L.E.K.

EXECUTIVE INSIGHTS

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A More Effective Approach to Traditional Cost Benchmarking

Given the significant pressures facing the building materials industry today, it has never been more important for manufacturers to improve cost positions relative to their competitors and have a strategy to achieve appropriate cost targets. This is particularly true for building materials companies with commodity supply dynamics who have operating margins that can be in the single digits. Today's economic uncertainty – and the additional pressure to improve profitability in order to survive the economic downturn – makes the goal of achieving a low-cost position critical to day-to-day operations.

L.E.K. Consulting has developed a proven cost benchmarking solution that is based on developing delivered cost supply curves for a specific market and modeling changes in:

- Your supply
- Your demand
- Competitors' initiatives to quantify production cost targets

Relative to traditional cost benchmarking, this approach leads to more effective decision making that increases profitability and also improves competitive advantage, capital allocation and pricing.

A View on the Shortcomings of Traditional Cost Benchmarking

Most companies in the materials sectors profiled by L.E.K. are not optimally setting and achieving competitive cost targets because they rely on traditional methods of benchmarking. Traditional cost benchmarking sets targets using production cost comparisons, without considering delivered cost positions – the relative cost (versus competitors) of the downstream supply chain given modalities, distances and other factors.

Traditional benchmarking is commonly used because the functional responsibilities for cost decisions (e.g., plant managers and manufacturing) are not often involved in the commercial decision-making process (e.g., sales and marketing). Advocates of traditional cost benchmarking (vs. delivered cost benchmark alternatives) point to a number of justifications for its use:

1. Understanding competitors' production costs informs our own manufacturing decisions and targets, which is still fundamentally useful

2. Estimating how much of a competitor's capacity is dedicated to a specific market is difficult, and therefore the implications on market-specific supply curves is not practical to determine

3. The downstream costs (modality options, transloading, terminals, etc.) complicate the problem

Of these arguments, the first usually has the most resonance. The theory goes "All things being equal, why shouldn't we be at the same production costs as (or better than) our competitors?" And this argument usually has strong appeal with the executives responsible for manufacturing/production functions. While competitive parity (or superiority) in production costs is an ideal goal in a perfect world, it is a practical solution only if you are already well positioned in the supply curve and have the investment required to achieve that competitive cost position, which generates positive economic profit.

A More Effective Approach to Traditional Cost Benchmarking was written by **Robert Rourke**, a Vice President, who leads L.E.K. Consulting's Building and Construction North American Practice and **Thilo Henkes**, Vice President. The authors would like to acknowledge **Marek Wiernusz** for his assistance in the preparation of this article. Please contact L.E.K. at industrial@lek.com for additional information.

Since neither of these factors can actually be determined without fully understanding the shape of the supply curve to the market, L.E.K. recommends moving away from plant-based cost benchmarking and incorporating the downstream costs of supply, and the resultant supply curve for all market players. L.E.K. has applied this alternative approach to cost benchmarking with great success in many building materials organizations (see the case study in this document as an example).

The L.E.K. Cost Targeting Methodology: Using Delivered Cost Supply Curves to Set Cost Benchmarks

L.E.K.'s cost targeting methodology offers a different approach to identifying better cost benchmarks. Rather than comparing the production costs from geographically proximate competitors, our methodology analyzes supply and develops the delivered cost supply curve for the competitors supplying a specific market (see Figure 1). This methodology ensures that all relevant supply, and its delivered costs, is captured as part of the competitive cost targeting assessment. The L.E.K. process of using supply curves to set cost benchmarks involves six steps:

1. Develop detailed delivered cost supply curves for your assets
2. Determine your position along the supply curve (this process is iterative with Step 1)
3. Develop an optimal target position that accounts for:
   a. Expectations of changes in supply and/or demand
   b. Initiatives competitors are pursuing
4. Benchmark against competitors at this point for reasonability
5. Identify the capital/labor/process initiatives required to achieve the target position
6. Determine IRR of initiatives to prioritize effort and preserve precious capital

Step One In this phase, we gather the required market intelligence to develop the cost curves. The information required is often considerably more in depth than the competitive data obtained in traditional approaches to cost targeting.

