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Delivering a turnaround on time, in full, with a better supply chain

Need improved performance fast? It's time to take on your supply chain.

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Many leaders face the need to rapidly improve the financial performance of their organizations. You might be in an established company facing tough economic conditions, or weathering shifts in core markets. Or you could work for an underperforming unit in an established business seeking to catch up with the wider group. Maybe you are a new CEO who wants to stamp your mark with a rapid turnaround. Increasingly, you might be a private equity investor looking to transform a business before selling it. The number of organizations in private equity (PE) ownership worldwide has risen sharply over the past decade, from around 5,000 in 2004, to nearly 14,000 in 2014.

Whatever the driver, most businesses focus on a few well-established approaches in their search for a quick performance boost. They look for opportunities to reduce staff overheads, they divest themselves of underutilized assets, and they cut unprofitable products from their portfolios. They seek ways to drive up productivity, often through the application of lean manufacturing and service techniques.

The supply chain is a frequently overlooked source of value improvement, however. The opportunity it provides comes from two sources. The first comes from freeing up working capital and cutting operating costs. Many businesses rely on high inventories to ensure their products are there for customers to buy. According to our research, average inventory levels in the chemicals, industrial equipment and consumer packaged goods sectors are more than 60 days on hand. In the pharmaceuticals sector, it's more than 150 days. That's five months of high-value product locked up in expensive warehouses.

Moving products to customers costs a lot too. Logistics costs account for more than 8 percent of total costs in the pharmaceutical and high tech sectors, for example, and almost 12 percent for the food industry.

These aren't the inevitable costs of doing business in these industries. The companies with the most efficient supply chains consistently outperform their peers, often to a significant degree. Best-in-class pharmaceutical companies have inventory levels some 12 percent lower than the sector average, for example, and their logistics costs are around half those of median performers.

Second, and even more significantly, supply chains need to work well. If customers can't get a company's products when they need them, they will look elsewhere or may not buy at all. And if they are disappointed once, they may never come back. Research suggests that average-performing US consumer packaged goods (CPG) companies lose around 1.5 percent of sales due to poor service levels. For bottom-quartile performers, that figure is 3.8 percent. Those figures translate into EBITDA margin reductions of 0.3 to 0.8 percentage points. Overall,

poor service levels cost the US CPG industry a staggering $24 billion dollars a year.

Why not fix the supply chain first?

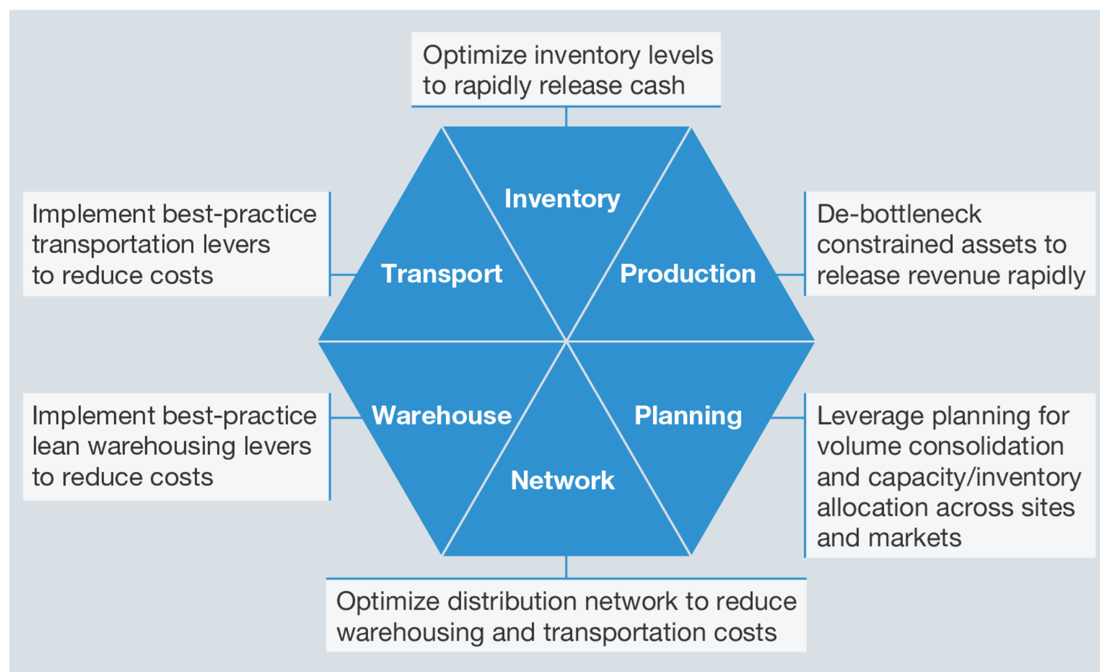
Even when they recognize the value at stake, many companies are reluctant to attempt rapid supply chain improvements. Speaking to executives, we come across two broad reasons for this. Sometimes, they fear that that attempts to cut costs might further damage critical service levels and cost more than they save. In other cases, they worry that the organization lacks the capabilities necessary to make the highly technical improvements needed to make their supply chain work more effectively.

