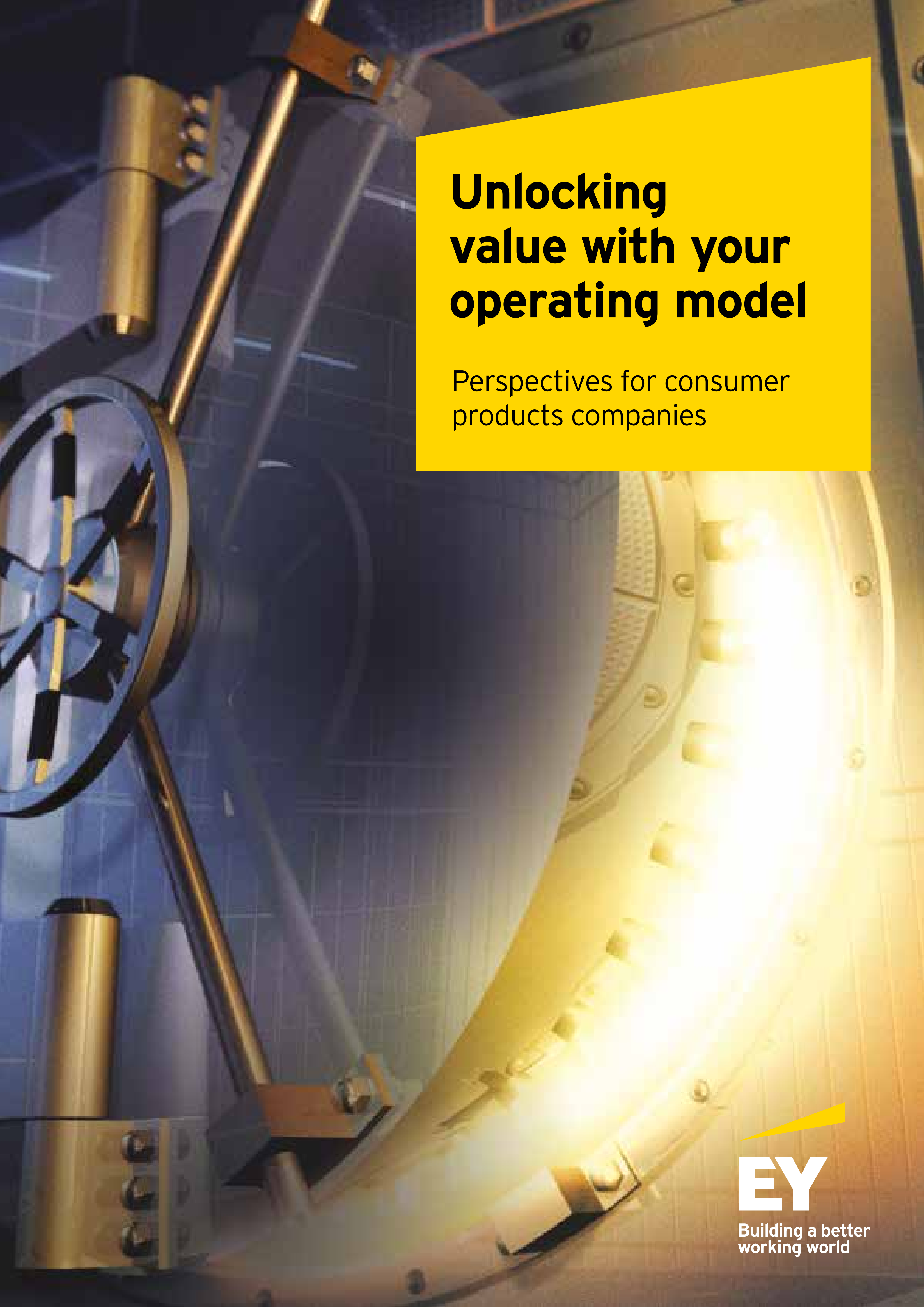


Unlocking value with your operating model

Perspectives for consumer products companies

Building a better working world

Key takeaways

Existing operating models are no longer effective for today's market environment.

