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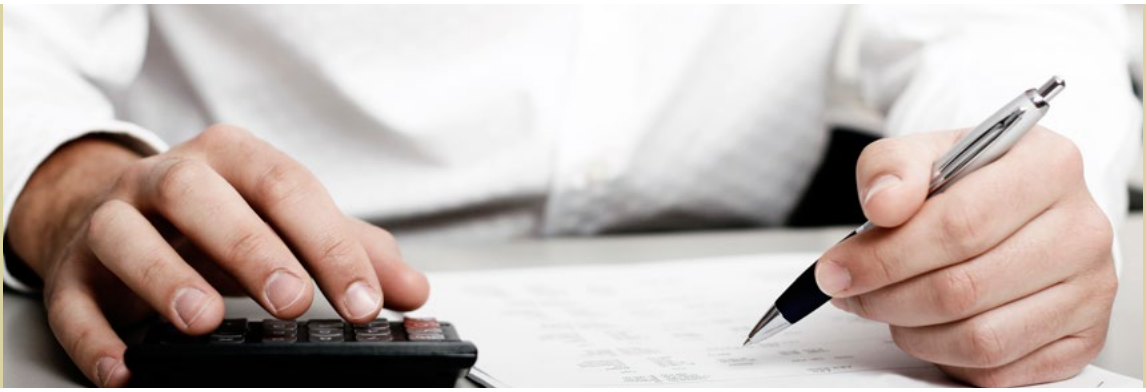
Reshaping Your Portfolio

The "Big Six" Mistakes of Portfolio Optimization and How to Avoid Them



Reshaping your Portfolio: The "Big Six" mistakes of Portfolio Optimization and how to avoid them

For years, companies have looked to drive growth by bringing new and innovative products to market. At the same time, they have chased growth by increasing their product range to meet the needs of more diverse customer groups. In many cases however, healthy pruning of the portfolio has not kept up with the rate of expansion. This happens for a variety of reasons, but the end result is often the same: bloated product portfolios that drive increased cost, extended cycle times, higher inventory, and even reduced market share. Indeed, customer confusion and the resulting market share loss can be the most counter-intuitive, but also the most troubling outcome of unchecked product proliferation.

Companies realizing they are in this situation will often embark on an optimization effort to pare back the portfolio and ultimately improve how they serve customers. Steve Jobs, for example, came back to save Apple in 1997 and refocused the business by reducing the number of products by 70%. Within a year, Apple returned to profitability. In the automotive industry, General Motors developed the concept of platform sharing which drastically improved inventory management and reduced design, engineering, and production costs. Volkswagen expanded upon the concept by sharing platforms across models and brands including Audi, Volkswagen, Skoda, and SEAT. In the consumer goods sector, Unilever reduced its portfolio of 1600 global brands to only 400 after experiencing stagnant growth and profitability and saw their annual revenues grow from 30 to 50 billion Euros, and their net income grow to over 5 billion Euros.

The benefits of portfolio optimization can be transformative. However, there are many challenges when embarking on such an effort, and many companies do not see the results they desire. This outcome is usually rooted in some common mistakes that we discuss below. The good news, however, is that with adequate, upfront consideration, many of the risks and mistakes from portfolio optimization can be minimized, saving time and disappointment down the road.

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The "Big Six" mistakes of Portfolio Optimization

1. Not quantifying the benefit case upfront

› It is common for production and operations managers to support portfolio reduction efforts as product variety only makes their job more difficult. However, without a clear business case they stand little chance of convincing their counterparts in sales and marketing. The finance team may also be skeptical of the financial impact of cutting SKUs. It therefore becomes very difficult to get support for the changes required. Upper management has no basis for deciding to move forward and thus business as usual prevails, despite the general consensus that the portfolio is too big.

