Arthur D Little

Viewpoint

Conversion toward ultra-high efficiency

A step change in productivity and operational costs

To remain viable in today's business world, incumbent companies across the globe are finding they need to adapt to constantly changing market needs. This has forced companies to make many additions to their original operational models, leading to a significant increase in the day-to-day complexity of the business. These changes lead to higher costs and less flexibility compared to those companies that are just starting out. As a result, it is time to rethink legacy models and aim toward more simplified, flexible, and, above all, economically efficient operations. The conversion toward ultra-high efficiency is worth the effort, as we have found this level of efficiency can lead to operational savings of more than 25%. In this Viewpoint, we share some of the key elements incumbent companies must consider when facing the challenge of ultra-high efficiency.

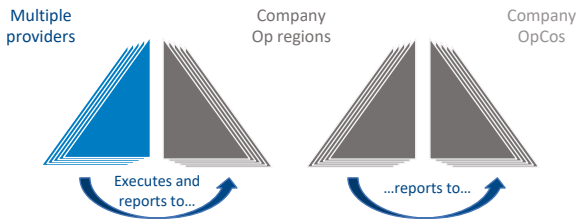
Inflationary costs but deflationary agility

Incumbent companies have evolved through painstaking, long-term transformational processes that required extensive CAPEX and resources to adapt to the market. The changes have not been a one-off event, as the market is continuously in flux.

The implementations required for market adaptation have not always been optimal. Many companies have used a "build-on" approach in response to the urgency to adapt and/or a lack of in-house capabilities. The combination of urgency and insufficient capacity have pushed companies to implement a myriad of addenda, delaying the implementation of leaner, longer-term, and holistic solutions.

Due to these build-on approaches and multiple addenda, companies are often working with multi-supplier models with heterogeneous agreements that require internal operations, have a low traceability of costs, and lack end-to-end responsibility with a "thick" management layer with multiple tiers (see figure opposite). Such models reduce the economies of scale and increase costs that include, among others, internal management and contract follow-up.

Multi-supplier model



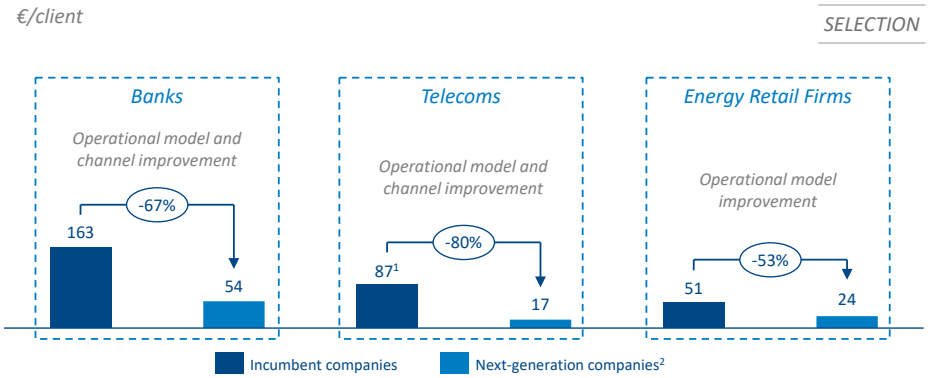
- Multi-supplier model with heterogeneous models
- Thick management layer with no end-to-end responsibility
- High operational costs linked to the internal management and contract follow-up

Source: Arthur D. Little analysis

As a result, multi-supplier models with heterogeneous agreements have significantly reduced the operational efficiency of incumbent companies, whose average OPEX per client is considerably higher compared to next-generation companies. These increased expenses put incumbent companies at a clear disadvantage (see figure below).

Incumbent companies must rethink their operative model to improve their profitability and become more agile. Such changes will allow them to compete against new emerging

Average OPEX per client



Source: Public information, Arthur D. Little analysis
Notes: (1) Estimation; (2) OPEX per client could be even lower when these companies gain scale

firms with leaner models. In this Viewpoint, we focus on the levers and areas most common to all industries (e.g., back-office operations, IT, corporate services, product offerings), but there are also key industry-specific elements organizations must consider when facing this challenge. As an example, banks and telecoms must redefine their strategy, migrating routine transactions from their extensive face-to-face network to digital channels.

Conversion toward ultra-high efficiency requires a customized solution

Conversion toward ultra-high efficiency requires improving a company's operational leverage by becoming leaner and increasing its flexibility. Improvements in these areas will in turn increase a company's ability to adapt to future trends, a key trait of the "Company of the Future."