Steps Two and Three These phases use your internal company data to determine where on the supply curve you are positioned and to identify cost targets for a specific market demand source (these steps are iterative with Step One). This process of identifying cost targets on the supply curve requires an understanding of how supply and demand dynamics evolve. Specifically, how do changes in demand affect the supply curve (e.g., supply that may become irrelevant in declining demand)? And how do competitive supply and competitor initiatives change relative cost positions on the supply curve? These inputs into the supply curve are important to capture to ensure that cost targeting is done in a dynamic, rather than a static, environment.

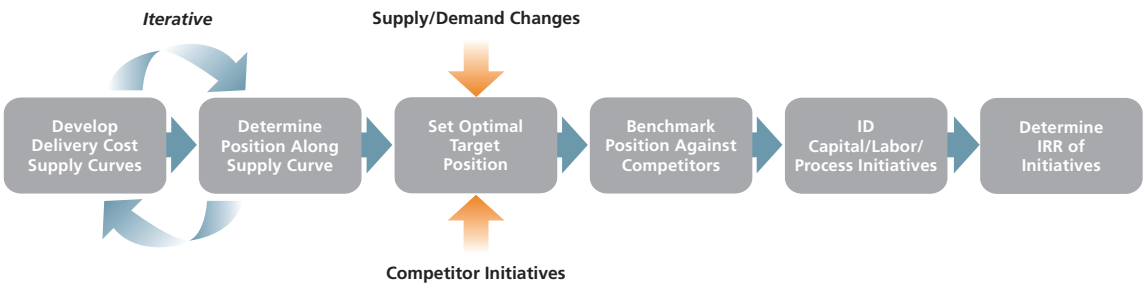
Steps Four, Five and Six These final steps of the process use the dynamic supply curve assessment to benchmark cost positions and drive investments and initiatives required to achieve the targeted cost positions. The ultimate goal is to determine if the return on those investments and/or initiatives are wise allocations of capital.

Optimizing Financial Returns and Strategic Differentiation

Investing in sound targeting methodologies has a very high payback for building materials organizations. L.E.K. analysis has shown that using the appropriate supply curves to set cost targets often results in dramatic improvement in profitability as well as new strategic perspectives on the competitive landscape. Specifically, applying this alternate methodology to cost benchmarking has resulted in:

Figure 1

L.E.K. Cost Targeting Methodology



- A 5%-7% improvement in margin expansion
- An improved short- and long-term competitive position, which is usually observed in an increase in market share
- Improved competitive intelligence, which translates into increased marketing and sales confidence
- Optimized asset allocation of resources
- Ultimately, a significant increase in cash flow

Conclusion

As commodity materials companies react to increased profitability and market share pressures, one valuable lever that can significantly influence profitability is effective cost targeting. However, typical cost targeting methodologies often identify incorrect benchmarks and therefore don't result in improved financial performance. Or worse yet, they can lead to poor decisions regarding cost targeting and result in the incorrect allocation of capital and inferior profitability.

L.E.K. has developed a cost targeting methodology and applied our approach to a range of commodity material types (e.g., lime, asphalt, aggregates, sands, fertilizers, cement and salt) where geographic proximity to markets, downstream investment and plant production costs set the rules for supply/demand. We have found that our methodology of evaluating cost curves has significantly improved our clients' profitability and cash flow and successfully improved their competitive position. The time to review your cost targeting methodology is now, as controlling expenditures could mean the difference between an enterprise that will survive the recession and one that will not.

An L.E.K. Cost Targeting Case Study

A building materials corporation focused on commodity materials was struggling with its competitive position in specific markets and wanted to benchmark its production costs in order to inform capacity decisions, cost targets and prioritize capital expenditures across a number of facilities.

Applying the L.E.K. Cost Targeting Methodology

Step One L.E.K. started by developing detailed supply curves consisting of the relevant competitive suppliers' production costs by plant (Figure 2). This foundation now needed to be expanded to include delivered costs and identify a target cost position.

Step Two Cost benchmarks need to include the right competitive supply set and the right costs required to be relevant in a market, including downstream costs to the customers. In this step, L.E.K. evaluated competitive supply based on delivered cost rather than production cost (see Figure 3 on page 4). Our analysis revealed that although the company had both higher production and delivered costs relative to competitive supply, the cost improvement required to be competitive was actually less than what had been benchmarked using only production costs.