› **Solution:** Building a fact base to support the internal case for change should be the first step in any portfolio optimization effort. The organization will need to be convinced that: (1) portfolio size is driving issues in the business, (2) there

Type of Benefit	How the benefit is accrued	Target Goal
Inventory Benefits	• Reducing the number of components and products to plan • Reducing the variable of demand for components and products • Reducing safety stock, excess, and obsolescence	~ 15% - 20% Reduction
Margin Benefits	• Eliminating profit dilutive products • Migrating customers to higher profitability products • Consolidating component spend and suppliers	~ 3 - 4% EBITDA inc.
Pricing Benefits	• Increasing price based on new views of cost, competition, market • Lowering price without top-line risk (improve volume) • Streamlining price administration and discounting	~ 0.5 - 2% EBITDA inc.
Capacity Benefits	• Reducing changeovers and manufacturing intervals • Minimizing rework, scrap, and waste • Standardizing product schedules	~ 2 - 4% Increase
Market Benefits	• Reducing customer confusion between products • Focusing Sales and Marketing efforts • Simplifying the path to market and streamlining the Sales process	Varying

are measurable financial benefits from optimizing the portfolio, and (3) portfolio optimization is feasible. A small project team to conduct a rapid assessment of the financial, operational, and customer benefits of portfolio optimization is one good way to get started. During this effort it is keenly important to focus on 80-20 insights without getting bogged down in data challenges—the goal is to get a directional sense of the opportunity. Upper management should support the need for speed and understanding over precision at this point and consider a time-boxed effort to start building momentum and urgency. If the team can clearly articulate the high-level business case, supporting facts, and the path to realize benefits upfront, then downstream progress will be much easier, faster, and more effective.

2. Approaching optimization only bottom-up with no top-down goals and targets

› Companies can get bogged down by the daunting task of a detailed bottom-up approach to SKU rationalization. They worry about adequate data, the risk of losing revenue, and simply the process itself for identifying the "right" SKUs to cut. Driven by the desire to be as thorough as possible and make the right decision, many companies end up debating the benefits and disadvantages on a SKU-by-SKU basis. This type of bottom-up analysis not only takes longer, but it almost always results in cutting fewer SKUs as any number of exceptions can come up—and when looked at SKU by SKU, the benefit from cutting an individual SKU can be difficult to articulate (but is much easier to articulate in aggregate for a % of SKUs). The results are minimal savings and inability to reduce overhead or fixed assets. While this outcome can be interpreted as a failure of the process, it is more a symptom of management not clearly setting a target or goal.

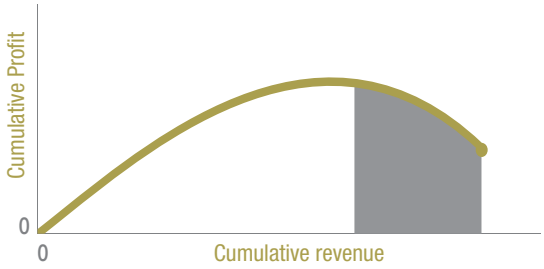
› **Solution:** Clear and quantifiable goals for portfolio optimization should be set very early in the effort. When developing financial targets, management should consider the desired operational outcomes, such as what it would mean to be able to close one or two facilities, radically improve lead-time or availability, or halve product development cycle time, and what level of SKU reduction that would require. Whatever the goals, they should be quantified (e.g.release $5M in fixed assets, reduce lead time by 5 days) and communicated. The approach and required decisions required to meet a 10% cost target will look very different from those that call for a 25% reduction.

3. Eliminating only the tail

› Many companies review their product portfolio based on SKU-level gross profit contribution favoring a 'cut the tail' approach. They focus on the least profit accretive (or likely, the most profit dilutive) products and end up eliminating only a minor portion of very unprofitable SKUs. Meanwhile, SKUs with low volume and/or minimal returns on the capital they employ remain in the product catalogue. When this happens, the organization finds itself with no less complexity in its operations.

› **Solution:** It is important to keep the full portfolio in scope and consider incremental revenue and substitutability of products. With this perspective, the decision making process is radically different. Now, even cutting profitable SKUs could prove valuable if they don't provide revenue above and beyond an existing substitute. The value of such decisions is in the operational simplification as well as the customer experience. In addition to looking at incremental revenue and substitutability, other factors can be applied to help meet target reductions. Such factors might include:

Portfolio optimization looks less like this…



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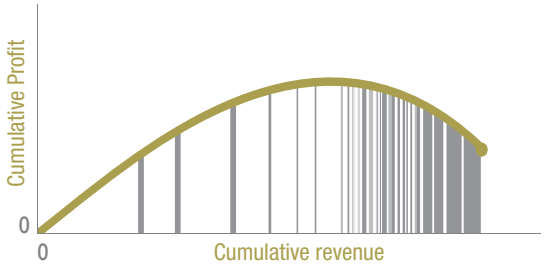


SKU to be cut SKU to be kept

i. Strategic: How does a product line fit with the current and future market and channel strategies?

ii. Operational: To what extent does a product contribute to operational exceptions such as delays, rework, scrap, inventory, delivery failure, etc?

iii. Competitive: How does a product line compare to competitive offerings as a viable alternative, differentiated solution, or "me-too" option?

iv. Regulatory: Does a product line require incremental controls to meet regulations, certifications, or compliance for specific applications that may be changing in the future?

