A SILK PURSE FROM A SOW'S EAR

Realizing Untapped Profitability

Infosys™
Portland

Generating new value is possible

The 16th-century proverb speaks to the impossibility of creating value from poor raw materials. Silk and swine are set as opposites.

The proverb's inherent impossibility perfectly encapsulates the concept at the core of our analysis. At face value, many potential sources of value seem unlikely if not impossible, so we typically do not devote any time or attention to them.

In business, indirect costs such as sales, general and administrative (SG&A) expenses, are effectively a sow's ear, a cost center, an area perceived to be of low-to-no strategic value. Profit centers are where the action is, and the attention of the executive team.

However, our data analysis illustrates that it is entirely possible to fashion a silk purse from the sow's ear of SG&A expenses. Moreover, it proves how procurement expertise can add clear strategic value to financial performance.

This paper demonstrates that strategic management of indirect costs can contribute to profit just as easily, if not faster, than generating new revenue. Achieving savings from indirect costs can significantly impact profits, particularly for companies operating on low margins.

Moreover, our analysis demonstrates how tomorrow's procurement capability – what we call NextGen Procurement – shifts the focus from delivering savings to delivering value. In this case, this is achieved through renewed capabilities in data analytics and a team highly skilled in extracting value from data, which subsequently unlocks new strategic savings and increases profit.

Context

Uncertainty is the name of the game

The last two or more years can be defined by the end of benevolent business conditions. For the first time in decades, inflation has become a major force that is affecting businesses and consumers alike. And even though inflation appears to have peaked at 8% in 2022, it is still running higher than the long-term average. Many companies have been caught off guard and are still struggling to rebalance their market posture to maintain margins if they can and ensure their business is on a sustainable footing.

At the same time, the cost of capital has risen markedly and access to capital has become more difficult for many. Similarly, while the world has adapted to sudden disruptions to supply chains caused by the conflict in Europe, they will persist.

Given the above, it is unsurprising that in the last three years, in the USA and across the G7, consumer sentiment has fluctuated a considerable amount and has not returned to the stability of pre-Covid years.

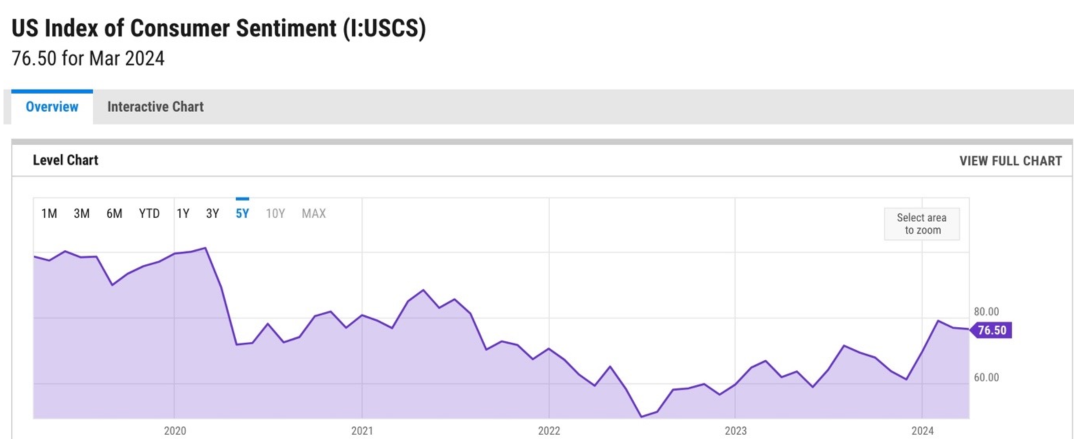


Figure 1 US Index of Consumer Sentiment,

The US Index of Consumer Sentiment (ICS), as provided by the University of Michigan, tracks consumer sentiment in the US, based on surveys of random samples of US households.

We also know from history that difficult trading conditions give rise to great innovation, especially from challenger brands and new entrants. Competition becomes fiercer and this too puts pressure on profits.