To sustain profitable growth, companies need to meet changing consumer demands and reconfigure their operating models.

Companies must take a holistic approach that takes into account both business and regulatory issues.

In 2012, 68% of the consumer products companies we surveyed told us that they were under pressure to reappraise their operating model.[1] Three years on, pressure is even more acute.

Companies are challenged to re-ignite growth in mature markets while finding new ways to capture profitable growth in volatile emerging markets. They must respond to changing consumer needs, the influence of digital and the rapid evolution of retail channels. And they must deal with a highly dynamic, fluid and complex regulatory and tax environment.

Growth is challenging
- Mature markets offer limited volume growth.
- Consumers seek value but want different things.
- Emerging markets offer opportunities with challenges.

Implications
- Drive efficiency in overall supply chain
- Create flexible supply chain that can adapt to emerging markets

Consumers are changing
- New consumer segments are growing in importance.
- Digital is empowering the consumer.
- Routes to market are increasingly complex.

Implications
- Establish centers of excellence to manage new communication trends and marketing channels
- Synchronize distribution channels through above-market product category management

Costs are hard to control
- External cost pressures are growing.
- Internal cost structures are challenged by market changes.
- Investment is needed to build new, relevant capabilities.

Implications
- Adopt a global/regional approach to manage volatility through centralized teams and functions
- Implement a regional/cluster approach to pricing to capitalize on price elasticity

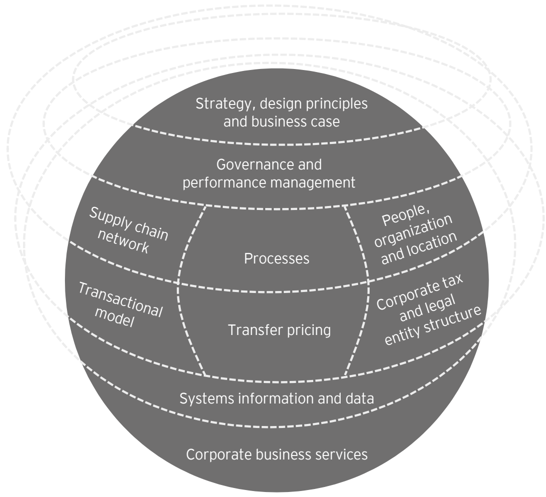
Regulatory framework is tightening
- Tax authorities are becoming more sophisticated, with increasingly aggressive audits.
- The media is focusing on tax structuring arrangements, increasing reputational risks.
- The OECD BEPS project is changing the game.

Implications
- Align functional profile to the tax structure to mitigate audit and reputational risk
- Capitalize on opportunities to manage the group effective tax rate

As a result, existing operating models are no longer fit for purpose. In the past, consumer products companies have often made incremental siloed improvements to address industry challenges. The problem is, incremental change delivers incremental results and adds to, rather than removes, complexity.

We believe that companies must take a holistic approach to their operating models that balances the need of the local markets with global scale. Clearly, the specific priorities will vary depending on the nature of the products being sold. It should, however, take into account everything from the talent and labor they need to IT systems implications and the legal and regulatory environment.

Integrated operating model design has brought significant performance enhancements



[1] *Disrupt or be disrupted,* Ernst & Young, 2012.

As companies seek to optimize their operating models, we believe they must consider each of the following questions.

1. What are the core drivers of value in the business?

The first step is to establish design requirements and principles. Operating models activate business strategy. Therefore, design requirements flow from an organization's business models. Understanding each business model segment and its unique performance needs will guide how investments are made across the business (e.g., capability requirements and what is shared versus distinctive). For instance, business models with standard products have unique performance needs relative to customized products. Understanding those varied needs establishes linkage to critical capabilities and processes, creating organizational value.

