Converting stock to new business

THE STOCK KILLER PROJECT – ARLA FOODS

Releasing unnecessary capital in inventory increases the finances available for sustainable investments that can stimulate more business and increase enterprise value.

DILEMMAS IN OPERATIONAL EFFICIENCY…

The key challenge is to balance inventory level, delivery service level, unit cost, production capability and capacity assets…

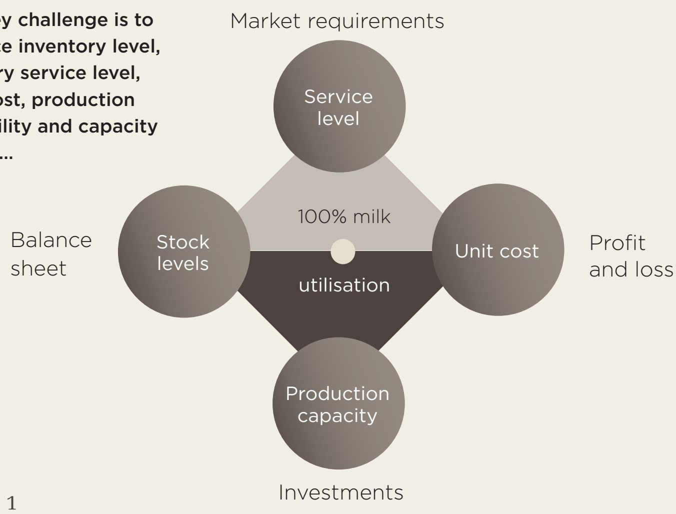

Figure 1

DILEMMAS IN ORGANISATIONAL FOCUS…

… in an environment, where "each stakeholder seeks to optimise his/her business within his/her areas of responsibility."

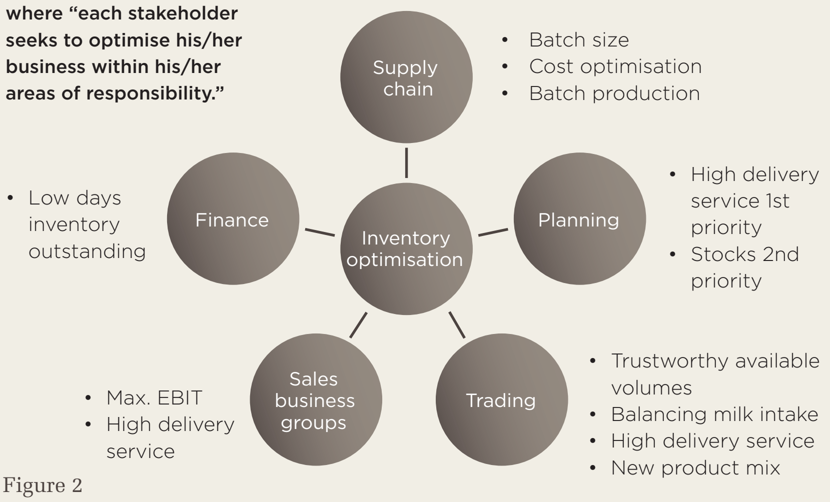

Figure 2

Running a competitive shop calls for investments in new growth opportunities. In the new financial climate, most companies prefer to raise capital inside the company to avoid costly loans. That is why working capital has become a critical target equal to cost savings (see figure 1).

Trade receivables and trade payables are typically the first levers that a CFO will pull. And tight credit margins on sales outstanding and longer reigns on accounts payable go a long way – but for most companies, not far enough. To release substantial amounts of working capital, the management needs to look to operations and the capital bound in inventory throughout the supply chain.

Too much capital bound in inventory is not necessarily a sign of inefficient operations. It may reflect a lack of transparency when it comes to inventory levels or, as is often the case, a lack of awareness of the key importance of inventory, when it comes to releasing working capital (see figure 2).

With a clear overview of operations and the specific levels of inventory throughout the supply chain, it is possible to identify exactly where the potential for release of working capital lies, and subsequently, design operational initiatives that will allow products to move faster through the supply chain. Operations become more agile, capital is released, and enterprise and stakeholder value increase.