Figure 2

Region A Cash Production Cost by Plant

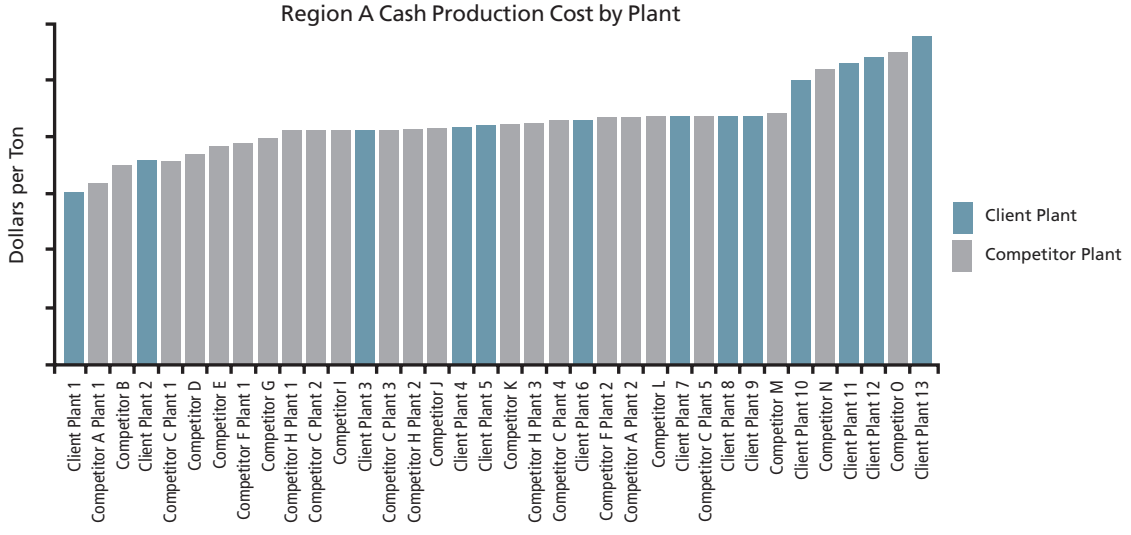


Figure 3

Competitive Supply Based on Delivered Cost

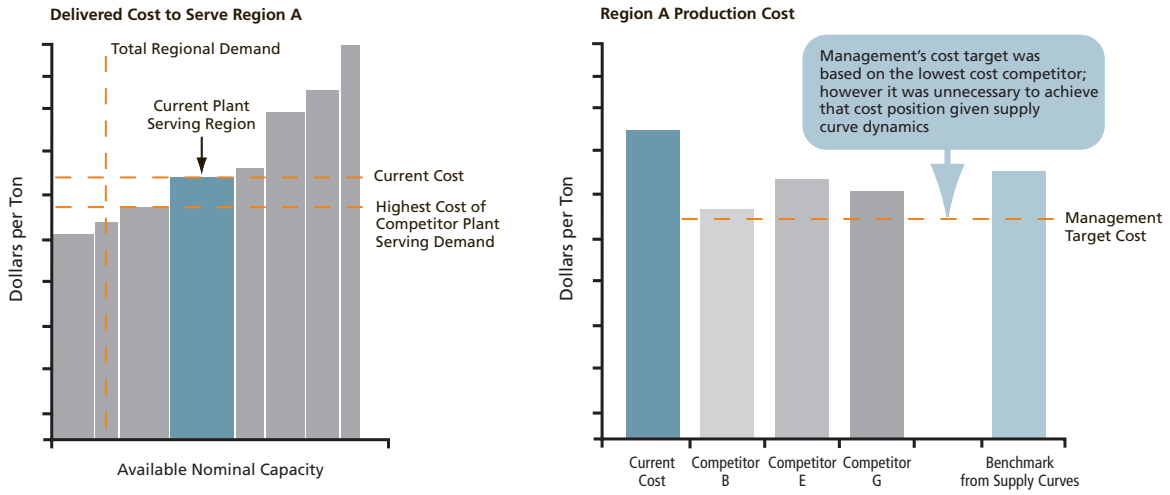
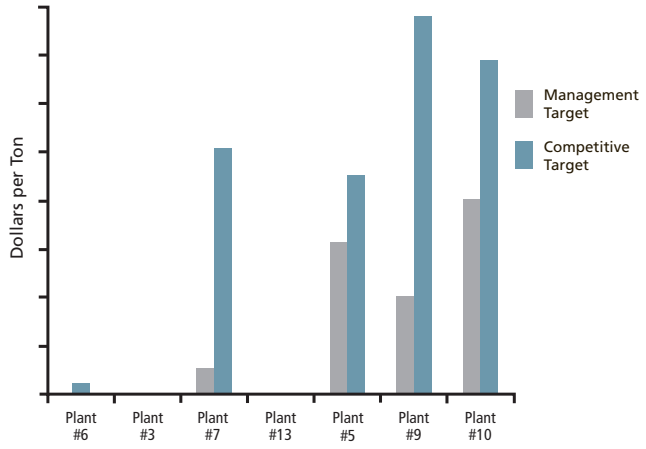


