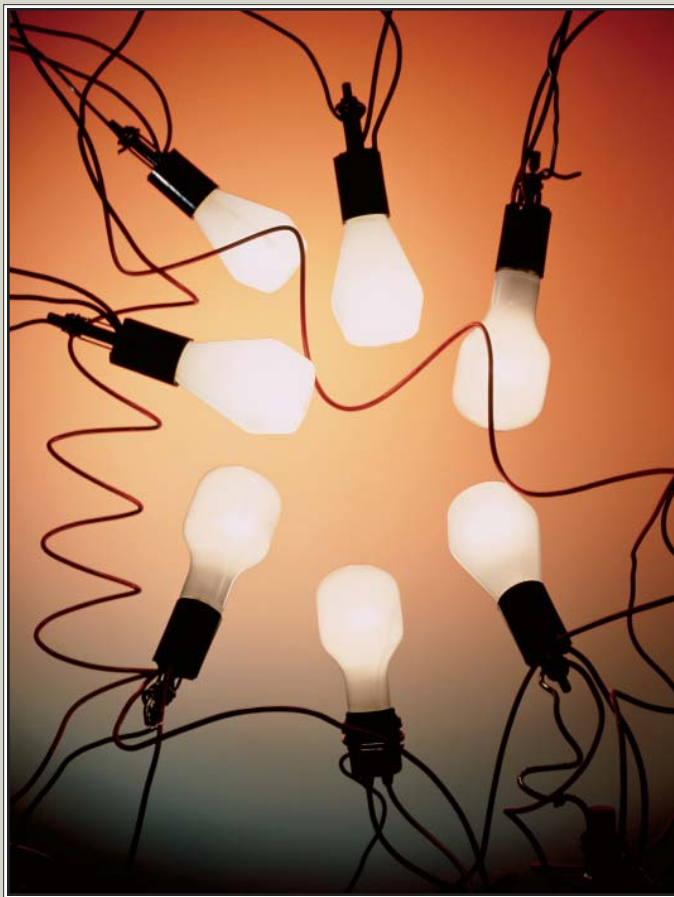


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EXECUTIVE AGENDA

IDEAS *and* INSIGHTS *for* BUSINESS LEADERS



ATKEARNEY

FEATURES

Do You Walk the Talk? 5
Leading companies are learning how to measure their intangible assets — employees who truly “live” the company’s cultural values. Living these values benefits everyone, including suppliers and customers.

Debunking the Myths of Marketing Sourcing 15
It’s true: Strategic sourcing can save marketing money without sacrificing quality or creative control. Here’s how.

How Low Should You Go? 25
In a Wal-Mart world, pricing right is trickier than ever.
But undercutting your biggest rival may not be the answer.

Learning a New Complexity Language 37
Complexity reduction is a good thing—as long as it’s not stifling new sources of value. Managing complexity trade-offs effectively is key.

BOOKMARKS

Growing to New Heights 47
Superior growth is within reach for all companies, in all industries, in all phases of the economic cycle.

RESEARCH REPORT

The Agile Government: It’s Not An Oxymoron 57
The public wants better and faster service from the public sector.
Can the taxman deliver?

VERTICAL VIEW

The Wireline Renaissance in Europe 67
Revenue growth has never been harder—or more critical—for telecommunications companies to achieve. An A.T. Kearney study looks at best practices in Europe.

EXECUTIVE SUMMARIES 76



Learning a New Complexity Language

“Variety is the spice of life,” according to the familiar saying. But for businesses, offering variety is costly—and complexity reduction is often the answer. Is it the right one? Companies can find out by creating a “complexity language” that connects the complexity-loving and complexity-hating parts of their organizations.

Complexity can be a good thing. That extra bit of service, a brand extension, another package size, a touch of customization—such efforts can add up to extra sales and market share. If complexity were all bad, we wouldn’t have so much in the first place. Yet the side effect is deadly: It can be very costly. Expensive enough, in fact, to offset the benefits. If the relationship between the cost and the value of

complexity were clear, managing the trade-off between the two would be a cinch.

Unfortunately, this relationship can be difficult to define. For example, a branded food manufacturer knows its customers value its range of flavors and tastes, different packaging sizes, perhaps even quality levels, and the periodic variations of its products. But it’s not likely to understand exactly how these different factors contribute to the total value

created. The food maker does not have the commodity producers' relative luxury of a market price.