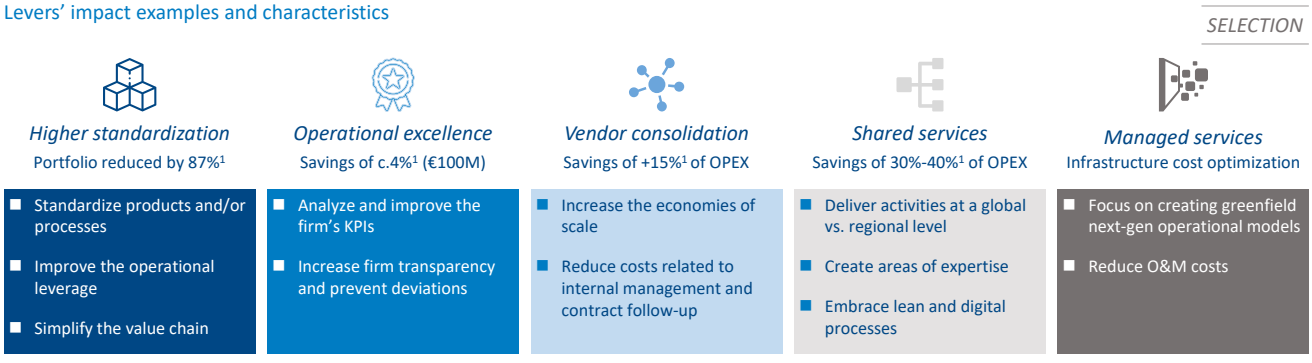
The need for change is a priority as well as a challenge for most companies. Additionally, the urgency to tackle a step-change operational transformation to gain efficiency has increased due to the situation with COVID-19, as many companies are struggling to survive and must enact new approaches to remain viable.

Boosting operational efficiency is a good strategy to achieve savings and improve a company's competitiveness in the short term, avoiding CAPEX-intensive transformational projects like technology updates. Also, operational efficiency projects have greater certainty regarding deadlines and costs because they do not rely only on technical implementations, which often result in delays and economic diversions.

In this Viewpoint, we focus on some of the main levers for conversion toward ultra-high efficiency (see figure below):

- Higher standardization of products and/or processes, which improves the firm's operational leverage. For example, a retail bank in Spain reduced its portfolio from 300 products to fewer than 40, impacting the whole value chain (front-end operations, outsourcing, etc.). With this change, the bank was able to migrate to leaner commercial solutions.
- Operational excellence focused on the analysis and continuous improvement of KPIs to understand unit costs, average operating time, volumes, and so on. The holistic approach to analyzing KPIs allows a company to understand and therefore prevent deviations. A next step, once we have obtained the KPIs for the different areas, is to do a benchmark with third parties or even put different workgroups in competition.
- Vendor consolidation benefits from increased economies of scale and from savings due to reduced internal contract management and contract follow-up needs.

Levers' impact examples and characteristics



Source: Public information, Arthur D. Little analysis
Notes: (1) Of the analyzed perimeter

According to Arthur D. Little's project experience, savings through consolidation can achieve as much as 15% or more for large agreements. For example, a leading utility in Spain has achieved near 25% of savings by consolidating its "non-differentiating" operations in four large contracts. The selected suppliers implemented several levers in order to maximize these savings, such as homogenization of services, robotization, and so on, but they did not face major system transformations and for the time being maintain the same technological stacks.

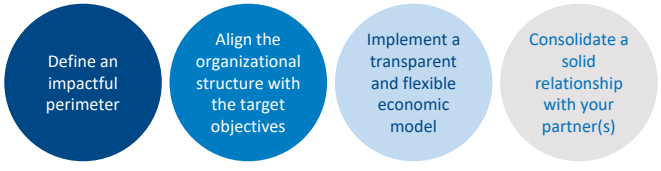
- Shared services focus on delivering certain activities (e.g., accounting) at a global versus regional level. Sharing services requires a high level of standardization of processes that tend to vary from one region to another, but provide benefits of scale when they are utilized. The benefits of shared services include increased agility in daily operations, improved management control model, simplification of the company's organizational structure, and a concentration of efforts on core business activities that add value – among others. The primary challenges arise from heterogeneity between geographies and the management of change in areas not previously shared. (See Arthur D. Little Viewpoint: Beyond cost efficiencies in shared service centers for more information.)
- Managed services assign the end-to-end provisioning of a service to a third party that owns the assets needed to provide the service. Vendors can further optimize processes by consolidating services provided to different clients with smaller unit costs. By employing such managed services, companies can focus on creating greenfield next-generation operational models from scratch.