Figure 4

Target Cost Reduction to Optimize Network Competitiveness



Step Three Once L.E.K. identified the complete competitive supply set and total delivered costs, we could set cost targets as a function of what was required to be commercially competitive in a market (Figure 4). A comparison between the traditional cost benchmarks and the targets we identified revealed a misalignment in the cost improvements required to optimize the company's network competitiveness.

Step Four Focusing on the relevant, competitive supply and including an assessment of total delivered cost indicated that this product's unique supply curve was actually quite different than originally thought. This revised supply curve provided a more accurate picture of required cost targets needed to be competitive for the local market demand (Figure 5).

Figure 5

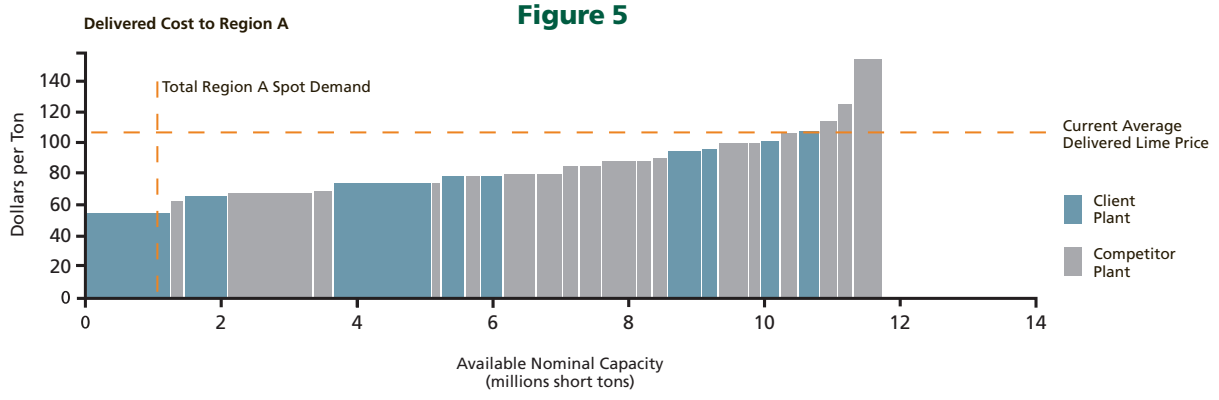
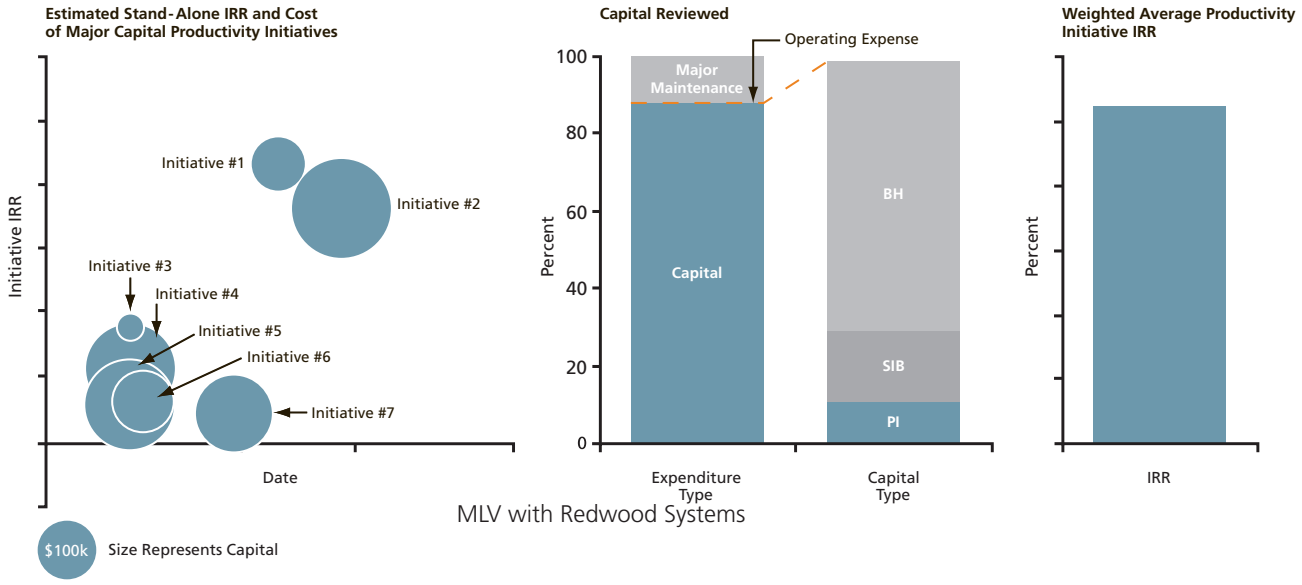