Instead, the food manufacturer has some discretion in setting its prices, which forces it to judge how much customers value the different elements of its offerings. Think of the options a yogurt manufacturer can choose from. Should it offer additional flavors? Different sizes? Add-ons such as sprinkles or granola? Different packaging? The best answer ultimately lies in the balance between the additional costs and the way customers will vote with their wallets.

Companies that have steadily grown to become multinational corporations, with multiple factories and sales organizations, also often find that complexity costs and complexity value are hard to reconcile. In such situations, effective complexity management becomes a real challenge, and chances are excellent that complexity has gradually built up to become unnecessarily expensive.

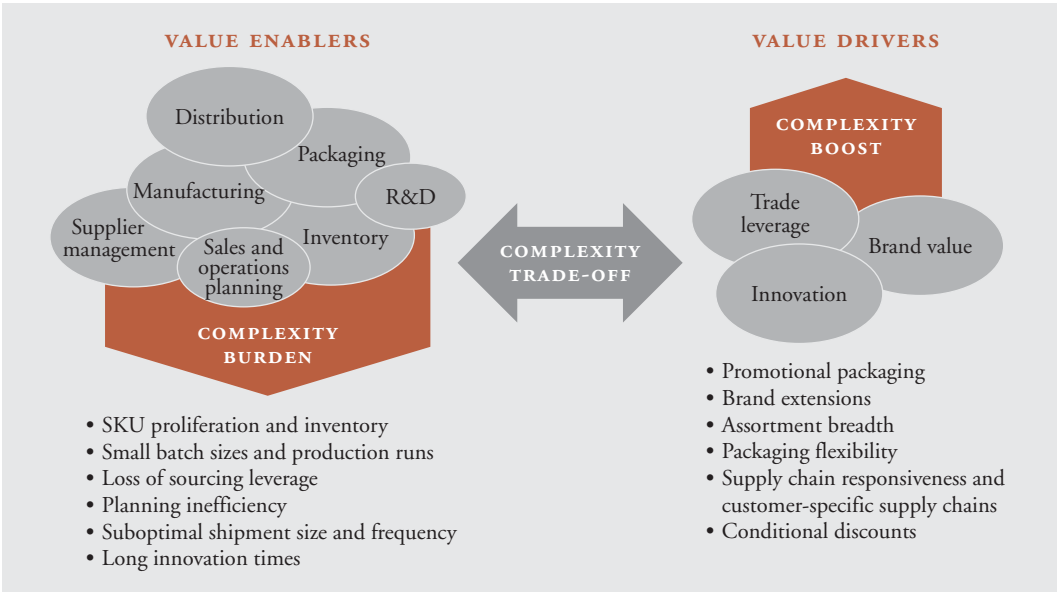
Take a fast moving consumer goods (FMCG) firm that sells a popular brand of candy bars. Its value rests squarely on its brand equity, its ability to innovate to keep this equity strong, and the influence it exerts in the market as a dominant player in multiple categories. The company needs first-class manufacturing, packaging and distribution—but these elements of the business bring in less value than brand equity and market influence. A king-size candy bar might lure more customers and increase the organization's power in the marketplace, but the additional options also increase costs by reducing the average

production and packaging batch size, increasing stock levels, and requiring more sophisticated planning (*see figure 1*). When such a company wants to manage the complexity trade-off, it faces a number of challenges:

- Complexity crosses functional, business and geographic boundaries.
- The information needed to make trade-offs is often insufficient and rarely connected across the different functions. It's not straightforward, for example, to link the output of consumer panels to the activity-based costing systems of the supply chain.
- Because of its cross-functional nature, managing complexity trade-offs requires senior-level business leadership.
- It takes a long time to learn to effectively manage complexity trade-offs, and it's an ongoing process.

These challenges set a cycle into motion. At first, complexity gradually builds as the company exploits successive market opportunities (such as acquiring a business, expanding into a new country or extending a brand). At some point, however, the net value of this gradually increasing complexity will level off. When a company realizes its average costs are increasing faster than additional sales, it typically undertakes focused complexity reduction efforts (*see figure 2 on page 40*). Companies consider steps that affect value drivers, such as rationalizing brands, harmonizing terms and conditions, and aligning service levels. They also look at measures that affect cost drivers—such as shrinking the supply base, harmonizing ingredients, and reducing variations in products, components and packaging.