It is important to consider that one size does not fit all regarding ultra-high efficiency conversion. Each firm requires a customized solution according to its needs when implementing certain levers. The strategy and its roadmap must be defined with a deep understanding of the firm's situation across regions and operational areas.

Four keys to succeed

Successful operating model redesign requires a deep analysis of the current operations prior to its implementation. As a result of deep company knowledge, companies do best by defining four key elements (see figure below).

Efficiency conversion – levers



Source: Arthur D. Little analysis

The first element a company should consider is defining an impactful perimeter (those areas to be considered in the project). As a starting point, the company should include within that perimeter those activities that are considered a "commodity" (those capabilities that are not a competitive differentiation). In parallel, companies must balance cost optimization efforts linked to "differentiating" or "non-commodity" capabilities to determine the competitive advantage that non-commodity capabilities offer.

Companies often rely on outsourcing of commodity capabilities, fighting for cost savings with third parties. This is not a new practice, but it means many in-house activities are ignored in the effort to reduce costs. In-house capabilities may offer a great savings opportunity, since their cost optimization previously has been overlooked (beyond the low-hanging fruit, such as lack of unit cost measurement or prices, benchmarking of average handling time across the company/market, etc.).

The second element to consider is aligning the organizational structure of the transformed areas. Based on Arthur D. Little experience, there are two clear objectives for an operating model: quality and cost optimization. Since the two objectives tend to oppose one another, it is vital to avoid conflicts of interest between the two. Based on our project experience, operational areas require quality and SLA-specific targets, while cost optimization calls for an independent and parallel structure. A unique area that is responsible for both operational quality and cost savings will not be able to fulfill both to their fullest. Employee incentives should also be aligned with the objectives the company sets (e.g., bonuses indexed to the efficiency achieved).

There are different organizational methods a company can use to enable its ultra-high efficiency conversion journey. To choose the best one, the firm must first understand which alternative is best suited to the company's unique situation. The most common approaches are:

- Define an independent area within the organization to be responsible for the operations and quality assurance and another area (independent of the first one) to be responsible for the cost optimization.
- Convert the before-mentioned area focused on operations and quality assurance into a firm (NewCo) that belongs to the company. This NewCo would have its own objectives, KPIs, and management, and will be closely monitored to reduce cost deviations.
- Share the ownership of the NewCo between the firm and the vendor in cases where there is a high level of externalization. This would further align the interests of both parties to optimize the cost structure of the NewCo at the same time it ensures service quality.

We would like to emphasize that each of these alternatives requires an independent team to look for additional cost optimization and leaner operations.

The third key element is to implement a transparent and flexible economic model. Economic transparency increases the trust and robustness of the model across the business and facilitates its success over time. A best practice is to implement pay-per-use models in which the volume of specific levers determines both prices (i.e., lower prices for higher volumes and vice versa) and costs. Each lever must have its own cap and floor values that trigger a price renegotiation.

To ensure ultra-high efficiency over the years, the economic model should also include incentives for additional savings as well as penalties if the agreed objectives are not met.

Flexibility is also key for the success of the new model. Firms should consider potential future needs such as the spin-off of some areas, the acquisition of other firms, and/or the evolution to new-generation technology stacks.

Finally, the company should consolidate a solid relationship with its partner(s) based on trust and information transparency. Win-win approaches guarantee the success of long-term relationships.

Keep in mind that the success of the negotiation depends on the depth of the understanding of the current and future situation of the company. The analysis will allow the firm to better understand its needs and growth drivers, maximizing the impact of the conversion toward ultra-high efficiency.

The path forward

Many companies have taken the first step toward their adaptation to the future. Is your company one of them? If not, you should start working on it.

In today's world, companies must improve their profitability. The conversion toward ultra-high efficiency will help companies adapt to future challenges and move closer to the Company of the Future, resulting in a game-changer advantage.

The best path to follow is not trivial and requires great effort to carry out a thorough analysis that fully illuminates the company's current and future needs. Each company's journey toward ultra-high efficiency must be customized to accommodate its uniqueness.

The changes required to transform an organization may lead to frictions between different areas. It is important to foresee potential issues and solve them properly to guarantee that the conversion is implemented to its full potential.

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Arthur D. Little

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