Those companies should think again. Our research[1] into supply chain performance in many countries and industries shows that high-performing supply chains provide better service *and* lower costs.

Our experience of multiple rapid supply chain turnarounds has shown us that there is plenty of "quick win" potential hidden in the supply chain of most companies (exhibit). Let's look at some real-world examples from six important areas.

Exhibit

Delivering rapid impact across six supply chain areas



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[1] *Six practices that drive supply chain performance*, Operations Extranet, 2008 (https://operations-extranet.mckinsey.com/content/function/Supply+Chain+Management/view/20081001_supply_chain_advantage)

- **Inventory.** One global CPG company held an average of 200 days of inventory in its warehouses, leading to high levels of product obsolescence in its fashion-oriented business. To combat this issue, it changed its whole approach to inventory planning, scheduling production based on real underlying demand rather than retailer orders and adjusting target stock levels based on the volatility of that demand. It also introduced regular sales and operations planning meetings between its production and commercial teams. Together, these actions helped it quickly reduce the value of its inventories by more than 15 percent.
- **Production.** Even the best efforts to improve flow in manufacturing have limited direct impact on profitability if they don't focus on the areas that matter most to customers. One chemicals company identified the products in its portfolio with the highest value order backlog, and focused manufacturing and scheduling improvement efforts intensively on those areas. It was able to reduce the manufacturing cycle time in these key products from 24 to 15 hours, eliminating 75 percent of the backlog in 4 weeks and boosting revenues for the category by a factor of four in only six weeks.
- **Distribution.** Many companies haven't modified their distribution networks in line with changing demand patterns, or the rapidly evolving logistics industry. Ensuring that they do[2], and creating networks that are designed to respond better[3] to future shifts in supply or demand economics, is a fast way to cut costs and boost service levels. When one US company reviewed the network of courier hubs it used to distribute products direct to its customers, it found that by cutting the number of hubs it used by two thirds and shifting more volume from regional distribution companies to a national parcel carrier, it was able to cut distribution costs by 30 percent and offer its customers a much shorter order to delivery time.
- **Warehousing.** Plenty of companies work hard to make their manufacturing processes leaner and more productive, but they let inefficient practices prevail in their warehouse operations. These can account for 30 to 50 percent of total supply chain costs. Lean warehousing[4] techniques—from improved layouts to moving labelling and repackaging activities upstream to suppliers—can cut warehouse-operating costs by 30 percent or more and reduce the occurrence of errors and delays.
- **Planning and forecasting.** Many companies are working harder than they need in order to compensate for shortcomings in their planning and forecasting processes. Perhaps one plant is battling against capacity constraints while another is

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[2] *Six practices that drive supply chain performance*, Operations Extranet, 2008 (https://operations-extranet.mckinsey.com/content/function/Supply+Chain+Management/view/20081001_supply_chain_advantage)

[3] *Agility in action: Agile network configuration*, Operations Extranet, 2012 (https://operations-extranet.mckinsey.com/content/topic/Agile+Operations/view/20120110_agility_network_config)

[4] *What's in your warehouse?,* Operations Extranet, 2008, (https://operations-extranet.mckinsey.com/content/function/Supply+Chain+Management/view/20080213_warehouse)

underutilized, or maybe poor coordination between sales and production means promotional activity is driving excessive demand volatility. A coordinated approach to planning and forecasting[5] is a fast way to solve a host of such problems, especially when companies start to make use of big data and advanced analytics[6] techniques to better understand what really drives demand for their products.

- **Transportation.** A company's choice of transport modes and their logistics contracts[7] have a big effect on overall supply chain costs and performance. It's no coincidence that a large-scale shift from air to ocean freight has been a key part of the oil service industry's response to the recent fall in prices, for example. The design of the transportation network is critical too. Efficient links between distribution centers allow companies to keep service levels up and inventories low by shifting products to where they are needed most. By changing the way its products were transported and replenished, one consumer products company was able to cut transportation costs by 28 percent and inventories by more than 40 percent, all with no drop in service levels.

Look at the whole chain

While the improvement actions described above are individually powerful, the biggest and fastest benefits come to those companies prepared to tackle changes across the supply chain from end to end. That's because there's so much interdependence between different supply chain elements. Should a company move production of a certain product to an underutilized factory, or will the resulting increase in transportation distances force it to increase inventories elsewhere? Navigating these complex trade-offs quickly takes a real mindset shift. In particular, successful fast supply chain transformations have two vital ingredients.

