Margin unlocked

Integrated margin management to deliver breakthrough performance in consumer products
About this report

EY, in collaboration with the Economist Intelligence Unit, conducted a global survey of 183 executives from consumer products companies. Approximately half of respondents were C-level, or board-level executives with the total pool from a range of sub-sectors, including food, beverages, home and personal care, luxury, tobacco and apparel. Around half of all respondents were based in North America and Europe, with the remainder in Asia-Pacific and Latin America.

In addition, EY conducted in-depth interviews with senior executives from across the consumer products industry to seek their views on current trends, leading practices in margin management and insights concerning future developments.
Executive summary

Consumer products companies are experiencing unprecedented challenges. As EY explored in our 2012 report *Disrupt or be disrupted*, the industry is facing a brand new order of continuous, accelerating change and spiraling complexity in which tried and tested ways of capturing value are no longer fit for purpose.

Margin1 management is no exception. Currently, many consumer products companies take a tactical, reactive approach to sustaining or growing margins. Rather than thinking about margin performance consistently across the entire business, they make incremental, localized changes focused on a specific part of the profit or loss or within a country, function or category.

This piecemeal approach may have worked in the past, but with companies facing a combination of slowing top-line growth in both developed and emerging markets, downward pressure on prices from customers and consumers, and rising input costs, it is increasingly ineffective. Instead, the scale of the challenge means that companies need a new, company-wide and integrated approach to margin management, driven by senior leadership, which permeates the entire business.

Of course, margin is not the only metric that concerns consumer products companies. They also need to focus on a range of other objectives, such as total shareholder returns or the cost of goods sold. Nevertheless, margin management is one of the key levers of improving returns over the long term. To help our clients improve their margin performance in a sustainable way, EY has developed a framework that we call Integrated Margin Management. This consists of three building blocks, which we believe should form part of the DNA of the organization:

1. **An integrated approach to margin management, driven by senior leadership**
   
   Senior leadership must recognize the need for change, commit to making it happen and drive an integrated approach through clear direction.

2. **Improved insight on margin performance for better, faster decisions**
   
   An understanding of the true drivers of margin and access to richer, more granular information about performance is essential to enable margin-focused decisions.

3. **An operating model that has margin at its core**
   
   Companies need to embed margin management so that it pervades the entire organization by upgrading capabilities and processes, aligning incentives and enabling joined-up thinking and execution.

By adopting this Integrated Margin Management framework, companies can drive competitive advantage by unlocking significant margin opportunities that were previously hidden. This end-to-end mindset helps companies to break down barriers to more effective margin management, and access the full benefit of their global scale and capability. In this report, we outline our point of view around Integrated Margin Management, and provide practical advice on how companies can adopt it in their business.

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1 For the purposes of this report, the term “margin” refers to operating margin (operating margin/revenue, or earnings before interest, tax, depreciation and amortization EBITDA as a percentage of revenue).
“Driving out costs and continuous excellence has to be a permanent thing because every organization tends to bring back inefficiency over time. The key is to work out what the consumer values and not incur cost on things that the consumer doesn’t value.”

José Lopez, COO of Nestlé
Margins at consumer products companies are being squeezed from multiple directions. In a survey of more than 180 consumer products executives conducted for this report, 75% of respondents say that it has become harder to sustain or grow operating margins over the past three years (see Chart 1).

In developed markets, top-line growth has either slowed dramatically or declined. Consumers are trading down and customers are placing intense pressure on companies to apply steep discounts or offer generous promotions. “Customers are pretty reluctant to take price increases even in good economic times, but in a very tough economic environment, that becomes even more challenging,” says CEO of a leading consumer products company.

In emerging markets, margins have also come under more intense pressure from spiraling wages, commodity prices, distribution costs. In our publication, Disrupt or be disrupted, consumer products executives named cost/pricing issues as among the top three barriers to executing company strategy. Although pressure has eased slightly in recent months, oil prices and commodity prices remain at high levels and, as long-term demand increases from emerging markets, further price rises are expected. “We need to adapt to a new reality in which demand for commodities will increase in emerging markets but at the same time their availability will decrease. That is the new paradigm,” says Yves Pellegrino, Corporate Finance Director at Danone.

