Four key areas for cost reduction and value creation in private equity (PART 2)

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Building a better working world

Against a challenging landscape, the ability to identify and execute the right cost optimization strategy can be a game changer.

(CONTINUED FROM PREVIOUS EDITION)

Four key areas for cost reduction and value creation

Once the cost reduction approach — and its scope — have been determined, the next question is which areas of the business should be targeted for improvement. Here are four key areas being addressed by management teams:

1. Get a grip on spending

Consider and examine all forms of spending, not only the product, input and contractor costs, but elements of indirect spending as well.

- The employment of traditional procurement measures such as the consolidation of demand, rationalizing and developing closer cooperation with suppliers, reverse auctions, or employing necessary hedging mechanisms are likely to deliver cost avoidance benefits as opposed to cost optimization, especially in a high inflationary environment. The key here is to ensure that supplier side measures align with the working capital agenda. For more information on cash optimization and working capital, see our first article in the value creation series: Three cash disciplines to create value and resilience | EY - Global
- To drive further cost optimization, organizations need to focus on reducing the internal "demand" side. This can be addressed by working with sales, R&D and operations to harmonize product ranges and services or deploy value engineering to remove costly input materials or processes that don't deliver value.
- Similarly, scrutinizing indirect spend can prove highly effective: it is important to decide what controls and policies should be put in place to reduce the internal need for indirect spend (e.g., applying a zero-base lens) and drive sufficient value. These steps often require an abandonment of the "how it's always been done" mentality, and an external, disruptive challenge is often necessary – one that is typically easier to initiate in a high inflationary environment.

2. Simplify where you can

Complexity grows in businesses over time, which can reduce productivity and increase costs. This complexity makes it more challenging to fully grasp the businesses' true cost drivers. Business simplification enables sustainable cost optimization. Some key factors to consider are:

- Build an efficient operating model that can scale effectively, embracing productivity and back-office automation.
- Complexity is derived over time from organic growth, historical choices that may no longer be optimal under the current economic or regulatory environment, or acquisitions that weren't fully integrated. This can lead to duplication of roles or legacy systems and infrastructure that often tie up resources and increase costs. Focusing on operating model optimization allows for increased agility and an attention to the businesses' core markets, which is key in navigating a high inflationary environment.
- The push to drive more choice and offerings for products and services often drives supply chain, operational and overhead complexity. In a more recessionary environment, where customers curtail spending to more basic products, services and choices, eliminating low or negative margin products, services or geographies is critical. This paring down of products and services needs to include a right sizing of the operations and overhead. The true cost (of SKUs and services growth) beyond the direct cost lines are not often readily evident, which makes the selection process difficult when the impact on growth is uncertain.

3. Build an efficient and resilient supply chain — don't forget tax

Supply chain costs are crucial for any business, and from an operational standpoint, resilience is critical. The recent disruption, along with economic and geopolitical pressures have exposed various opportunities for cost optimization:

- **Remove excess spend.** In the past few years, many businesses have had to expedite shipments or ship partial loads to offset deficiencies. As this became the "new normal," the extra incurred costs did not always disappear as supply chain pressures eased. This provides an additional opportunity to integrate environmental, social and governance (ESG) agendas, further enhancing businesses' buoyancy against uncertainty.
- **Drive efficiencies.** Typically, zero-based efficiency reviews yield significant opportunities. When businesses were forced to change their operational approaches during the pandemic, they often rapidly set up new infrastructure that prioritized guaranteeing delivery over more cost-effective ways of supplying products and services. This offers two opportunities: 1) increasing the efficiency of the "sticky plaster" solutions; and 2) rightsizing and removing fixed cost in legacy supply chains with declining volumes.
- **Ensure resilience.** Some smaller suppliers are struggling with macroeconomic challenges. The urgency to swiftly replace suppliers often leads to short-term cost increased that need to be optimized. Greater transparency into which suppliers could put the business at risk is key to establishing both strength and cost avoidance.
- **Recognize that cost efficiency and tax efficiency go hand in hand.** There are several key areas to consider within tax. First, holistically examine the supply chain from a tax efficiency perspective. Second, consider the legal entity structure. Legal entities cost money and resources to hold and manage. A meaningful reduction in legal entities produces administrative cost savings, frees resources, reduces risk and increases transparency. Third, map the company's tax footprint and use this information to develop tax planning to reduce the total tax cost.

4. Focus on talent

Labor costs are key to any COS. To offset inflationary wage increases, focus on productivity and the removal of activities where there is low value add or duplication. Recruitment teams today face an ongoing battle for talent, where skilled employees are increasingly expensive to attract and retain, with rising hiring costs forcing the wider use of contractors. The retention and development of talent, combined with recruiting the right high-quality leadership, are core factors in creating a value-driven culture.

Looking ahead

The burdens business leaders face today are unprecedented, with inflationary pressures, energy challenges, the increased focus on ESG, supply chain disruption and talent shortages all coming together.

To survive and thrive in this environment, businesses need to rethink their approaches to cost reduction. While traditional focus areas and approaches still have value, they often result in short-term gains, where costs can creep back in 12 to 18 months down the road.

Leaders need to look holistically at business operations, bringing together a mix of competencies across commercial, finance, operations and data analytics to focus on the immediate priorities that deliver sustainable value.

Summary

Given demands on management's agenda, the C-suite needs clarity of thought around identifying, quantifying and executing on cost reduction priorities. The winners will be the ones that use this opportunity to manage costs for growing a more resilient business.■

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