Other factors or guiding principles may come to mind as well, but the important part is gaining executive alignment on the criteria at the start of the project.

4. Ignoring the market

› When companies look to optimize their portfolios, they often focus on areas where they have good data and over which feel they have significant control. They critically analyze and review the financial and operational implications of portfolio changes, but too often spend minimal effort gathering market feedback. This can be a complicated and time consuming task. However, lack of understanding of the market can lead to sub-optimal outcomes, from cutting the wrong SKUs, to not cutting deep enough, to organizational gridlock. A detailed understanding of customer preferences can not only provide clarity for product substitutability estimates (a key

input into any financial model) but it can also help identify risks and further support the internal case for change.

- **Solution:** Companies should incorporate at least some level of market feedback across the value chain (including channel partners, sales people, end-customers, etc.). Depending on the level of detail required and the amount of risk involved, this may be as simple as a few key customer interviews or as involved as a statistically representative survey. Regardless of the specific approach, all portfolio optimization efforts should include a customer perspective.

5. Getting fixated on the analysis (and not thinking ahead to implementation)

- Traditionally, the portfolio optimization process has been conducted in discrete linear phases beginning with analysis, progressing to a decision, and culminating in implementation. Too often, companies only begin to think about implementation after the decision of what SKUs to eliminate has been made. As a result, it is not uncommon to end up with a set of rationalized SKUs, only to later find out that they pose significant implementation challenges. This may mean something as simple as minor changes to the market communication plan or as drastic as significant investment in production, new suppliers, or technical certifications.
- **Solution:** Organizations should identify key implementation risks and dependencies prior to completing the decision making process. The level of asset sharing across product is one indicator of implementation complexity. The more sharing there is, the harder it might be to eliminate costs. Additionally, for what might be considered higher-risk actions, a pilot may be required to test assumptions and to gather lessons learned before a broader roll out. By considering implementation early in the process, companies can avoid organizational fatigue, miscommunication to the market, and ultimately undermining the portfolio optimization objectives.

6. Making it a one-time project (vs. an ongoing capability)

- Even the most flawlessly executed portfolio optimization does not necessarily defend against future portfolio bloating. In the face of revenue and market pressures, it is easy to slip back into the trap of chasing incremental revenue through new product introductions that meet every niche market. If new processes and business rules are not in place, products will proliferate again.
- **Solution:** Portfolio optimization should be viewed as simply one step in the broader and more continuous product and portfolio management process. As part of a disciplined product management process, companies should set up regular, formal portfolio reviews and create a multi-functional governance structure to guide future portfolio decisions. Creating simple business rules such as “one in, one out” that more tightly control new product development and product lifecycle management decisions have proven practical for many companies.

Conclusion

Portfolio optimization can unlock a tremendous amount of value and remove large amounts of unnecessary complexity. The benefits are significant: for operations, for the sales force, for customers. Benefits include lower inventory levels, better service levels, greater productivity, improved customer buying experiences, and significant EBITDA increases. It is not unusual for top-line sales to significantly increase as product availability, customer experience, and service levels all improve. Given the strategic and organizational impact of such an initiative, companies should spend time reviewing and incorporating lessons-learned in their plans. By spending time upfront to understand common pitfalls, companies can expect much better outcomes. Change is difficult enough. Why position yourself for an uphill battle?

Ultimately, portfolio optimization should be an ongoing process

1. Review existing portfolio performance

- Review performance of existing portfolio
- Identify low and high performing products and potential actions to address

2. Review NPD pipeline

- Review development pipeline and status of each potential product
- Update financial and unit outlooks against market

3. Understand competitive portfolio offering

- Compare portfolio to competitors to determine relative strengths, weaknesses, and gaps

4. Discuss market feedback

- Review feedback from across the value chain (incl. distributors, commercial organization, customers, end-users, etc.)

5. Create plan for each product

- Determine the status and future plans for each product line and SKU (e.g. maintain, invest in marketing, adjust pricing, phase out, etc.)