Consumers and customers may be pushing for lower prices, but they still respond to innovative new products and services, and that means that companies must continue to invest in product development, while at the same time keeping a close eye on costs. “In our category, innovation is happening more quickly than I’ve ever seen,” says James Barrett, Group Head - Marketing Finance at British American Tobacco. “There’s a lot of real change in the industry, which of course is driving up your product cost, because it’s new technology and new ways of doing things and you don’t enjoy the same economy of scale that you had previously. That inflation in product cost caused by innovation makes it essential that margin enhancement models are robust.”

Mr. Barrett emphasizes the need for discipline around the process of introducing new products or brands. “Over the past 18 months, we’ve introduced a much tighter process around business case control,” says. So if you want to launch a product, or a new brand, or you want to do something according to certain thresholds, you have to make a business case for it, and one of the sections looks at operating margin enhancement. The reason we’ve done that is because we found that in the headlong rush for market share, it’s quite possible to dilute your operating margin.”

Paul Walsh, former CEO of Diageo PLC, emphasizes the need to think about margin in the context of what consumers want. “Margin expansion starts with how you add value to the consumer,” he says. “Not all cost is bad cost, because if we can come out with a far superior package that may cost more but be worth more in the eyes of the consumer, then this can allow us to increase margins.”

With profitability under pressure in both developed and rapid-growth markets, companies recognize that they must apply a more rigorous focus to margin management than has previously been the case. Diageo, for example, made operating margin growth one of its key priorities and released guidance describing how it planned to add 200 basis points of operating margin growth over the next three years. “We recognized that there was some margin pressure and decided that we needed to take steps to increase operating margins after a period of relatively flat growth,” says Chris Davies, former CFO for North America at Diageo. “This created a rallying cry around the organization to do things a little differently.”

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Margin unlocked: integrated margin management to deliver breakthrough performance in consumer products
Looking into the future, there are few signs that the pressure on margins is about to dissipate. In October 2013, for example, Unilever announced its first profit warning for almost a decade, citing slowing growth and weakening currencies in emerging markets as a key factor. The company said that it was expecting underlying sales growth of 3% to 3.5% in the third quarter of the 2013 financial year, compared with 5% achieved in the first half.

There is a strong sense across the industry that companies face strong headwinds that make it difficult to sustain margin performance. “Operating margin pressures will remain as companies continue to evolve with the change in customer needs and demands,” says the director of leading global retailer. “The ability to fulfill these changing customer needs will require companies to continue to innovate in areas such as product, delivery, service and even the way they interface with the customer – all of which will put pressure on companies to become more efficient.”

Asked about how they expect their company’s ability to sustain or grow operating margins to change over the next three years, a majority of respondents only sees the squeeze becoming even more intense as shown in Chart 2 below. “A low-growth environment in developed markets combined with inflationary headwinds and falling spending power means that demand is flat and growth cannot come from pricing,” agrees Gary Turner, a leader in the Operational Transaction Services practice at EY. “In this environment, companies still think the right thing to do is to try and serve all customers, all the time with all products and services at the highest level of quality. If you try to do this, the reality is that it just drags in a cost base that’s not sustainable and you are picked off by more focused competitors.”

Margin growth will be particularly challenging in emerging markets, with 67% of respondents thinking it will be harder to grow or sustain margins, compared with 60% in developed markets. As emerging markets comprise an increasingly important part of consumer product companies’ revenues and growth prospects, careful attention must be paid to ensure that this growth is profitable. Improving margin performance in emerging markets must be a key area of focus for the industry as the center of economic gravity shifts toward these economies.

“Operating margin pressures will remain as companies continue to evolve with the change in customer needs and demands.”
Director of leading global retailer

Chart 2:
Do you expect your company’s ability to sustain or grow operating margins in developed and emerging markets to become easier or harder over the next three years?

A need to step up margin performance

The intense margin pressure that many consumer products companies face is encouraging them to think differently about how they manage margin. In the past, a typical approach to margin management was tactical, and focused on making specific improvements to elements of the P&L, or within geographic or functional boundaries. Many companies embarked on a series of one-off initiatives, frequently driven by market pressure, that were designed to achieve a very specific goal. For example, they may have implemented an overhead reduction program or undertaken a consumer pricing initiative.

In isolation, these initiatives may have achieved their goals and delivered modest margin performance improvements, but they have done little to overcome the relentless margin pressure that companies continue to face. Like the arcade game of “Whac-A-Mole,” in which players strike mechanical “moles” with a mallet only for them to pop up elsewhere, sustaining margins using isolated, piecemeal solutions can start to feel like a futile task.