Moreover, many economists forecast soft economic conditions will continue across all sectors, with the prospect of a potential downturn on the horizon. With so many adverse conditions it is even more compelling that companies become more strategic and more disciplined about the way they manage costs.

* https://ycharts.com/indicators/us_consumer_sentiment_index

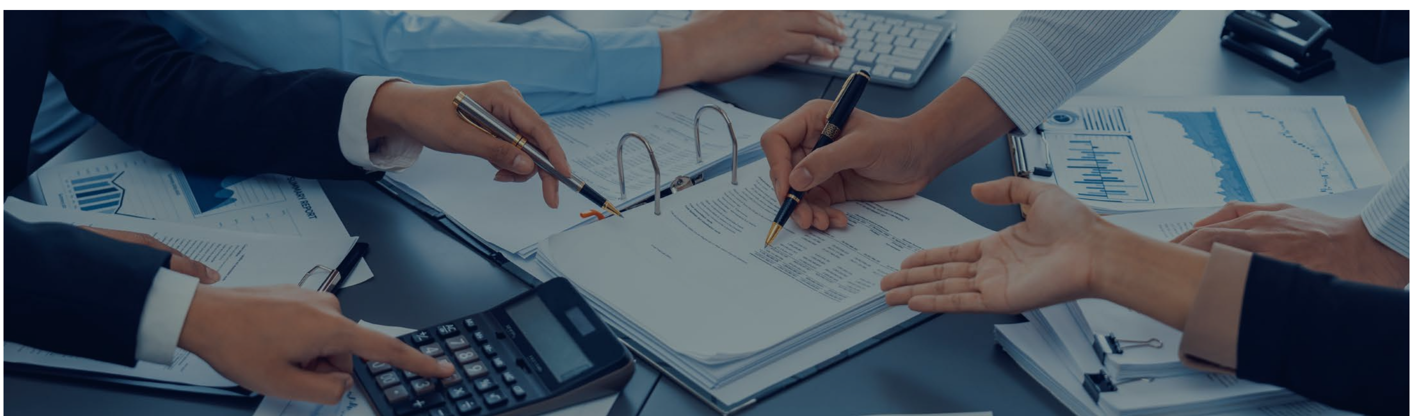
Introducing Value Analytics

Strategic procurement has a strong case

An imperative for the next generation of procurement capability is to drive value across the enterprise. And, to do that, one of the arrows procurement teams have in their quiver is cost savings.

We analyzed a multitude of industry sectors, including over 240 publicly traded companies in the USA, which have a combined revenue of $8.4 trillion (2023) and represent over 30% of the Gross Domestic Product of the United States. Each of the 240 companies was studied at an individual level, looking at revenue, expenses and profit over the period. As a result, we have data of substantial scale and detail. Also, our findings are both in aggregate and by industry sectors. Our analysis clearly shows that substantial value can be unlocked.

The objective of our work is to help companies unlock financial value by looking at their organization through the lens of strategic procurement. This work enables executives to think and act more strategically about the costs of a company's performance since the impact this can have on profit can be profound.



The Story of Revenue and Cost

A dollar is a dollar

There isn't a company on earth that cannot make savings from its indirect costs. Yet so few do. Why?

Through our analysis, you will see that it is not as hard as you might think to make systematic and valuable savings through more strategic management of indirect expenses.

For argument's sake, let's assume that a company makes a profit of 10% from the revenue it can generate. To make an extra $1 of profit, that will go directly to the bottom line, the company needs to generate extra revenue of $10.