6. Agree on action plan, owners, & timeline

- For product lines or SKUs requiring specific actions, assign owner and timeline

Understanding the impact of complexity on the portfolio

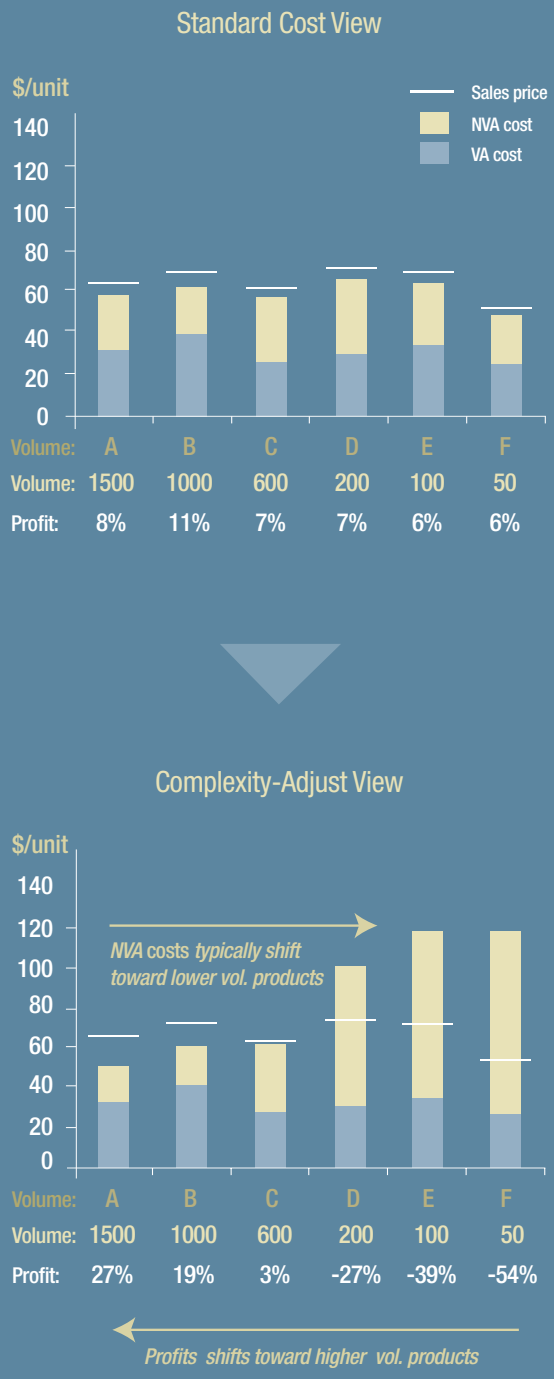
AgriCo, a $10B agricultural consumer goods company, had one division where product proliferation led to a portfolio of tens of thousands of SKUs. The company manufactured both high-margin branded products and low-margin commodity products through a network of 70+ plants and distribution centers. Each region had a unique product mix, customer base, and cost structure. Furthermore, the business manufactured custom orders to fill capacity and combat the low utilization driven by such a fragmented production footprint.

While AgriCo had begun to sense that it had issues, the business struggled to effectively evaluate its products, and its portfolio continued to expand. In particular, the unique plant cost structures, and significant cross subsidization between products, provided management with an unclear understanding of true product profitability.

Seeking an alternative to a lengthy Activity Based Costing project, AgriCo partnered with WP&C to perform a top-down complexity costing exercise to analyze product and customer profitability in just six weeks. This effort introduced a third type of cost, complexity costs, to the traditional fixed and variable construct; one driven by non-linear relationships to volume. After adjusting for complexity, AgriCo found a significant difference between real and previously reported profitability across several products and market segments. Specifically, the team identified a near immediate 12% gross profit improvement opportunity. Additionally, the complexity costing exercise shed light on significant cost distortions in portfolio management, new product introduction, and integration across operations and commercial functions that the team helped AgriCo later address.

Other key insights include:

- AgriCo was not considering the true cost of complexity on operations when evaluating new opportunities and as a consequence was under pricing
- There were significant cost reduction opportunities within transportation and storage as well as manufacturing
- Only by taking a top-down view could the company see how product proliferation was "trapping" significant organizational cost and impeding the opportunity for scale and growth



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Aligning organization, portfolio, and customer needs

IndusCo, a manufacturer of industrial equipment and market leader had enjoyed consistent growth and profitability over the years; however, in the last five years inventory had exploded, growing nearly four times the rate of revenue growth. Similarly, SKU growth more than tripled revenue growth. Perhaps most concerning, distributors were complaining that end-customers were confused by the offering and frustrated with the sales process. An unmanaged, and now bloated, portfolio was now starting to impact the business, both on the top and bottom lines.