This becomes evident when we look at the margin performance of leading consumer products companies over the past decade. Most have managed only to deliver modest margin growth, with the overall increase in the weighted average margin for the largest 50 consumer products companies increasing just 60 basis points over a 10-year period (see Chart 3).

![Chart 3: Operating margin performance of the top 50 CP companies over 10 years](chart.png)

Capital IQ. Chart shows weighted EBITDA margin performance of the top 50 CP (Food, Beverage, HPC and Tobacco) companies as ranked by revenues in 2012.

Margin unlocked: integrated margin management to deliver breakthrough performance in consumer products
Breakthrough performance

Despite these challenges, our research provides encouraging evidence of a number of companies that have delivered breakthrough margin performance over the past 10 years, surpassing the results delivered by their peers. Chart 4 maps the operating margin and change in operating margin for the largest consumer products companies. The results are diverse, but breakthrough high performers, those positioned toward the top right-hand corner including Anheuser-Busch InBev (ABI), British American Tobacco and Reckitt Benckiser, are bucking the trend. Not only are they among those delivering margin at the top of their industry group they also have delivered an increase in the weighted average margin of 530 basis points over the last decade.

Our research and experience of working with companies across the consumer products industry points to a number of key features that are common to the way in which these breakthrough, high performing companies view and manage margin within their organizations. In particular, they take an active approach to breaking down barriers across the organization and apply innovative, non-traditional thinking to improve margin performance. By managing margin end to end, they look beyond cost reduction and price increases to find a more integrated way of driving overall results. This puts the company in the best possible position to drive margin improvement across the entire organization.

“Companies that deliver breakthrough margin performance approach margin holistically and embed Integrated Margin Management into the DNA of their organization.”

Gustav Mauer, Advisory Director at EY

ABI, for example, has a market-leading operating margin of 32%, which is higher than not only other beer companies but also many premium spirits manufacturers. Formerly private equity owned, ABI’s simple, focused and clear approach to its business and margin, articulated via the “ABI way,” has had a significant impact, consistently delivering increasing EBITDA margins since its formation in 2008. The ABI way comprises four key strands: a lean cost structure (including zero-based budgeting) being in the right markets, focusing on the right brands and a pursuit of price leadership.

Chart 4:
Distribution of operating margins and operating margin growth for the top 50 CP companies

Operating margin defined as EBITDA margin. Excludes companies which did not report data in 2003.
ABI generates impressive operating margins of 32% ahead of not just leading beer companies but also premium spirits players such as Diageo and Pernod Ricard.

ABI's EBITDA margin has increased for 13 consecutive quarters, year over year, since ABI was created in 2008.
Three building blocks for delivering breakthrough margin performance

So, how do companies deliver margin at the top of their industry group? EY believes that, in order to increase margin consistently and sustainably, companies need to apply a framework that we call Integrated Margin Management. This consists of three key building blocks.

1. An integrated approach to margin management, driven by senior leadership

The first building block anchors the new way of thinking from the top to the bottom of the organization, the second turns it into an integral part of performance management while the third embeds it into the operating model of the company.

2. Improved insight on margin performance for better, faster decisions

3. An operating model with margin at its core
Margin addressed in a piecemeal way, with country or functional approach

Responses to margin pressure happen reactively within execution timeframe

Internal focus around basic cost and price improvement

Emphasis on management of current product margin

Margin initiatives largely cost-focused

Business leadership takes a holistic, organization-wide view of margin, recognizes the need for change, commits to make it happen and leads from the front to deliver

Responses to margin pressure are proactive, anticipate the need to react and take place over a strategic timeframe

Internal and external focus with supplier and customer margin challenge

Focus on management of lifecycle margin across product and portfolio

Margin initiatives balance cost reduction and value creation to provide a holistic response

Fragmented, siloed decisions, not always based on evidence and facts

Business drivers and their impact on margin inconsistently understood and managed

Disparate data platforms and processes

Margin decisions solely based on past experience

Decisions based on insight and take into account business interdependencies

Business drivers understood across the organization and integrated with strategic, commercial and operational margin management processes

Information platforms integrated horizontally (across business functions) and vertically (to the granular data level)

Connected, fast and forward-looking insights, through predictive modelling and simulations

Margin performance primarily owned and influenced by country businesses

Economies of scale not fully exploited

Skills mainly reside in country

Unexploited margin opportunities due to lack of investment and capability

Center-led cross-functional margin management across country and regional/global teams

Economies of scale fully exploited

Centralized functions/Centers of Excellence deliver deep, focused skill set

Investment and central/external capacity fully leveraged to execute on margin opportunities
An integrated approach to margin management, driven by senior leadership

Approaches to sustaining or growing margins that worked well in the past are now failing to deliver the required results.