KEY FACTS

Arla Foods

- Industry: FMCG
- Arla Foods was originally formed in April 2000 as a result of a merger between the Swedish dairy cooperative, Arla, and the Danish dairy company, MD foods
- Headquartered in Aarhus, Denmark, with production facilities in 11 countries and sales offices in 30 countries
- Annual revenue: DKK 73.6 bn
- Employees: 19,600 in 30 countries worldwide
- Core markets: the United Kingdom, Germany, Sweden, Denmark, the Netherlands and Finland. Growth markets: the Middle East, Africa, China and Russia
- Key divisions: Consumer sales/regional (milk and similar products), international industrial sales and finished goods products (cheese, butter, milk powder)

It sounds fairly straightforward. But the reality for most companies is rarely straightforward due to sub-optimisation in other perspectives. As this case shows.

Arla Foods
Arla Foods is a Swedish-Danish cooperative owned by around 13,500 dairy farmers in Northern Europe. With an annual revenue of DKK 73.6 bn (2013), Arla is the largest producer of dairy products in Scandinavia and the sixth-largest dairy company in the world. Arla's Global Categories and Operations division (GCO) holds the global responsibility for the production of finished goods – that is cheese, butter and milk powder while fresh diary milk products are supplied from consumer divisions per geography.

Milk makes the world go round at Arla. It is the company's main raw material as well as its primary commodity. Arla is committed to receiving all the milk supplied by its farmers as shown in figure 1 and adding value to it – by turning it into high-quality dairy products that deliver a high profit, which is ultimately returned to its farmer owners in the form of higher milk prices.

The company has performed really well over the years when it comes to managing the value chain from cow to consumer, delivering on their obligation to secure the highest value for milk. But significant changes are looming, which have put working capital at the top of Arla's corporate agenda.

The milk wheel is spinning

Arla increased its milk volume significantly in 2013 – from 10.4 bn/kg in 2012 to the current level of 12.7 bn/kg – the largest volume of milk received by any cooperative in Europe. And the volumes are about to increase even further.

The EU's milk quota system will disappear in April 2015. This means that farmers can produce as much milk as they like to boost their earnings. According to Arla's predictions, the lifting of the milk quota will result in an inflow of 3 – 5% more raw milk to Arla's dairies. This translates into 1 billion kg milk annually – in addition to the 12.7 billion kg that they already receive.

This is good news. More milk makes Arla's milk wheel spin even faster, stimulating growth and higher earnings. But an increase in volumes also puts pressure on the company, primarily on two fronts. It requires greater capacity in terms of stock and processing facilities, and it requires new commercial outlets for more products. The European markets, currently Arla's core markets, will not be able to absorb an increased amount of dairy products. So the company is investing in new sales opportunities in profitable growth markets, such as the Middle East, Africa, China and Russia.

In short, more milk calls for substantial investments in new capacity and commercial activities. That is why Arla has turned its attention to working capital as the main foundation for future investments.

> *" Arla previously calculated inventory at the end of the month. The purpose was simply to get a sense of current levels – from a financial perspective. That was it. To support our growth strategy, we need to work far more professionally with our balances by focusing on the supply chain and the values bound here ..."*
>
> *Mogens Kaspersen, VP, GCO Finance*

Programme Zero

In 2012, Arla launched Programme Zero with the specific purpose of optimising Arla's working capital. The financial initiatives – trade receivables/trade payables – delivered satisfactory results, but it soon became clear to the top management that the value-bound inventory had to be addressed.

“Arla previously calculated inventory at the end of the month. The purpose was simply to get a sense of current levels – from a financial perspective. That was it,” explains Mogens Kaspersen, VP, GCO Finance. “To support our growth strategy, we need to work far more professionally with our balances by focusing on the supply chain and the values bound here.” So in 2011, a reduction of inventory in the Global Categories & Operations (GCO) supply chain was added to Programme Zero’s agenda (see figure 3).