This understanding, alongside design principles, allows design decisions and trade-offs. Design principles define desired operating model characteristics. Due to the complexity of many organizations, identifying design principles is challenging. In our experience, a cross-functional team is required. For example, while considering mature market needs, a simple design principle might be, "We need to apply scale in our mature markets." However, translating this into an actionable road map requires an investigation into what scale means in each functional area.

2. How do you overcome organizational inertia and create the impetus for change?

Reconfiguring the operating model cannot be taken lightly and is often triggered by major business events such as acquisitions and divestments. It is a major business transformation, requiring change across every aspect of the company, including people, processes, governance and IT:

- Key employees may need to be relocated and their roles redesigned.
- Existing infrastructure investments, such as manufacturing plants or office locations, may need to be closed, and new ones opened elsewhere.
- Regulatory and tax hurdles will need to be overcome.

We advise companies to think about where P&L responsibility should lie and connect new and/or existing KPIs to the desired outcome. When a region, for example, is given full responsibility for top- and bottom-line performance, and is given stretched performance targets, this serves as a powerful catalyst for regional managers to reconfigure their operating models. Very often, they realize that they need to think differently, centralizing previously fragmented activities into regional hubs or clusters.

3. To what extent are you considering the tax implications of operating model changes?

Whenever the operating model footprint changes on a cross-border basis, tax opportunities and costs could result. For example, a company may need to close multiple plants in a high-cost location serving local customers and then relocate the capacities to a new greenfield site in an emerging economy that serves regional and local customers. The company's tax and finance professionals will need to be included in the team that evaluates such options so that the decision can be made holistically. Such a decision could trigger income tax implications in the country where the plants are being closed, customs duty considerations because of cross-border trade, opportunities for tax incentives or grants in the country where the new jobs are being created, and the ability to integrate the change into a new or existing principal operating company structure.

4. Which activities will benefit from global or regional scale, and which should be retained locally?

There is always a tension between the need to realize the benefits of scale and the ability to capture growth opportunities at the local level. At the heart of this tension, companies need to make decisions about centralizing or decentralizing high-value activities and locating management functions operationally where it makes the most sense, based on the category characteristics, category maturity, the existing talent pool and the company's appetite for change. In our experience, it is often the manufacturing and supply chain functions (such as supply planning, demand planning, network optimization, procurement, supply chain and logistics functions) that are co-located first in a regionalization exercise. In contrast, sales and marketing functionality may not be centralized to the same extent in order to stay "close to the market."

5. Do the classic geographical groupings, such as EMEA or Asia-Pacific, continue to make sense?

Regions such as EMEA or Asia-Pacific, which encompass developed, emerging and frontier markets, may be too broad. Instead, companies should consider clustering markets according to their stage of development, channel structures, national tastes and preferences and so forth. For example, in Asia-Pacific, markets such as Japan, Australia and South Korea may be grouped together because they have similar dynamics in terms of the maturity of modern trade. Another cluster could comprise Myanmar, Vietnam and Laos, where traditional trade still dominates. This clustering approach enables companies to stay close and relevant to the market while still realizing some scale benefits by bringing similar markets together within the same regional structure.

6. How do you retain local agility when centralizing a function?

The benefits of scale must be balanced against the need to create the right level of connectivity with local operations to retain agility. For example, some larger consumer products companies have created procurement organizations with a combination of global and regional characteristics. The key question to answer is how much should be left with the local operations. Various food companies have pushed entrepreneurship and product development closer to, or right into, growth markets, and thus away from regional centers that are occasionaly seen as too remote to understand local consumers.

This approach allows for setting effective strategies, innovating and deploying sustainable procurement practices at a local level. Rather than only thinking about how to procure items more cheaply, they are embedding procurement into the supply chain and thinking about how it can add value. This approach has tangible benefits. For example, multinational beverage companies have reduced input costs by 3% to 12% by implementing professional procurement organizations.