A key problem has been a lack of collaboration. Approaches to margin management tended to be reactive, and were influenced more by functional objectives than the business as a whole. For example, supply chain leaders have made great strides in delivering value through centralizing procurement, implementing lean manufacturing and outsourcing logistics, but they are reaching the point where they need collaboration with their colleagues in the commercial organization to unlock the next step change in margin performance.

“"In the past, we normally went after margin through cost reductions in the supply chain,” says an executive from a global food company. “Now, we’re looking at opportunities across the whole P&L — not just the supply chain, but really starting to work with the commercial side of the business as well.”

Consumer products companies must look at margin holistically, considering performance and opportunities in a more end-to-end way (see Chart 5). This means working collaboratively with internal and external stakeholders as a single organizational unit rather than as a collection of functions, partners and geographies. By taking a holistic approach right across the entire value chain, consumer products companies should be able to increase margin opportunities in every part of the business, as well as outside the boundaries of their own organizations.

Chart 5:
Integrated margin management functional interventions are making way for an end-to-end approach
At Nestlé, for example, a culture of removing waste is embedded across all functions and levels of the organization. The company has introduced a focus on end-to-end processes to eliminate waste, maximize efficiency and enable synergies. Nestlé’s business excellence framework ensures that best practices on waste elimination are shared and enables more transparent and informed decision making about which activities to remove and which to optimize.

“Our focus on continuous improvement means that we are constantly driving waste out of the system,” says José Lopez, COO of Nestlé. “Driving out costs and continuous excellence has to be a permanent thing because every organization tends to bring back inefficiency over time. The key is to work out what the consumer values and not incur cost on things that the consumer doesn’t value.”

The majority of companies believe that much more must be done to improve margin performance. Our research for Disrupt or be disrupted found that almost three-quarters agree that significant changes to their business model are needed just to sustain historic margin levels. It is also striking that, for every major activity within the company, more than half see further opportunities to grow margins. In the case of marketing and R&D, three-quarters see further opportunities (see Chart 6).

**Chart 6:**
Generally speaking, are there further opportunities for your company to grow its margins in the following areas of your organization?

<table>
<thead>
<tr>
<th>Area</th>
<th>Agree</th>
<th>Disagree</th>
</tr>
</thead>
<tbody>
<tr>
<td>Marketing</td>
<td>76%</td>
<td></td>
</tr>
<tr>
<td>R&amp;D</td>
<td>75%</td>
<td></td>
</tr>
<tr>
<td>Finance</td>
<td>71%</td>
<td></td>
</tr>
<tr>
<td>Manufacturing</td>
<td>68%</td>
<td></td>
</tr>
<tr>
<td>Sales</td>
<td>68%</td>
<td></td>
</tr>
<tr>
<td>Information technology</td>
<td>66%</td>
<td></td>
</tr>
<tr>
<td>Distribution</td>
<td>63%</td>
<td></td>
</tr>
<tr>
<td>Procurement</td>
<td>61%</td>
<td></td>
</tr>
<tr>
<td>Supply chain planning</td>
<td>61%</td>
<td></td>
</tr>
<tr>
<td>Human resources</td>
<td>55%</td>
<td></td>
</tr>
</tbody>
</table>

The importance of leadership

Yet there are challenges that make it difficult for companies to capture these opportunities. Asked about the main internal barriers that prevent their company from doing more to sustain or improve margins, respondents point to a limited “margin mindset” in the organizational culture as a key obstacle (see Chart 7). In other words, specific margin initiatives are undertaken, but not enough effort is made to make margin part of the fabric of the organizational culture.

Embedding a pervasive culture of margin management starts with the vision and urgency for change articulated by senior leadership. Driving this change will not happen overnight. Business leaders must remain at the forefront and continue to break down the barriers to unlock the full margin potential of their products and brands. “Senior leaders in our company are dedicating 20% to 25% of their time to making our margin management program a long-term sustainable process,” says an executive from a Fortune 500 consumer products company. “Without that commitment, it would be very difficult to make it work.”

