Cost Reduction
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 of the 1930s. 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 more developed economies to grow by only 0.5 percent in 2009.

These three macroeconomic factors are already impacting China’s economic performance. GDP growth dropped to 9 percent in the third quarter of 2008, down from 10.1 percent in the 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, for example, losing over half its value.

\(^1\)National Bureau of Statistics of China
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 many companies in China may not be sufficiently 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. 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.

When facing revenue and cost pressures, organisations often implement rapid and broad cost cutting measures. Furthermore, organisations often look at costs from the perspective of each function, rather than from a service perspective. KPMG studies, along with our experience with clients around the world, consistently show that while such initiatives may deliver short-term benefits, they often do not get to the heart of cost drivers.

Nevertheless, initiatives to rapidly reduce costs, particularly operating expenses, are a priority for many organizations today, despite the structural issues that rapid reductions may cause in the medium to long term. At worst, in the short term, these rapid cost reduction measures impact operations and may hamper service delivery and quality. The reality of the current environment means that the option to invest in process improvements to reduce costs may not be available.

While organisations need to act decisively, they need to balance short-term concerns (e.g., shoring up cash and working capital, and the ability to respond effectively to increased activity and demand on resources) against longer term objectives to demonstrate that they can be self-sufficient and deliver ‘value for money’.

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.
| Working capital management | Working capital management is a vital component of a healthy business. It is also subject to exposure and risks from a multitude of areas, including receivable, payable, inventory management, and 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. 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 pressures. |
| Operational efficiency | Companies in China have enjoyed many years of very rapid growth, despite a lack of a sustainable and effective frameworks for systems, processes, and developing people skills. Successful companies understand that financial strength is built from a cohesive and well-managed operational platform. As organisations face financial stress, their business processes may no longer be optimal, hindering efficiencies and ultimately strong financial performance. Process efficiencies within core and support services can help reduce risks of revenue leakage and eliminate unnecessary costs. |
| Procurement | The procurement function has evolved significantly to the point where better practice companies think of it as a competitive and strategic component of their businesses. Many procurement teams face growing pressure to reduce costs, particularly from China. 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. The ability of a company to adequately scope and manage change is a prerequisite to realising competitive advantage. Inefficiencies in channel management and distribution networks need to be identified and understood to optimize efficiency gains along the supply chain. |
Ingredients of a successful cost optimisation program

An effective cost optimisation program based on techniques such as cost driver analysis or spend analysis can assist management to better understand their cost structures in order to identify, quantify and prioritise savings opportunities. With sufficient analysis and understanding, a program of change may be designed to drive out costs through strategic changes, efficiency initiatives and targeted cost reduction without compromising investor or market perception or quality of service.

Rapid cost reduction efforts may yield sustainable results if performed appropriately. However, when cost reduction is carried out progressively, organisations can make significantly greater gains in value creation.

KPMG’s research shows that cost ownership is often unclear and too narrow while in many cases cost discipline is not embedded in the culture of the organisation. Cost strategies are often too cautious with both public and private bodies commonly pick the easier option of across the board cost cutting initiatives, rather than the one that will yield the most savings.

Finally, cost savings can only be effectively achieved if the organisation has insight into what actually drives cost within its operations. This knowledge is vital to ensure any cost cutting is targeted in the right places.

The challenge of working capital

Companies in China have grown accustomed to easy credit, which had become cheap and plentiful following an extended period of economic growth. Today it is a different story. Although Chinese banks are less affected by the credit crunch than their overseas counterparts, the supply of cash is nevertheless reducing and the reality that many companies must face is that funding is being restricted.

Four key questions that companies may wish to think about are:

- Is there sufficient liquidity to manage existing facilities for the next 18 months under base case and sensitised scenarios?
- Are there any planned debt repayments due or significant uncovered commitments, such as deferred purchase costs, in the next twelve months?
- Is there sufficient headroom against banking covenants now and at future test dates?
- Are any major customers, suppliers or other key stakeholders known to be in financial distress?
Understanding your cost drivers

Understanding the factors that drive your costs – regardless of whether they are direct or overhead costs – is critical to develop and execute a more effective and sustainable cost optimisation initiative. KPMG can analyse and quantify the impact of demand management, price, process efficiency and labour productivity on your cost structure, and help you develop a cost reduction plan that yields savings while limiting the impact on quality and service delivery.

The magnitude of cost savings opportunities depends on the ability to understand and challenge the inherent and management drivers of cost

Cost Drivers

- Inherent Drivers
  - Government policy
  - Asset base, e.g., age profile
  - Geographic location
  - Technology
  - Operating environment
  - Customer service standards
  - Service levels
  - Industrial agreements
  - Leave provisions and on-costs
  - Workcover premiums
  - Labour rates

- Management Drivers
  - Service demand
  - Staff mix and coverage
  - Skills and competencies
  - Support & indirect labour
  - Overtime levels
  - Staff utilisation
  - Business processes

- Process Drivers
  - Labour utilisation
  - Materials costs
  - Occupancy costs

- Price Drivers

Analysis of cost savings opportunities takes an enterprise-wide approach that addresses both the portfolio mix specific saving initiatives
How we have helped

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 an 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 organizational 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 additional savings by redesigning the company’s operating model. The new company was designed and the savings projected and presented to investors.

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 real opportunities for savings and margin enhancement. 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.
Benefits

KPMG China has been involved in a wide range of cost optimisation projects and we leverage our experience and our previous successes both within China and around the world. Our structured Cost Optimisation framework helps to:

- Enable rapid cost reduction in a targeted, efficient manner to realise savings in the short term
- Develop a cost optimisation plan incorporating a long term view to reduce key costs
- Embed a culture of cost management throughout the organisation
- Improve cash flow position, balance sheet and performance
- Improve accounts payable, accounts receivable and aged debtor collections
- Generate efficiencies around 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

KPMG has helped clients achieve successful cost optimisation programs that produce a positive return on investment and enable the organisation to demonstrate that it is delivering additional value from its funding sources (regardless of whether it is the government or taxpayers).
About KPMG

KPMG is a global network of professional firms providing audit, tax, and advisory services, with an industry focus. We operate in 144 countries and have more than 137,000 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 of 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
- dealing with business change management and the people issues which arise from it.
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