7. What are the benefits of establishing procurement as a stand-alone company?

From a governance perspective, the central procurement model is increasingly implemented as a stand-alone company serving the group companies. This deliberate recognition of procurement as a business provides chief procurement officers (CPOs) with greater control while requiring implementation of service-level agreements and performance metrics to ensure group companies are served appropriately.

This extreme form of centralization offers an ideal platform for category managers to develop the supply base, re-engineer input material requirements and invest in leading-edge tools and capabilities. However, this is often not feasible when the procurement structure is more distributed. In addition, these structures enable the co-location of procurement with supply chain management operations, which can provide additional enhancement.

8. How do you navigate the complex and dynamic global tax environment?

Companies are looking for greater clarity about their regulatory and compliance obligations. They need to understand how to navigate the various tax regimes, as well as how they trickle down to different regulatory or legal requirements, and adjust the operating model accordingly.

For example, in Asia, it is likely companies will have at least two centralized supply chain operating models because some Asian jurisdictions have complex foreign exchange regulations. That means domestically produced and sold products do not fit within the typical regionally centralized models. Also, different countries in Asia have interpreted tax concepts quite differently from each other, meaning holding stock in-country (by the principal) in some locations can create a permanent establishment, whereas in others it does not. This means companies need to create flexible supply chains to cope with jurisdictional differences, something they may not have needed to do in the European context.

9. How do you need to rethink the commercial aspects of the operating model?

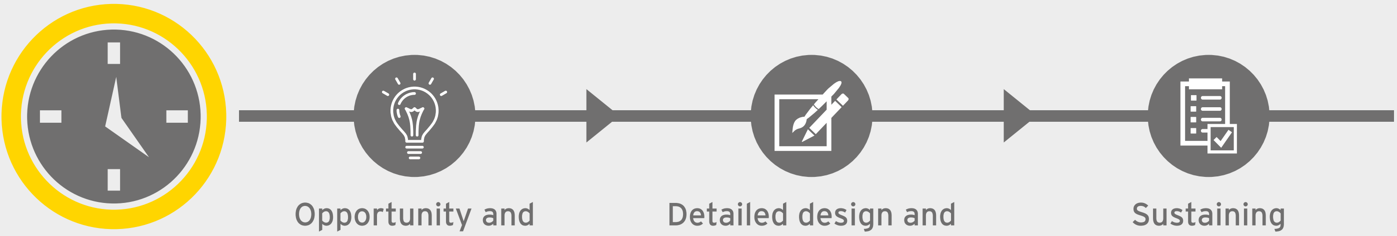
The rise of omni-channel, social media, changing consumption patterns and the shift of economic gravity to emerging markets demand a change in commercial strategies to ensure profitable growth. There are six key shifts that companies need to consider:

- Moving from supply-led innovation to demand-led innovation to ensure responsiveness to customer and consumer needs alike
- Bringing together fragmented brand portfolios into a single, centrally managed portfolio
- Adopting and fully integrating new channels, including e-commerce, into the supply chain
- Replacing supply-led pricing approaches with customer-led, above-market pricing decisions
- Establishing clear account segmentation strategies and treatment models (e.g., where and how to apply account management structures, channel priorities and focus)
- Adopting a core brand management strategy rather than traditional brand product management

For example, in the case of omni-channel, this means considering a central management company that manages a single face to the customer, aligns and synchronizes all distribution channels into one operating model, and facilitates the access to different channels.

Next steps for consumer products firms

Given the level of complexity, operating model change can seem daunting although the benefits are often significant. To make it more manageable, organizations can approach the transformation in three stages:



Opportunity and feasibility assessment

This involves an assessment of how a revised operating model can add value.

Detailed design and implementation

Here, companies look at what the detailed design looks like and how to drive change.

Sustaining the model

At this stage, companies examine how to manage risk and protect value on a continuous basis.