By driving margin performance from the very top, companies can embed it deeply into the business and make it part of the fabric of day-to-day decision making. “A culture and metrics around margin must permeate the company,” says Gilberto Meirelles Xandó Baptista, President of Vigor, SA, a Brazilian dairy and food company. “Initiatives around pricing that are embedded across the whole value chain should be closely linked to sales team metrics, not only based on volume, but also on bottom line results.”

Chart 7:
What do you consider to be the main internal barriers preventing your company from doing more to sustain or improve margins?

- Limited “margin mindset” in organizational culture - 39%
- Operating model (e.g., process organization, performance measures) - 33%
- No internal sense of urgency - 28%
- Wrong time to absorb additional change - 28%
- Too many locked in fixed costs in the business - 25%
- Changes required create too much risk - 22%
- Insufficient data and insight available - 22%
- Lack of skills and competencies - 21%
- Lack of focus from leadership team - 21%
- Too much investment required - 20%

2 Improved insight on margin performance to drive better, faster decisions

In the past 10 years, information systems have improved dramatically. Most multinational consumer products companies have now implemented ERP platforms such as SAP and other complementary systems. Whilst these have the ability to provide vast amounts of useful data, the problem for many companies lies in accessing this data, driven by poor integration and a lack of standardization, leaving them struggling to realize the full potential benefits of their investment. Even where good quality data is accessible, a big challenge lies in extracting meaning from it.

The CEO of a global consumer products company outlines the scale of the challenge. “Our management data came in the form of a 700-page report of financial line items,” he says. “This means that we spent 90% of our time playing detective – trying to assemble the data and ask the right questions – and 10% on the issue. Those proportions needed to be reversed.”

EY’s Integrated Margin Management approach requires companies to make step changes to the visibility of performance data and then to use that information to make the right margin decisions for the organization. This requires companies to address the following steps.

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**Chart 8:**
The importance of insight across key drivers of margin and monitoring angles

<table>
<thead>
<tr>
<th>Key drivers of margin</th>
<th>Category/product/brand</th>
<th>Region/country/area</th>
<th>Channel/customer</th>
<th>Function/process/activity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Price</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Volume mix</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of innovation</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Marketing spend</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost of goods</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Cost to serve</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Back office costs</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
Gain a consistent view of the drivers of margin performance

Analyzing data to enable impactful decisions requires companies to understand the key drivers of margin performance across the end-to-end value chain. Without this understanding, they can easily spend valuable time and company resources analyzing the wrong data, miss the real issues that impact margin and fail to spot improvement opportunities.

Most businesses understand the forces that drive margin. Yet, many find it challenging to access a consistent and common view of the most significant drivers across dimensions including product, channel, geography, market, segment or business unit. This makes it difficult to turn the data that exists in the organization into insight. The breakthrough, high margin performers in the industry, which operate under Integrated Margin Management principles, typically have data readily available across this spectrum, allowing them to identify quickly the root causes of changes and trends impacting margin to an appropriate level of granularity.

Look beyond the boundaries of the organization to identify drivers of margin performance

Failure to identify the critical drivers in the end-to-end value chain and to correlate their impact on margin performance means that companies struggle to understand why a performance metric has moved. This means that they often make decisions that lead to sub-optimal margin performance. For example, while they may know that sales have fallen in Brazil and risen in Uruguay, they do not know why and so cannot respond. Or, they might conclude that exceeding a revenue target means a job well done whereas, in fact, it could be hiding poor performance elsewhere.

To enable Integrated Margin Management, companies need to consider the upstream and downstream processes in the value chain. For example, while the product portfolio and initiative pipeline are vital for growth, they must be understood in context of the downstream supply cost implications that they cause. Likewise, it is necessary to look beyond the confines of the organization to the external drivers that impact margin. For example, a new competitor with a substitute product could have a profound impact on both price and volumes. But, if the company is not proactively monitoring these external factors and fails to identify them, it will struggle to understand the root causes of the margin change.

Make bold decisions quickly to enable effective competition

Among our survey respondents, just 13% say that they are very effective at leveraging data and analytics to inform margin decision-making. Information is only as valuable as the decisions it drives. Company leadership needs confidence that they have the right information to make choices that maximize medium and long-term margin growth across category and geography combinations. This is an evolving area and one where many companies are still finding their way. A common problem is that ineffective analysis and information exchange between local units and central headquarters fail to generate insight. Establishing a focused analytics capability that is able to provide the required information consistently, while incorporating data as a core part of operations through the business cycle, goes some way towards addressing this challenge.

