Cost optimisation
Protecting your margins in a turbulent economic environment
The perfect storm: Tighter credit - economic uncertainty - higher operation costs

The past year has been characterised by three macroeconomic trends, each of which has affected the revenues and cost base of companies operating in China and Hong Kong SAR.

The first half of 2008 saw record inflation rates in China. The country’s consumer price index (CPI) reached 8.7 percent in February 2008, the highest rate in over 11 years. The CPI subsequently hovered in the range of 6 to 7 percent for several months. This sharply impacted the cost of raw materials as well as rental, fuel and transportation costs. Combined with higher wages and an appreciating currency, these trends have impacted China’s competitiveness as a sourcing location.

The second half of 2008 has seen the advent of the most severe instability of the global financial system since the Great Depression. The resulting credit contraction has dramatically affected businesses’ ability to find and afford short-term financing. Concerns over increased costs have been overshadowed by even more profound liquidity concerns for many businesses.

In addition, falling real estate prices and fears of recession are causing many consumers around the globe to dramatically cut back on spending. With consumer spending being a major contributor to gross domestic product (GDP), the new trend is expected to impact GDP growth in the near term. The International Monetary Fund (IMF) expects the developed-world economies to grow by only 0.5 percent in 2009.

These three macroeconomic factors are already affecting China’s economic performance. GDP growth dropped to 9 percent in the third quarter of 2008, down from 10.1 percent second quarter. Although this is still healthy growth when compared to other major economies, it is the first time the country’s GDP growth has dipped below 10 percent in almost three years.¹

These trends have also directly and negatively impacted company earnings. The expectation of further pressure on company earnings has contributed to a slump in Chinese share values, with the Shanghai Stock Exchange falling more than 70 percent from its high.

¹ National Bureau of Statistics of China

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Structured cost management: Positioning for growth

The impact of the global downturn in China may not prove to be as severe as elsewhere in the world, but equally many companies in China are not comparatively well-prepared for the impact of a downturn. Until recently, top line growth was the overriding priority for many companies in China. Whether they were seeking to seize market share within China, or increase output to meet demand in other markets, cost control measures were often relatively neglected. Revenue growth has led a lot of businesses to take their eyes off the ball on cost. In light of the events of the past year, companies in China are now reassessing their strategies and preparing for a far more austere economic environment.

This is not the time to panic, however. When facing margin pressures, businesses often implement rapid and broad cost cutting measures. These may deliver short-term benefits, but not get to the heart of cost drivers. At worst, these measures impact business operations and may hamper future business growth.

A study conducted by KPMG International and the Economist Intelligence Unit revealed that many businesses find it hard to reduce cost in a sustainable fashion, with 9 out of 10 cost reduction programs failing to achieve their targets.² The study also showed that the gains that are achieved appear to be short lived. While companies need to act decisively, they need to balance short-term concerns (e.g. shoring up cash and working capital) against longer term objectives to position the company to recover strongly when the economy rebounds. The focus should be making a leaner, more flexible organisation, with cost reduction as a consequence, not necessarily just the target.

A structured approach to cost management therefore means thinking beyond short-term cost savings to assess and question underlying business models. By focusing on some of the key dimensions of the business, leaders can identify the core cost drivers and take steps to effectively manage costs in a sustainable manner.

Some of the key levers to cost management include working capital management, operational efficiency, procurement and supply chain.

Working capital management
- Working capital management is a vital component of a healthy business. The key objective is to focus on working capital and unlock cash flows to ensure sustainability and reduce reliance and exposure to short-term funding needs.
- It is also subject to exposure and risks from areas including receivables, payables, and inventory management, as well as cash management.
- Each area presents a different challenge to meeting liquidity needs, ensuring the most efficient process and cycle times, embracing new technology, and assessing the quality of working capital on the balance sheet.

Operational efficiency
- The recent focus of companies in China has been on strategic growth, often resulting in a reduced focus on processes and operational effectiveness.
- Successful companies understand that financial strength is built from a cohesive and well-managed operational platform. However, as organisations face a slow down in growth and higher operating costs, these inefficiencies become major risks.
- Driving out process inefficiencies improves costs and the company’s position for future growth.

Procurement
- Over the past five years, the procurement function has evolved significantly to the point where “best practice” companies think of it as a competitive and strategic component of their businesses.
- With rising costs in China, many procurement teams face growing pressure.
- This can entail more strategic sourcing, consolidation of suppliers, and improved contract and inventory management through purchase execution and procurement process effectiveness.

Supply chain
- Companies must now reconfigure their supply chains to realise working capital and cost efficiencies and to respond to the changing ways of doing business with both customers and suppliers.
- Inefficiencies in channel management and distribution networks need to be identified and understood to optimise efficiency gains along the supply chain.
- The ability of a company to adequately scope and manage change is a prerequisite to realising competitive advantage.