> *In GCO, our primary focus is to grow our three global brands significantly, control our costs and reduce our net working capital. We will obtain these goals by constantly assessing which activities add value and which do not. Furthermore, we will free capital by optimising our stocks through the “Stock Killer project …”*
>
> *Jais Valeur, Director, Global Categories & Operations*

Taking action on inventory

For years, Arla has worked steadfastly to make its supply chain as efficient as possible to bring down unit costs and deliver better products at lower prices. When the management turned its attention to further inventory actions, it was the operational mindset that gave cause for concern. Senior VP, GCO Trade and Planning, Thomas Carstensen, explains:

“Arla’s operations have always relied on two fundamental principles. One is “quality takes time” and the other is “we always deliver”. Cheeses need time to mature, and they undergo thorough lab testing. So there is only so much speed you can introduce into operations when optimal taste and food safety have to be observed. Or at least that is how our thinking goes. Then there is our “always deliver” mantra. At Arla, we would rather add extra volumes here and there to make sure that we can accommodate almost any unforeseen circumstance, rather than disappoint the customer. Surplus can always be stocked or converted into different products. But when everyone – frontline sales, planning and site managers – adds a few extra per cent, inventory levels automatically soar.”

GCO INVENTORY

Total GCO inventory equals index 100. However, the scope of the Stock Killer project only accounts for 76% of total GCO inventory.

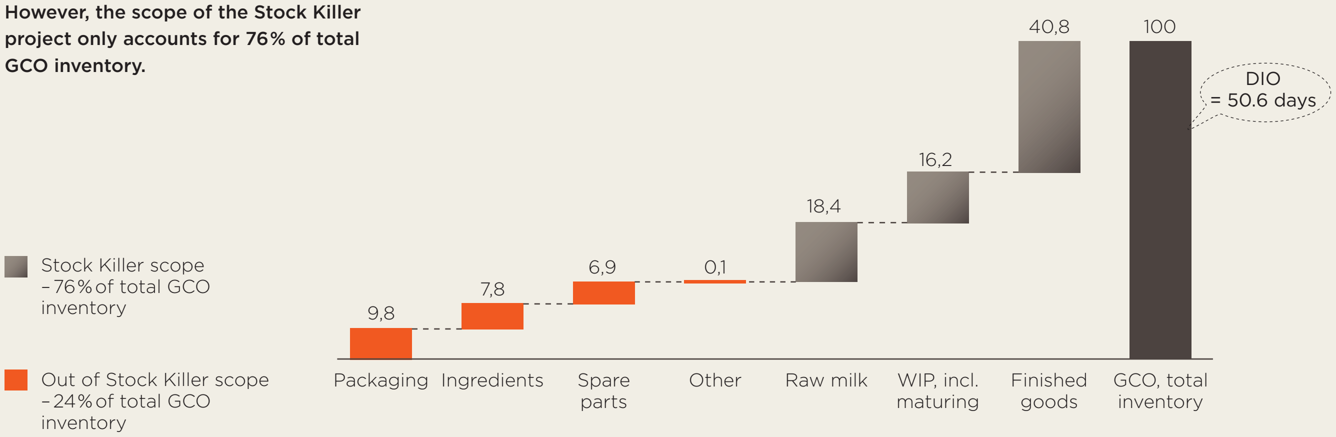

Figure 3
Source: BFC/BEX, BS100 report for November 2012.

The "buffer mentality" is a costly affair. In the GCO division alone, the value of one day's inventory is around DKK 70 million. So finding ways to cut inventory by just a few days goes a long way when it comes to raising working capital.

Arla was clearly aware of the nature of the problem, even the cause of it. What proved more difficult, however, was doing something about it.

"It was clear to us that we had a difficult problem on our hands," Thomas Carstensen explains. "The internal planning and forecasting initiatives we had set up were not paying off. Reducing inventory called for external tools and expertise. Most importantly, it called for people who could provide a different perspective. Stimulate motivation and drive momentum."

Implement was invited to help.

New operational DNA

The project was given the ambitious name, Stock Killer. Implement's brief was to optimise finished goods inventory levels through better operational control principles and planning logic. Jan Lythcke-Jørgensen and Jens Erik Jagd Hansen were put in charge of the team.

"From a top-line perspective, Arla's results are great," Jan Lythcke-Jørgensen explains. "But top-line growth can be achieved more efficiently if both cost and capital become critical success factors when it comes to delivering on strategy targets. We identified the need for new operational DNA – a new way of thinking, when it comes to handling inventory – that would help Arla improve its working capital without jeopardising product quality or the ability to deliver."