Slow and ineffective decision-making is a real concern because it prevents businesses from reacting to new opportunities and threats. EY’s recent publication *Making better decisions faster* outlines further the case for employing a driver-based decision-making approach, enabling decision-makers to prioritize actions on the highest impact drivers.

“The decision we took was to get margin into the conversation and the rhythm of the business, equipping people with the tools they need to manage it themselves.”

Chris Davies, former CFO for the Americas, Diageo
Case study

A large multinational organization considers its analytics capability as a source of competitive advantage

With sponsorship coming from the highest levels in the organization, a large global organization has built the governance, infrastructure and processes to analyze business drivers, drawing insight and delivering measurable value to the business. To drive significant improvements in margin it put in place an analytics program covering multiple domains including revenue generation, cost avoidance, cost reduction, cost recovery, risk reduction and working capital. In fact it manages its analytics pipeline as a portfolio the same way it manages its drugs product pipeline – accelerating value creating projects while stopping projects not delivering quickly.

There are three critical success factors driving the program, which were monitored throughout implementation and beyond, are:

1. Building a performance improvement culture through a value realization framework and the “value thermometer”
2. Using an “agile” approach to accelerate the time it takes for ideas to translate into value
3. Creating an environment whereby business domain expertise, analytical problem solving and end-to-end data driven solution development come together

Value thermometer

[Diagram showing a thermometer with labels for Unidentified opportunity $, Pipeline potential $, In process $, and Realized $]
An operating model with margin at its core

Companies need to assess the structure of their operating model to ensure that it is optimized to deliver strong margin performance.

Strong margin delivery depends on having the right operating model. This helps to embed accountability, drives the right behavior across the organization, and ensures that margin performance remains a key priority that is monitored and managed appropriately.

For now, many companies still have a silo-based operating model. This can inhibit end-to-end thinking around margin, and mean that decisions are taken with consequences that are poorly understood. There may be a lack of rigor around performance management and incentives to drive margin performance. Likewise, companies may fail to invest in the capabilities that enable leading practices in margin management to be identified and disseminated throughout the organization.

With an operating model that is not fit for purpose, many companies struggle to deliver the margin improvements that stakeholders expect. Just 4% of respondents, for example, say that they are very effective at spotting opportunities to improve margin, and just 17% think they are very good at integrating margin-focused decision-making into their core business processes (see Chart 9).

An Integrated Margin Management framework helps companies to challenge the structure of its operating model and ensure that it is fit for purpose. There are three key priorities that companies need to consider.

Chart 9:
How would you rate the effectiveness of your company at the following?


Margin unlocked: integrated margin management to deliver breakthrough performance in consumer products.
1: Transcend traditional barriers with margin orchestration

Embedding a culture of margin management requires companies to ensure that the right accountability is in place to drive the right behavior. Increasingly, companies are putting in place functions and leadership roles with a specific focus on margin. Creating this “margin orchestration” capability provides end-to-end accountability for total margin across the organization. The role, which incorporates the identification of margin challenges, coordination of interventions and reporting on performance, makes companies better able to prioritize and focus on the right opportunities, measure success with the right performance metrics and also facilitate the sharing of knowledge and leading practices across the organization.

Examples of companies successfully integrating margin orchestration into business as usual include Procter & Gamble, where a Global Productivity and Organization Transformation Officer has been appointed to focus on company-wide improvements. Another leading consumer products company has also established a margin management team at a global level.

The way in which margin orchestration can be incorporated into the organization will vary depending on how the wider business is structured.

Margin orchestration enabled via a category/product aligned operating model

A consumer products company with an operating model aligned to global categories can adopt margin orchestration across every function, including sales, marketing, R&D and the supply chain, with some overall coordination between them and targeted intervention as required. The principles of this approach could comprise the following:

- A cross-functional team that looks at margin leakage from strategic pricing through to raw material costs
- Monthly dashboard review of margin performance across all brands, products and countries
- Priority areas of margin underperformance identified and opportunities for improvement agreed
- Cross-functional margin improvement taskforce deployed to evaluate margin improvement opportunities and develop action plans alongside country leadership
- Task force brings required skills and toolkit to accelerate effective interventions

Margin orchestration introduced via a specific role

In geographically aligned organizations, the value chain is more fragmented and multiple P&Ls are impacted to reach end-to-end margin optimization. This can make margin orchestration more difficult to achieve and it is likely that a specific margin orchestration role will be required. At one large global foods manufacturer that is organized along a regional model, a new global margin management director was recruited to help overcome this challenge. The role is aimed at driving the following key outcomes:

- Identifying a margin champion who can take a strategic view of margin performance
- Challenging the organization to think outside the box and seek innovative opportunities both within and outside the company
- Developing an integrated margin management approach and capabilities by initially working with key markets and then rolling out to the rest of the world
- Maintaining margin accountability with the regions and countries
2: Increase awareness, motivation and organizational capability at every level of the company

To introduce EY’s Integrated Margin Management framework, organizations need to start from the very basics by building a common understanding of what margin is, why it is important as one of the key levers to improve long-term returns, and how they can influence it. Companies may well find that employees do not even know what operating margin means, or have different views about what matters concerning margin sustainability.

Building awareness

An example at Diageo shows the importance of building awareness. The company announced that it would drive 200 basis points of operating margin growth in the next two years. This had a significant positive impact on share price, and the whole company started to rally around this new objective. Planned initiatives were presented in context of this ambition and a process of educating functional teams on what they could do to influence operating margin was implemented.

For example, a simple and effective document outlining “10 things we can do to improve margin” was created and distributed to sales teams to ensure that they understood their role in the initiative. The document covered every key line on the P&L, starting from the top with price, discount and promotional spend all the way down to the bottom-line margin. In doing so, it illustrated how the various parts of the organization could influence margin performance.

Constant communication reinforces the message about the importance of margin management, and embeds it in the culture. “We always seek to communicate and explain our strategy and direction,” says Leonardo Senra, Finance, Investor relations and IT Director at Souza Cruz, a Brazilian tobacco company. “This requires a great deal of functional discipline, effective budget management, accuracy and solid action plans to execute well. We have also embedded a controller function in each department to demonstrate the importance of costs, create discipline and build internal awareness of costs and margins. As such, the functional areas expect costs and margins to be continually assessed and reviewed. It is part of the day-to-day culture.”

Creating the motivation for change

Part of the shift to an Integrated Margin Management approach requires companies to re-evaluate how they set targets and structure incentives. As with any business objective, margin targets need to be incorporated into the annual target-setting process for the next year, but also for the strategic planning horizon. Targets then need to be cascaded through the organization and incentives aligned to ensure that Integrated Margin Management comes to life in day-to-day execution.

Among our respondents, this pervasive approach to incentivizing margin performance is far from universal, with 44% of the most senior leaders at the Global/Regional executive Leadership level not incentivized on this measure (see Chart 10).

Chart 10:
Which of the following roles in your company are incentivized to deliver margin improvement?

- Global/Regional executive leadership
  - 66%
- Market/Country leadership
  - 60%
- Operational management (e.g. factory manager, brand manager)
  - 58%
- Centralized functional leadership (e.g. procurement)
  - 46%
- All other employees
  - 45%

Many companies find it difficult to implement a culture of margin management in the business because of difficulties finding the right metrics on which to base incentives. To overcome this challenge in North America, Diageo developed a points-based system for its sales teams that was based around a proxy measure for operating margin performance.

Ultimately, margin needs to be the responsibility of everyone in the organization. “We have focused on having overall better quality products and have tried to avoid low margin products with low EBITDA,” says the director of large Brazilian consumer products company. “As part of this strategy, we have reduced 40% of our low margin SKUs. We believe we have been effective here by analyzing cost reduction, costs of SKUs, conducting factory benchmarking and conducting product management reports.”

Building new capabilities

In addition to building basic awareness and education, companies need to develop a deeper skill set to analyze margin leakage and define action that is needed to make improvements. In many cases, companies may need to recruit or develop these skills – for example, into a global commercial center of excellence (CoE) – because they are not already present within the key functional areas where margin improvement opportunities need to be identified.

Driving front office improvements with a center of excellence (CoE)

One global consumer products company found that its sales teams were frequently “giving away” significant margin through unnecessary discounts and promotions. In the past, expertise in pricing, promotions and trade investment experience resided at the market level. The company realized this was inefficient and decided to establish a CoE that could provide deeper analysis and develop leading practices globally for sales teams in different markets. In addition, the CoE monitors and tracks performance, identifies risk areas and provides intervention and support. Following an initial successful pilot in which positive results were seen both with individual customers and in overall margin performance, the CoE was made a permanent fixture within the organization.

“A mindset of end-to-end margin management should be part of the DNA and embedded from distribution to the factory floor.”