With the mission of rationalizing the portfolio, IndusCo created a cross-functional team, and enlisted WP&C support to determine the right mix of products that would optimize inventory and profitability and improve the customer experience. The team quickly identified two key drivers of product proliferation as well as some barriers to optimization.

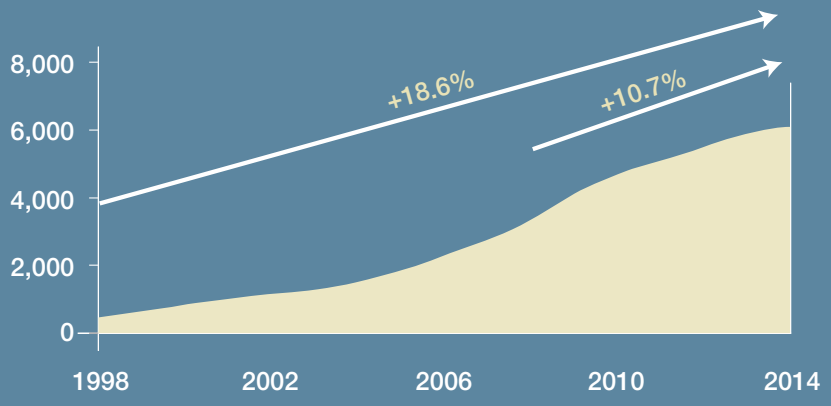
First, there was disagreement internally over whether a broad portfolio was truly problematic. While Operations deemed it necessary to cut products, as managing inventory and ensuring on-time product delivery had become increasingly difficult, Sales was against the idea, as they feared fewer SKUs would mean less revenue.

Second, those in favor of portfolio optimization had trouble quantifying the benefits of doing so. There was significant component overlap between product families, and the business had moved to a build-to-order manufacturing model so the cost of complexity couldn't necessarily be seen in excess, aged, or obsolete finished goods inventory. The use of distributors also muddied any feedback from end users. Without a clear benefit case, IndusCo found it hard to generate the necessary business case for change.

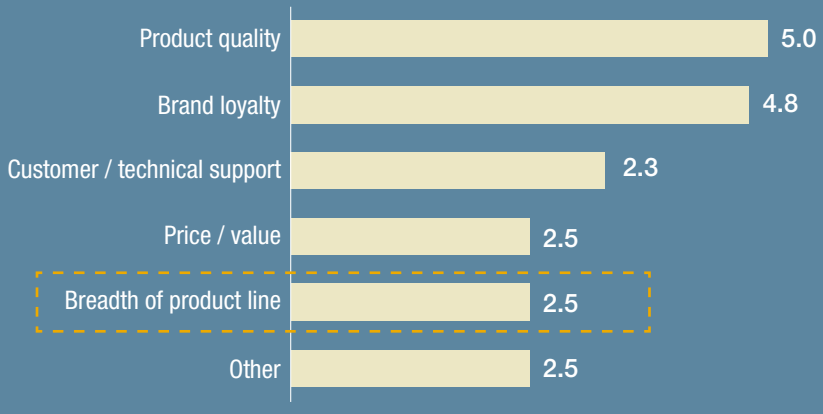
To combat these issues, the project team conducted extensive financial, technical, and commercial analyses. Component, functionality, and range overlap within and between product families were critically examined internally and relative to newly-developed competitive benchmarks. The team also developed a robust view of the customers' specific needs, substitutability, and potential growth by segment through extensive interviews with distributors and end-customers.

Ultimately, the team's holistic approach and analysis identified an opportunity to reduce SKUs by 35% while clearly defining a path to realize an EBIT increase of 2% of sales and a ~ 20-40% inventory reduction. As a result, the team was able to drive alignment between operations and sales and mitigate the concern of "real" benefits and revenue at risk, as customers were happier with IndusCo's simplified offering. With such alignment gained during the project, IndusCo was able to start implementing portfolio optimization recommendations and start seeing inventory and profitability improvements quickly.

Annualized Portfolio Growth (Active SKUs) Over Time



Rank in order of importance to Client Customer



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