Figure 1: Complexity Trade-Offs for a Branded Fast Moving Consumer Goods Company



Source: A.T. Kearney

Complexity reduction efforts are generally focused inside the different functions in the organization rather than being integrated throughout. Product rationalization efforts, for example, often eliminate all variants that don't add value to reduce costs.

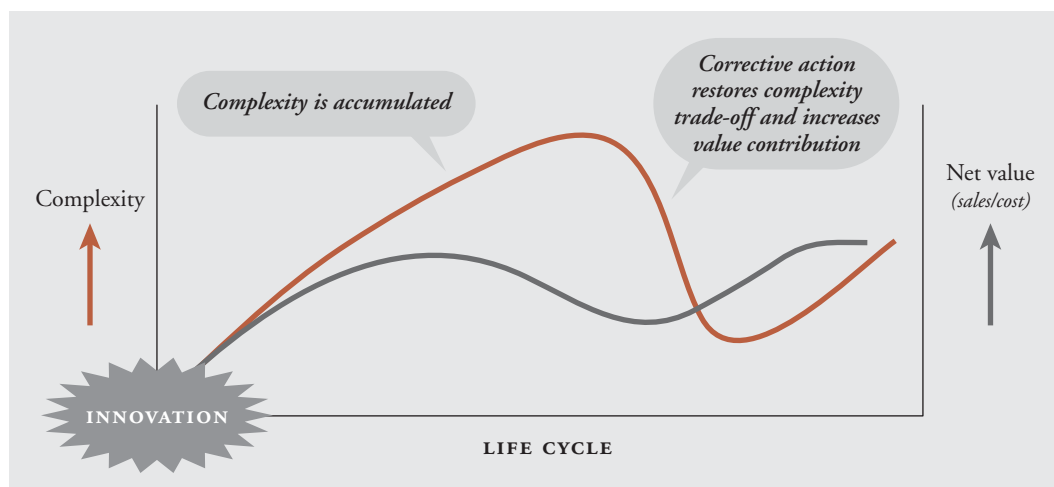
Such approaches cut down on non-value-adding complexity that has built up over time, but they don't necessarily help increase the value brought to the market. Here's a simple example of managing this trade-off: Suppose a company's sales and marketing departments could choose between 10 product families at an average cost of \$100 for a specific sales volume or eight product families at an average cost of \$93. Fewer product families might represent a slightly reduced fit with the market, but \$7 worth of costs of goods sold becomes avail-

able, which can be used to increase trade margins or to spend on other activities.

WHAT'S IT WORTH?

This immediately raises another issue. It is one thing for the supply chain functions to offer such a trade-off, and quite another for sales and marketing to be able to appropriately value these choices. The challenge is at its height in environments where the sales price is set as a matter of policy (for branded goods, for example) rather than as a market price (such as for commodities). Managing this trade-off on an ongoing basis requires solid approaches to valuing the different forms of complexity the firm takes to the market.

Why not just reduce complexity instead of going to the effort of managing the

Figure 2: *Typical Complexity Build-up and Corrective Action Over Time*

Source: A.T. Kearney

trade-off? This might seem like a logical question. Cutting out complexity that adds no value is a great place to start, but it shouldn't keep companies from also addressing their longer-term need to become able to continuously manage the complexity trade-off. And the need for such complexity management is increasing in many industries. Companies cannot become adept at continuously managing the trade-off overnight; the effort requires significant investments in processes, ways of working and information support.