First, they need strong leadership commitment. Radically improving supply chain performance will require each part of the business to change the way it operates and the way it interacts with other functions. Stopping improvement efforts foundering on disagreements between functions requires the effort of an aspirational, committed CEO, backed up by the whole senior leadership team. Making things happen quickly requires those leaders to communicate a real sense of urgency to the rest of the business, with a clear, compelling and regularly reinforced case for change.

Second, they need the courage to make big changes. While there are plenty of quick wins to be found across the supply chain, the full potential improvement can only be captured by companies willing to take a clean-sheet approach—comparing their supply chain with the very best in the world and using all the tools at their disposal in the

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[5] *When a plan comes together*, Operations Extranet, 2011 (https://operations-extranet.mckinsey.com/content/function/Supply+Chain+Management/view/20110517_plan_comes_together)

[6] *Capturing value from SCM IT in the consumer goods industry*, Operations Extranet, 2014 (https://operations-extranet.mckinsey.com/content/function/Supply+Chain+Management/view/20140225_capturing_value_from_SCM_IT_in_CPG)

[7] *Logistics outsourcing excellence: from price to performance*, Operations Extranet, 2011 (https://operations-extranet.mckinsey.com/content/function/Supply+Chain+Management/view/20110816_logistics_outsourcing)

quest for improvements. Doing that calls for tough decisions: a company may have to overcome considerable internal momentum to abandon or radically alter well-established and familiar approaches.

An important component of a high performing supply chain is the ability to cut across siloes. For this, these companies establish an effective end-to-end planning process that drives the company to align against supply chain priorities, like maximizing service, or minimizing cost. These companies understand that service can be addressed not just by the product supply or logistics organizations, but also by adequate order management, and commercial support to shape the customer's demands, through pricing or trade spend allocation, for example. In addition, these companies are much better at uncovering where they need to improve, through constant identification of root causes (e.g., supplier reliability, or poor demand planning), and they quickly put in motion plans to fix those issues.

As the examples following this article show, companies that do take a bold and committed approach to supply chain improvement have been able to capture significant benefits extremely rapidly, turning their supply chains around in three to six months. Better still, the gains they make aren't just for the short term. Better performing supply chains go on delivering value long after the initial changes have been implemented. And the new capabilities and processes a company develops during a rapid supply chain turnaround make it more agile, robust, efficient and better equipped to meet future challenges. If your business needs to get better fast, is it time you cast a wider net in the search for improvement opportunities?■

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Case example 1: Boosting service and reducing inventory in chemicals

One global chemicals player was struggling with an expensive combination of high inventory and poor service. While on average it kept 150 days of inventory on hand, at any one time more than 15 percent of its SKUs were below safety stock levels or sold out completely. It was only managing to fulfil half of its customer orders on time and in full and its order backlog had reached 4 percent of revenues.

To tackle the issue, the company assembled a “control tower” staffed by representatives from the supply chain, manufacturing, and *sales* & marketing functions. This team began an intense cross-functional effort to get the supply chain moving, with daily problem solving sessions and weekly meetings with executives from across the business. The control tower team embarked on a broad set of changes. They applied lean tools to reduce production bottlenecks. They started a program to aggressively sell off excess inventories of slow moving products, while increasing prices for those made on the most highly constrained manufacturing lines. They re-segmented the supply chain, adopting make-to-order or finish-to order strategies for more products where appropriate. And they adopted new supply and demand planning tools, supported by a reorganized supply chain organization.

After three months, the improvement effort had moved the company’s supply chain performance from the bottom to top quartile for its industry. Overall service levels rose by more than 25 percent, order backlogs were reduced by 40 percent and inventory levels were cut by 20 percent.

Case example 2: Cutting supply chain costs in consumer goods

A large consumer packaged goods company was facing rising supply chain costs despite falling revenues. The company embarked on an aggressive effort to cut excessive costs from its supply chain. It evaluated its current transportation choices on a route-by-route basis, using “clean sheet” techniques to renegotiate prices with providers based on their actual costs. It reviewed its warehousing operations to identify opportunities to bring in lean practices to improve productivity, and outsourced some warehouse operations to third party providers. It rationalized the design of its manufacturing and distribution network, cutting production plants, reducing the number of last-mile distribution locations to improve the truck utilization and adopting a “milk run” approach to supply groups of smaller distribution centers using the same trucks.

These efforts yielded dramatic cost reductions across the organization’s supply chain. Manufacturing costs fell by a quarter, warehouse costs by almost a third and the new transportation approach cut costs by more than 35 percent in an area where costs had risen by 15 percent in the previous five years.