Using this approach, organizations can kick-start the process of building an operating model that plays to their key capabilities today — and the capabilities they will need to compete tomorrow.

Industry perspectives

Apparel — speed and agility come to the fore

The trend toward centralization

In the past, apparel companies typically had regional procurement models, with hubs in North America, Europe and Asia. Today, there is a trend toward greater centralization, with the main hub often located in Asia, the market where growth opportunities are greatest, and where most of the supply base is concentrated. In our experience, centralized procurement models, ideally using co-located teams, tend to deliver the most operational benefits because they enable the creation of economies of scale.

At the same time, the need for speed and agility is paramount. Companies should consider the use of regionally focused principal companies, which not only drive functional excellence and standardization of processes, but also the ability to adapt quickly to changing consumer demands and provide rapid time to market. The higher costs of bringing manufacturing closer to the consumer will typically far outweigh the costs of having to mark down goods in stores when key fashion trends are missed due to long response times.

Aggregating inventory to minimize markdowns

Apparel companies should also seek greater flexibility through their distribution centers. By aggregating as much inventory as possible, they can react quickly to changing demand, reallocating goods among wholesale, retail and e-commerce sales. If something is not selling in one region of the world, they can reallocate it to another region where that item is in greater demand. This again helps to minimize the need for markdowns.

Optimizing relationships with licensees

Finally, apparel companies need to optimize their relationships with licensees who are responsible for distribution rights. In recent years, we have seen stronger relationships emerge between apparel companies and licensees, who must now be the ambassadors for the brand in that market. To be truly effective, licensees must not only meet the requirements of the license agreement in terms of their management of the brand, but also develop the brand and align their own operations with the operating model of the apparel company.

Beverages — leveraging global scale

Untapped potential

There are strong, global-scale dynamics at play within beverages. Products are frequently global and may only differ subtly across markets. Only a few beverage companies have, however, implemented true regional or global supply chain management. There is significant untapped potential to pool resources across countries to improve product availability, working capital and asset utilization.

Effective procurement operating models

In recent years, leading companies have invested significantly in professional procurement organizations. While centralized models prevail, the most effective procurement operating models typically consist of a centralized core, with regional and local variants for specific categories, such as water or labor, but also mega categories, like packaging or bottles. This provides maximum control while also enabling a degree of local variance, depending on factors such as category maturity, the existing talent pool and the beverage company's appetite for change. By optimizing procurement, beverage companies have cut input costs by 3% to 12%.

Exploring the buy-sell model

Some companies are exploring buy-sell models, where the central procurement company becomes the only supplier to the group. Further integrating this with sales and operations planning ensures optimal forecasting and capacity planning across the supply/demand network. For some, toll manufacturing is the next step. This means that the central supply chain company will own all the input materials and manage the associated inventory and production risks. It buys directly from suppliers and sells to the group sales and distribution entities. The manufacturing entity charges a "brewing fee" to the supply chain company but never owns the product.

Implemented correctly, this setup creates unprecedented supply chain visibility, allows for better decision-making, simplifies transactional flows and can also introduce tax benefits. The flipside is that indirect tax complexities, duties and systems setup can be very challenging across continents. Moreover, some jurisdictions do not allow foreign entities to own local materials. So, while companies are trying to implement leading operating models, local variations are inevitable and require careful cross-functional design.

Co-location with other functions

Co-location of procurement with other functions, such as supply chain, enables a more integrated approach. Rather than simply sourcing glass for bottling, procurement teams could play a bigger role in areas such as product and packaging — for example, determining whether it would be possible to re-engineer the thickness of the bottle without impacting manufacturing effectiveness or consumer experience, while driving lower total cost.

Food — a new approach to market clustering

Tailoring the supply chain to the needs of the consumer

Food companies must constantly adjust their operating models to "unlock" value from their global business operations. Many food companies have arguably become too centralized in recent years and recognize that they need a more regionally driven model. Proximity to the consumer is key because tastes vary widely from market to market. The perishability of many items, along with food safety issues, also tends to favor a closer proximity of supply and production. This means that supply chains tend to be shorter, more complex and more tailored to the needs of the local consumer.