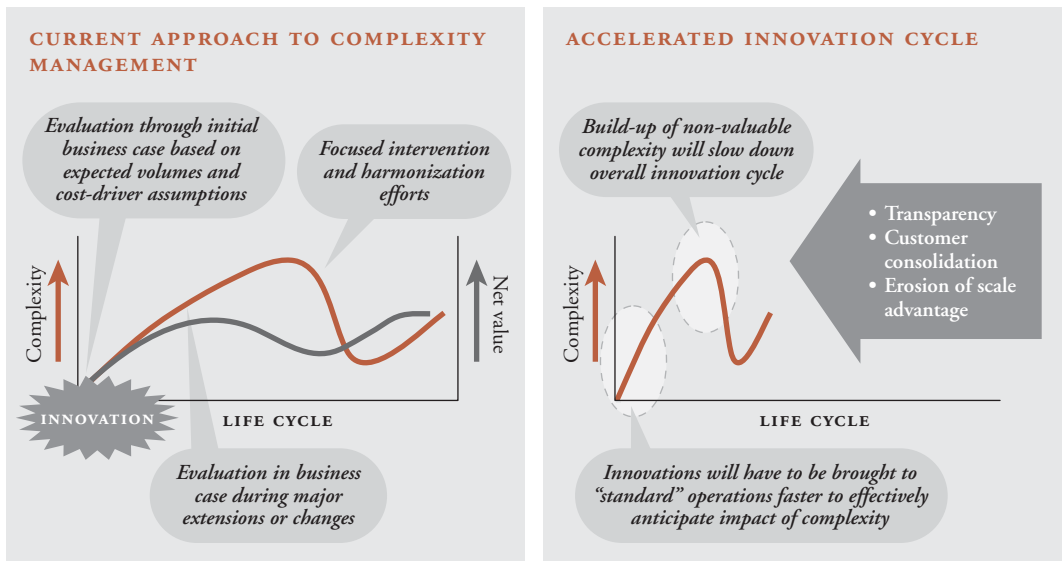
The main reason to master the trade-offs in complexity management is that it is not becoming any easier to grow. Increasing market transparency makes differentiation more difficult. Customers are consolidating, increasing their buying power and reducing their volume disadvantage for private label ranges or parallel imports.

As a result, competitive advantage erodes

faster than ever before. There is little room left for the costs of non-value-adding complexity, and it cannot be allowed to increase. Companies need more effective control over their operations, so they build the *appropriate* complexity into product and service innovations and improvements and bring them to market quickly (see figure 3). This control can reside in obvious areas, such as the ability to effectively tap into the company's existing base of components and subassemblies during product development, and the ability to realistically model the supply chain impact of new products (beyond direct costs).

Many businesses with slim margins have already addressed this issue by conducting some form of activity-based costing linked to revenues to gain insight into profitability. Because their pricing is closer to a market price, these companies have an indication of the *value* of complexity. For more

Figure 3: Limitations of Cyclical Corrective Complexity Reduction



Source: A.T. Kearney

differentiated industries characterized by greater discretionary pricing, however, it will be harder to achieve this insight, although it's just as valuable.

A NEW VIEW

The aluminum packaging division of Pechiney, a French steel and aluminum producer, learned to carefully manage complexity trade-offs. Steadily eroding margins, increasing competition and tougher customer buying behavior forced it to increase control, not just over its operations and costs, but also over its market offering. By combining these elements into a single "complexity language" spanning the entire firm, it created the ability to manage the trade-off between complexity costs and value. To achieve this, it focused on two areas: creating an appropriate level of cost

transparency, including the impact of complexity drivers, and creating insight into the relative market value of various complexity (and cost) drivers.

Pechiney worked with A.T. Kearney to create a pragmatic activity-based costing model to produce the appropriate cost transparency. Both cost and complexity drivers were used to realistically represent costs.

The real breakthrough in managing the complexity trade-off, though, wasn't on the cost side. The company gained critical insights in the relative *value* of complexity by investigating the price elasticities of the different complexity drivers. The company asked customers to value specific trade-offs, such as choosing between a slightly lower price or an occasional rush order to help the company assess the market's appreciation for different complexity drivers.

By matching these complexity value insights with the cost transparency model, the company knew which trade-offs to make. It found, for instance, that no customer was prepared to pay for the true costs of batch sizes of fewer than 20,000 pieces. This finding reaches further than traditional activity-based costing profitability insights: It shows not only where profit is and is not made, but also where there is room in the market to change the price and improve the value mix brought to the market.

WHEN MORE IS BETTER

Being able to express complexity value has other advantages as well. Companies can create a business case for investing in new capabilities that support complexity that has clear market value. It's essential to be able to do so for complexity drivers that are both costly and significant sources of potential value. Because costs are easier to measure than value in most companies, the high costs of the complexity driver may prompt executives to lower costs by reducing the volume of the cost driver. Given the high value associated with the complexity driver, however, it would be prudent to search instead for opportunities to actually *increase* the driver volume at lower cost. This obviously requires that some measure of value for this driver can be expressed strongly enough to create the business case for this investment.