Director of leading food company
3: Make margin management sustainable by embedding it into business-as-usual

From the annual strategic processes through to day-to-day execution, a consideration of margin must be built into the formal processes and policies of the organization.

**Strategic planning**

Companies need to plan for margin performance as part of the strategic timeframe, challenging the organization to think beyond its historical top-line focus and current constraints. This should include driving big decisions, for example, to change the operating model, sell manufacturing assets or exit underperforming businesses, brands or countries. There may be opportunities to outsource non-core business functions, such as logistics or the reverse via insourcing. Equally, there may be margin opportunities that can be unlocked by buying out downstream suppliers.

**Innovation and portfolio management**

Bigger, bolder innovation can be a strong driver of margin. There are opportunities to make greater use of product platforms to leverage R&D investment and drive procurement and manufacturing economies of scale and to source innovation more cheaply and quickly from outside the organization by working with suppliers, universities and other companies. At the same time, companies should look to manage the overall portfolio size, introduce margin-focused gating decisions on incoming products and phase out underperforming products to create space for new growth and margin drivers.

“Companies need to adopt a radical view of the products and services they are willing to invest in, and those that are not core and should be removed from the portfolio,” says Gary Turner, EY. “In addition to moving non-core products from the portfolio, they need to address the cost base for serving those products, which means stripping out complexity, simplifying the business and optimizing the footprint.”

**Planning and execution**

Traditional Sales and Operations Planning (S&OP) processes match demand in the market with resources in the supply chain and typically aim to meet committed top-line targets that are monitored on a monthly basis. S&OP also offers margin management opportunities. For example, when supply shortages occur, margin and strategic considerations should be front of mind when deciding which markets or products should take priority. Taking this one step further and making margin a key consideration in this “core drumbeat” of the organization via the monthly business planning cycle helps to ensure that the various moving parts of the Integrated Margin Management approach come together with a regular review. This helps to ensure that necessary changes and interventions take place and follow through into business execution right across the business.
Challenging product and portfolio complexity to drive margin improvement

A multinational consumer products company had significant non-value added product and portfolio complexity, which drove increased cost across the value chain. For example, 60% of its SKUs were making a contribution of just 4% of gross profits. To address this problem, the company initiated a cross-functional, end-to-end program that took a hypothesis-led approach to focus on the “big ideas” that could drive real margin improvement. Hypotheses came from across the value chain, and included suggestions such as “move co-pack in house” and “stop promotional packaging unless ROI reaches a certain level.” The focus was on a data model that helped the company to understand the impact of the hypotheses and inform the right business decision, balancing net complexity reduction with commercial risk. There was also a focus on sustainability to prevent complexity reoccurring. On completion, the project aims to deliver a saving of up to US$40m.

Philip Morris International’s (PMI) direct sourcing of tobacco leaf reduces costs while ensuring quality and stability of supply

Since PMI was spun off from Altria in 2008, its rate of operating profit performance improvement has doubled to 9.2% (Chart 11) and its operating margins are now the highest among the global tobacco companies.

Chart 11: PMI local currency organic operating profit CAGR

<table>
<thead>
<tr>
<th>Year Range</th>
<th>CAGR</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003-2007</td>
<td>4.6%</td>
</tr>
<tr>
<td>2008-2012</td>
<td>9.2%</td>
</tr>
</tbody>
</table>

“Philip Morris International Inc.,” Morgan Stanley, 17 October 2013, via ThomsonONE.com

To achieve its impressive profit growth, PMI has placed strong focus on both the top-line and cost drivers of margin. From a top-line perspective, the company’s ownership of almost half of the top 15 global tobacco brands, including Marlboro, gives it a clear advantage by helping to drive pricing and the company believes an average $1.8b in annual pricing is achievable.

PMI has also made significant progress on the cost elements of margin, achieving US$1.5b in savings between 2008 and 2010. The company aims to limit the annual growth of its traditional combustible product cost base to 1%-3% by improving the efficiency of trade and marketing spend, simplifying organizational structure and processes, optimising the factory footprint and increasing productivity across the supply chain. For example in 2010 the company began to directly source tobacco leaf from around 17,000 tobacco farmers in Brazil. The vertically integrated structure helps ensure the sustainability of leaf supply in Brazil, improves cost efficiencies and enables better alignment between leaf supply and demand.
Respondent profile

For the purposes of this report, the term “margin” refers to operating margin (operating margin/revenue), or earnings before interest, tax, depreciation and amortization (EBITDA) as a percentage of revenue.

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