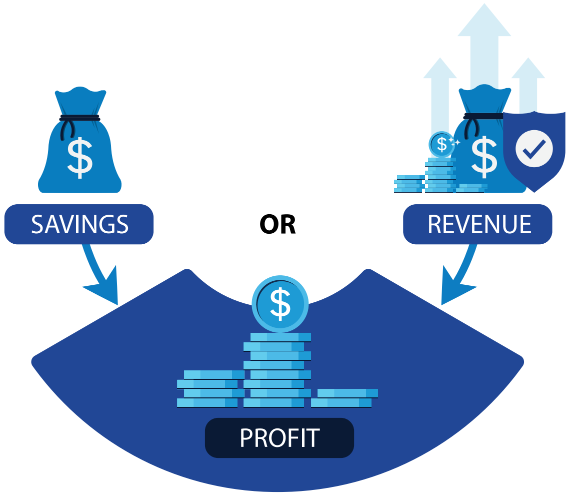
The same company has various indirect expenses. In particular, it will have sales, general and administrative (SG&A) expenses. Reducing $1 from these expenses can go straight to the bottom line as profit, without the effort to generate an extra $10 in revenue first. This is simply a case of reducing $1 from the expenses column and adding that same $1 to the profit column. The procurement team managing indirect expenses should be highly focused on this as a strategic objective.

Conventional wisdom suggests revenue growth is the best path to improve profit. However, the softening economic outlook presents a higher degree of difficulty in achieving revenue growth.

Typically, in corporate culture, greater value is attached to the dollars that come to the organization through the growth of revenue, through profit centers. And much time, effort and resources are devoted to growing revenue.

Our analysis shows that there is additional value to be gained, which justifies the devotion of time, effort and resources to achieve savings in the management of indirect costs.

To realize the potential, companies need to recalibrate how they think about expenses. There is an ongoing value to be gained if indirect expenses are managed strategically. The starting point is for executive decision-makers to be agnostic about the source of every dollar of profit.



Key Findings

The expense explosion

Figure 2 below shows that in FY22, 40% of companies earning more than $50 Bn had their indirect expenses grow at a faster rate than their profit. The situation is more acute for companies earning less than $50 Bn. In 2022, as many as 49% of these companies had their indirect expenses grow faster than their profits. Then in 2023, the number of companies experiencing this value-destroying relationship rose even further to a whopping 56% (>$50 Bn) and 54% (<$50 Bn), respectively.

Escalation of this trend will constrain future profit potential, particularly for the 41.8% of companies where the pace of growth in revenues does not keep up with the rising cost of expenses.

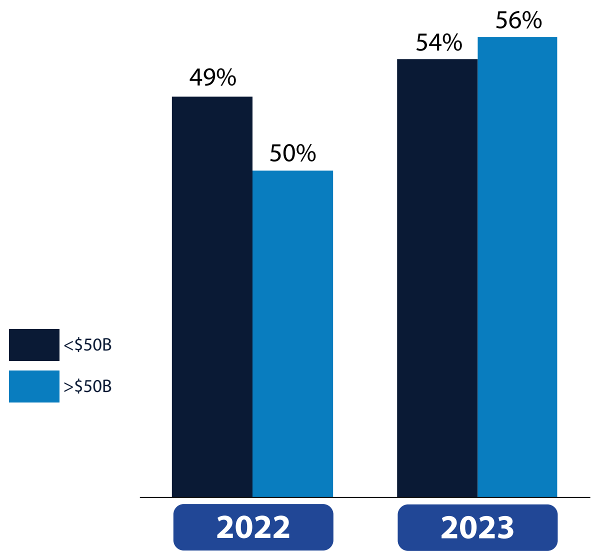


Figure 2 Percentage of companies with expenses growing more than profit.

The data shows that for 2023, on average, across all industry sectors, every dollar of savings in SG&A is equivalent to almost $16 gained from revenue, from an operating profit perspective.

This ratio varies from industry to industry, with some multiples being as low as 6x and others up to 23x on average for the industry. Indeed, for some individual organizations, the ratio exceeded 110x.

Additionally, much indirect spend is less tied to industry markers like raw materials and other indexes, and there are significant opportunities to improve margins through a focus on category management, sourcing, and optimization of indirect spend.

Industry By Industry Ratios

Earlier we gave the hypothetical example of a company that makes a profit of 10% from the revenue it can generate. To make an extra $1 of profit, that will go directly to the bottom line, the company needs to generate extra revenue of $10. We made the point that reducing $1 from expenses can go straight to the bottom line as profit without the effort to generate an extra $10 first. For the purpose of the following discussion, it helps to think about this hypothetical as having a ratio of 1:10.