Figure 6

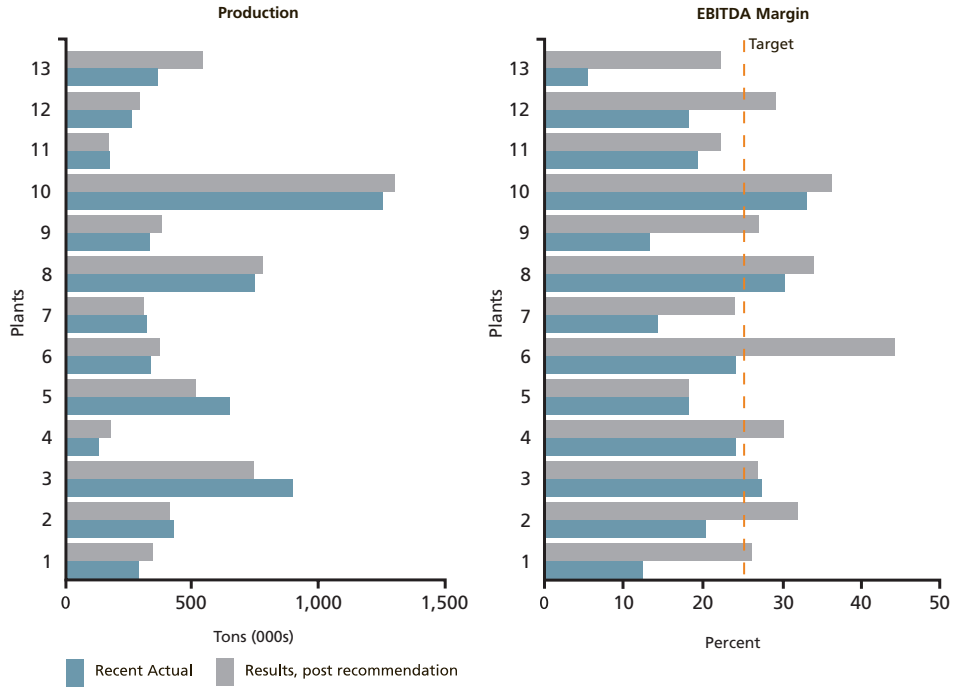


Note: PI = Productivity Improvements, SIB = Stay in Business, BH = Bag House

Step Five Ultimately, this revised supply curve resulted in a change in the allocation of invested capital across the company's facilities (Figure 6).

Step Six Understanding the true competitiveness of the supply situation by market also resulted in the optimization of production across the company's assets, which improved capital efficiency and profitability (Figure 7).

Figure 7



L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and analytical rigor to help clients solve their most critical business problems. Founded more than 25 years ago, L.E.K. employs more than 900 professionals in 20 offices across Europe, the Americas and Asia-Pacific. L.E.K. advises and supports global companies that are leaders in their industries – including the largest private and public sector organizations, private equity firms and emerging entrepreneurial businesses. L.E.K. helps business leaders consistently make better decisions, deliver improved business performance and create greater shareholder returns.
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