² Rethinking Cost Structures, KPMG International / The Economist Intelligence Unit, 2006

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Levers to achieve a successful cost optimisation program

At the outset, an effective cost optimisation program, is based on deep analysis and fact-finding techniques such as cost driver analysis or spend analysis to assist management in understanding better cost structures in order to identify, quantify and prioritise savings opportunities. With this factual analysis, management can implement a programme of change to drive out costs through strategic changes to business models and implementing efficiency initiatives throughout the business or supply chain.

Key decision points
- How to best establish the cost optimisation program?
- What are the goals / scope of the program?
- What is the scale of the cost optimisation opportunities?
- What opportunities are available and which ones should be developed?
- Which opportunities should be implemented and in what order?
- What can be done better?
- How can the benefits and improvement to the financial performance be permanently embedded?

Example of activities
- Review organisation’s goals and strategy
- Build initial optimisation hypothesis and detailed project plan
- Identify gaps and savings opportunities
- Identify, quantify and agree on quick win opportunities
- Agree on cost optimisation priorities
- Defined design of all business and selected cost optimisation’s levers for selected planning
- Estimate implementation risks and probability
- Implement step plans from design phase
- Develop ongoing programs and training for maintenance
- Activate maintenance programs
- Post implementation reviews
- Assess growth areas and design project plan

Core cost optimisation team

Cost optimisation levers
- Procurement
- Working Capital Management
- Operational Efficiency
- Supply Chain
Benefits

KPMG China has been involved in a wide range of cost optimisation projects and we can leverage the lessons of our previous successes both within China and around the world. A structured approach to cost optimisation can:

- Embed a culture of cost management throughout the business
- Improve cash flows position, balance sheet and performance
- Improve accounts payable, accounts receivable and aged debtor collections
- Generate efficiencies around production, inventory and supply processes
- Create flexible and agile operating and business processes
- Streamline traditional financial and regulatory processes to reduce costs and free up resources
- Simplify planning, sourcing, collaboration and supply chain execution.

Typically, successful cost optimisation efforts produce positive ROI that sets the business up for future growth.
How we have helped

KPMG member firms have assisted clients in the following areas.

**Improving working capital**

A pharmaceutical company needed support in identifying and implementing enhancements to working capital management. The focus was both on realisation of quick wins and sustained improvements in working capital performance. KPMG conducted analysis of data in the area of accounts payable and accounts receivable as well as stock and consumption data within the most important business units. We then worked with the management to develop a new working capital management model and introduced effective and efficient organisational structures, processes and systems to realise sustainable operating cost savings.

**Identifying tax efficiencies**

A multinational consumer goods company was seeking to expand its manufacturing capabilities to meet rising demand for its products. The company was trying to obtain and plan for use of tax incentives related to its new investments. We assisted the company in identifying and obtaining tax incentives associated with the new plant construction. We also developed tax and transfer pricing models to enhance and accelerate the utilisation of tax incentives and a strategy to realise longer-term tax efficiencies in the supply chain.

**Realising post-deal synergies**

Under the governance of a global private equity house, a global industrial goods manufacturer had grown significantly through acquisition. However, realising value through synergy savings had proved difficult. As the private equity house looked to exit its investment, the pressure grew. The private equity house wanted to take a fresh look at the organisation and help management think about new opportunities. The management team had a target for the amount it believed could be saved through synergies, but had been unable to identify the exact sources of the synergies. KPMG quickly identified and documented these synergies and presented them to investors. During our work, we identified an additional savings by redesigning the company’s operating model. The projected savings were presented to investors based on the recommended design.

**Enhancing the supply chain**

A sportswear and equipment retailer was facing severe difficulties in managing sales forecasts and orders. They believed their total distribution network was under-enhanced and there were saving opportunities. KPMG conducted a critical assessment and re-definition of the processes of high-season sales planning and order management and defined an optimal distribution model and finished goods flow. We also calculated cost savings and performance improvements linked with the new model including a reduction of stock level at retailers and outlets. From there, we assisted the client to define an enhanced distribution network with new volumes and costs including a reduction of total logistic costs covering warehousing, transportation and capital expenditure.
About KPMG

KPMG is a global network of professional firms providing audit, tax, and advisory services, with an industry focus. We operate in 145 countries and have more than 123,000 professionals working in member firms around the world.

KPMG China

In 1992, KPMG was the first international accounting firm to be granted a joint venture licence in China, and our Hong Kong operations have been established for over 60 years. This early commitment to the China market, together with our unwavering focus on quality, has been the foundation for accumulated industry experience that is difficult to rival.

With our expanding number of offices and more than 8,500 professionals, our single management structure across China and Hong Kong SAR allows efficient and rapid allocation of resources wherever you are located.

Business Performance Services (BPS)

KPMG’s BPS team has experience in a wide range of industry sectors and uses this knowledge to deliver business transformation and operations improvement services. KPMG’s Business Performance Services practice helps leading public and private organisations respond to change and add value to the enterprise. We offer practical guidance on:

- improving operations
- driving value and helping optimise capital and cost structures
- developing and applying business strategies to improve financial and operational performance
- optimising efficiency in systems and controls within Finance, Procurement, the IT function, treasury and HR
- dealing with business change management and the people issues which arise from it.

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