Clustering markets by stage of development

There is a growing argument, however, that companies should think differently about how they cluster regions and activities. Regions such as Asia-Pacific, which encompasses developed, emerging and frontier markets, are too broad. Instead, companies should consider clustering markets according to their stage of development. Markets such as Japan, Australia and South Korea can be grouped together because they have similar dynamics in terms of the maturity of modern trade. Another cluster could comprise Myanmar, Vietnam and Laos, where traditional trade still dominates. This clustering approach enables companies to stay close and relevant to the market, while still realizing some scale benefits by bringing similar markets together within the same regional structure.

Companies can also think about clustering around factors other than geographical or economic proximity. For example, an R&D hub developing new savory breakfast products could serve multiple markets in different regions, not just those within a single geographic grouping.

Taking constraints into consideration

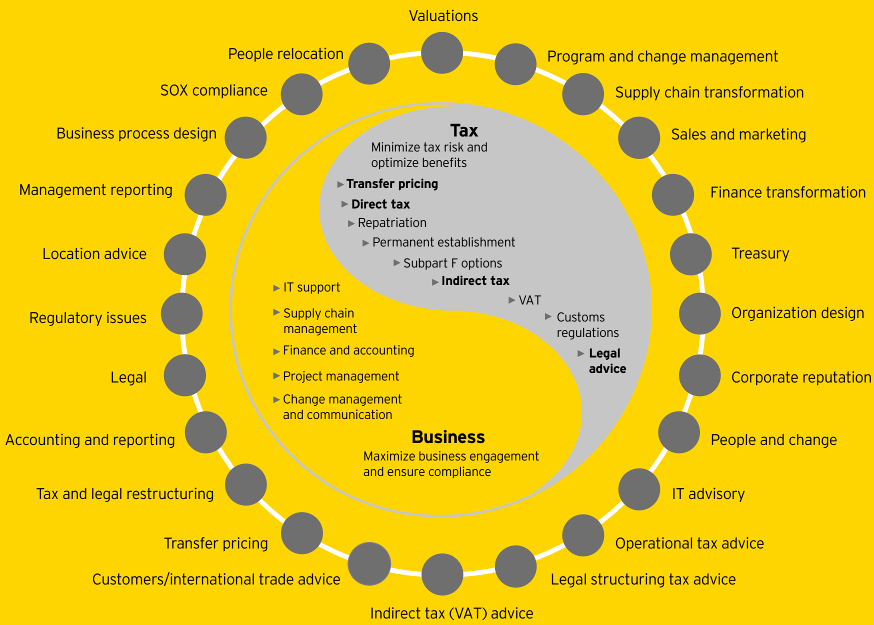
The constraints of markets should be factored into the design of these clusters. For example, various economies in Asia-Pacific have restrictions on the cross-border movement of products, and may apply significant duties or not provide the required licenses. While this may restrict the size of clusters, it can also introduce further opportunities in choosing locations where fiscal regimes and talent differentials exists.

Why EY?

We have a proven and standard approach and service offerings refined over 20 years of success in delivering operating model design projects for clients. We have conducted over 175 operating model transformation feasibility and design projects – more than any of our competitors – and have performed more than 80 full implementations with EY in the lead role.

We have truly global, highly mobile teams that match the footprint of our clients' businesses, with hubs and dedicated professionals in North America, Latin America, Europe, the Middle East, Hong Kong and Singapore.

We have created a variety of multidisciplinary teams, with sector experience, that integrate our Advisory, Transaction Advisory Services and Tax offerings across the operating model. These teams help companies to optimize the operating model across all the different layers: business restructuring, processes, organization, systems implications, transfer pricing, direct and indirect tax, customs, human resources, finance and accounting.



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