Promotional packaging for a fast moving consumer goods company is such a complexity driver. Because promotional packaging is non-routine—for example, bundling three

products in a blister pack to support a three-for-the-price-of-two promotion for the retailer—it is cumbersome and error prone. In fact, it's disruptive and thus costly because it doesn't fit in the standard supply chain operations of many FMCG firms.

But promotional packaging is also becoming increasingly important in terms of trade leverage. So rather than minimizing the costs of promotional support (such as through capping the amount of promotions or outsourcing), it makes sense to assess how promotional packaging could be handled more effectively. Does the company need more volume, and should different business units pool their requirements? Would a new planning system help? Should production processes be modified to better integrate with promotional packaging processes? Once the company can more efficiently handle the highly valued promotional packaging support, it gains competitive advantage.

As mentioned earlier, many business-to-business industries with limited room for true differentiation have been forced to address the complexity trade-off. To maintain a healthy balance between revenues and costs, they combine different forms of cost accounting and activity-based costing with aligned terms and conditions. They can then identify where their complexity fails to deliver value and take appropriate measures. For other industries, such as where brands, patents or innovation rule, it's much harder to determine the connection between the costs and value of complexity—and as a result, companies haven't done it yet.

“Perhaps we ALREADY
HAVE A PLETHORA of,
say, peach flavors, but
we’re always LOOKING FOR
THAT ‘WOW!’ FACTOR....”

—*Smita Patel, vice president,
research and development, Snapple Beverage Group*

Beverage World, November 2002

CONNECTING COST AND VALUE

The simplest way to think about this connection is as a language that brings together the different functions in cost and value terms. Such a cross-functional language will be essential for companies seeking to manage complexity. This blueprint should focus on linking the costs of the most important complexity drivers with the dominant market-facing value drivers. The exercise of identifying those interrelationships will contribute significantly in understanding how complexity costs relate to value.

Such a complexity language can be seen as a matrix; one axis represents the most important (complexity) cost drivers, and the other axis the dominant (complexity) value drivers. The complexity cost drivers can be derived from the different supply chain steps, research and development, sales and marketing processes, and support functions where relevant. They can be quantified with tools such as activity-based costing systems. The individual complexity value drivers affect the different complexity cost drivers in specific ways. They might affect more than one complexity cost driver. Different product packaging sizes, for instance, will affect production batch sizes, changeover times, stock levels, and terms and conditions management, to name a few.

When the Snapple and Gatorade brands both belonged to the beverage business unit of Quaker, the differences between value drivers and complexity drivers were apparent. Although both are single-brand beverage businesses of considerable size, they have very different value drivers.

Gatorade is a performance drink sports enthusiasts use to rehydrate after exercise. Because of this, different packaging sizes ranging all the way up to a gallon represent an important value driver. Gatorade has a variety of flavors, but taste takes a back seat to slaking a serious thirst. Translated in the new complexity language, this means that multiple flavors represent less value than bottle sizes, which represent an important value driver that justifies investments in the capability to efficiently deal with multiple bottle sizes.

Snapple could not be more different. It is mainly consumed during lunch breaks, when different flavors command significant value since consumers all want to escape in their own way. Bottle sizes play a much smaller role in the value equation. In fact, the thought of a gallon of “mango explosion” inside one’s stomach around lunchtime would probably represent a fair amount of negative value. It is no surprise, therefore, that the Snapple complexity cost drivers are geared toward being able to handle many different tastes effectively, and even test new flavors easily in the market—nearly the opposite of the Gatorade beverage.

PUTTING THE PLAN INTO ACTION

Once a business draws up a complexity language blueprint, it faces the challenges of implementing it. One key step will be to create the required level of information support. Activity-based costing systems will have to be tailored to incorporate complexity drivers more explicitly. On the market-facing side, companies will need sound insights

into what creates value, gained either through tailoring or creating focused market intelligence systems or through dedicated projects and ways of working focused on understanding the value elasticities of different complexity drivers. The effort will also require a platform that includes support tools for more effectively managing the trade-offs.

However, insights and support tools alone will not be sufficient. Because of its cross-functional nature, complexity management will require a governance structure

that ensures that the complexity trade-off is addressed on an ongoing basis. Although effective complexity management should bring benefits to all functions and thus create a natural pull, different parts of it will have to be jump-started with the right incentives.

Creating the capability to manage the complexity trade-off will take considerable time and effort. In fact, it could take years to fully manage the transition—but of course, complexity touches the heart of the organization. 

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