The ratios shown in Figure 3 tell us the dollar amount of revenue required to achieve an additional dollar of profit compared to a dollar reduction in indirect expenses becoming profit. The ratio is also, to an extent, a reflection of the profit margins in each industry sector.

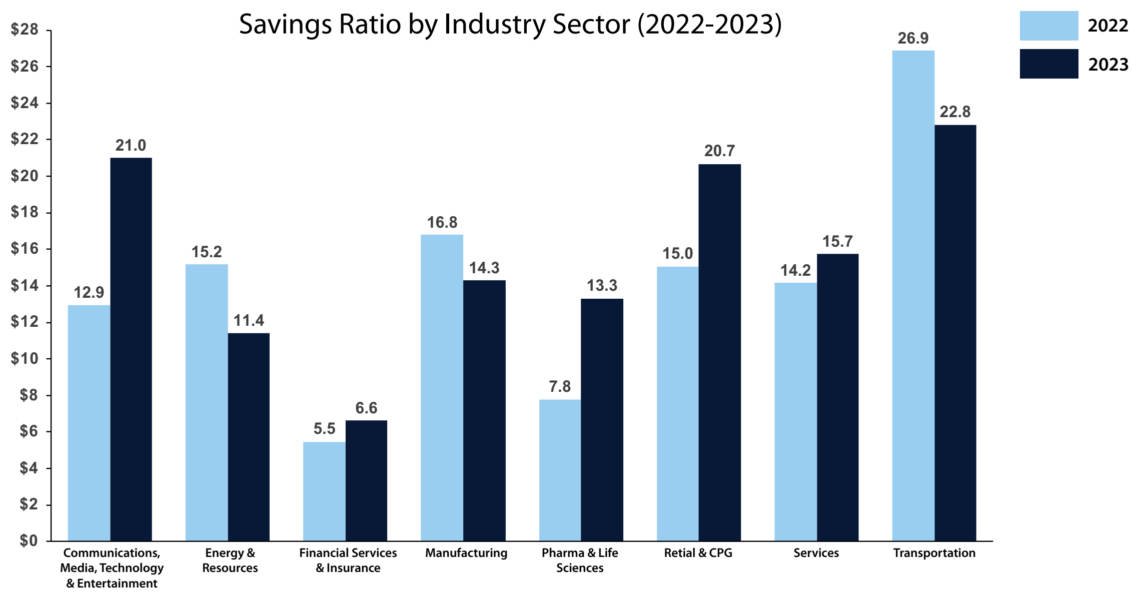


Figure 3 Savings to revenue ratio by industry sector in 2022 and 2023

The highest ratios we found for 2023 were in transportation, followed by communications & technology, retail, services, and manufacturing. These industries are generally characterized as having relatively low-profit margins.

By contrast, financial services and insurance has the lowest ratio, reflecting the much higher margins found in this sector, and is followed by pharmaceuticals and life sciences, a sector where profit margins have the added protection of intellectual property rights and regulatory barriers. Although we can see that even in pharmaceuticals the ratio increases by a considerable amount between 2022 and 2023.

The variation we see across industry sectors and within each sector is remarkable. No doubt each sector has patterns and trends that all companies must deal with. At the same time, the data suggests no two companies are alike.

The aggregate and industry data helps all companies to at least benchmark themselves, but the greatest value will be found in a detailed examination of each company's unique circumstances and the nature of its procurement capabilities and practices.

Recommendations

This analysis warrants an increased focus from executive suites across the USA and around the world to rethink the way their companies manage indirect costs. Such a focus has the potential to significantly improve the way resources are allocated across corporate America and in other markets.

Procurement teams can use our data and analysis to argue the case for more strategic management of the procurement function and to usher in a new generation of capability.

Importantly, we are certain that this type of value analytics will only become even more crucial, just as data analytics is becoming increasingly vital for business performance and strategy. It represents next-generation procurement.

We invite you to put our capabilities to the test. If you are interested in a focused report on your company, please get in touch.

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