The new operational DNA involved the introduction of concepts, such as "speed" and "flow". In Arla's case, this involved reducing physical and administrative lead times, speeding up planning and execution cycles and synchronising supply systems much more with estimated and actual demand. Introducing these new ways of working – and supporting them with new management metrics and salary incentives for operational efficiency – would make Arla's supply chain more agile and allow for scaling of inventory levels at the respective sites, so they comply with the theoretical minimum stock level of a given product.

However, to define specific Stock Killer initiatives, the foundations had to be in place: organisational commitment, data transparency and a viable project framework (see figure 4).

IMPLEMENT'S APPROACH USED TO DEVELOP "NEW OPERATIONAL DNA" PER PRODUCT CATEGORY

	Mobilisation	Analysis	Solution design	Target setting	Execute
SCOPE OF WORK	• Key knowledge on-boarding project • Initial hypothesis workshop • Design of analysis	• Data analysis • Planning process mapping • Data validation and solution workshop	• Conceptual design from generic levers • Solution review with key stakeholders • Solution workshop	• Target setting • KPI tool design and governance • Review of plans and target workshop	• Implementation of pilot project • Roll-out sites • Benchmarking performance

Figure 4

> *”By systematically focusing on the organisation’s operational DNA, you not only release working capital, but optimise operations in the process – without compromising product quality or increasing production costs …”*
>
> *Jan Lythcke-Jørgensen, Senior Partner Implement Consulting Group*

Project take-off

The lifting of the milk quotas combined with ambitious strategic goals automatically prompted a burning platform at corporate level. Anders Beck Larsen, Senior Director, GCO Trade & Planning, was put in charge of the team that was to make sure that the platform became equally hot at site level. In collaboration with Implement, the Stock Killer team was given the task of creating commitment and driving initiatives to bring down inventory through the GCO supply chain. But something vital was missing.

“When Implement came on board, we had no clear overview of inventory levels at each site, let alone the exact volume of products stored at various stages in our supply chains. Without clear, transparent data, we would be stabbing in the dark as to where to focus our Stock Killer initiatives,” says Anders Beck Larsen.

Arla dived into the engine room to retrieve an extensive set of data on all inventory at their respective sites. Thousands of transaction and raw data from SAP were entered into spreadsheets and, gradually, an instrument emerged – the so-called Stock Monitor – which became a fundamental tool and reference point for the entire project. “It gave us an accurate basis for our inventory analyses,” explains Jens Erik Jagd Hansen, “and it effectively demonstrated to Arla’s site managers the status on inventory throughout the value chain at their particular site” (see figure 5).

“Having crunched the data delivered by the Stock Monitor, we set up a series of workshops with Arla’s key stakeholders to identify specific inventory reduction potential and possible initiatives for reducing inventory levels throughout Arla’s supply chain. These initiatives became known as Stock Killer initiatives,” says Jens Erik Jagd Hansen.

To get the Stock Killer project off the ground, the project team chose a combination of a top-down/bottom-up approach. Line Hildebrandt Smith, Stock Killer Project Manager, explains:

“Based on the insights delivered by the Stock Monitor data and Implement’s analyses, we defined the structural and conceptual framework for the project, identifying overall targets and specific initiatives that we found relevant to most of our production sites. The next step was to get this framework anchored locally. We asked local stakeholders at our key sites to translate the conceptual framework into local Stock Killer initiatives, and we helped them define precise targets for each initiative.”

“Although the top-down/bottom-up approach is clearly more time-consuming, it makes great sense for us,” reflects Anders Beck Larsen. “It creates buy-in from the people who are responsible for making things happen on site – and we make sure that we are not pushing theoretical ideas that will not work in practice. What is more, our sites are different. So a one-size-fits-all approach is a no-go for a project of this nature.”

Successes and challenges

The project got off to a good start, primarily through a combination of clear, consistent communication to raise awareness and the picking of low-hanging fruit to deliver quick results.

STOCK MONITOR KPIs TO MANAGE GLOBAL STOCK DEVELOPMENTS

Days of Inventory Outstanding (DIO), GCO total inventory

Total inventory days have been reduced by more than 10 days from 2013 to 2014.

Total inventory can be broken down into product categories and production sites.

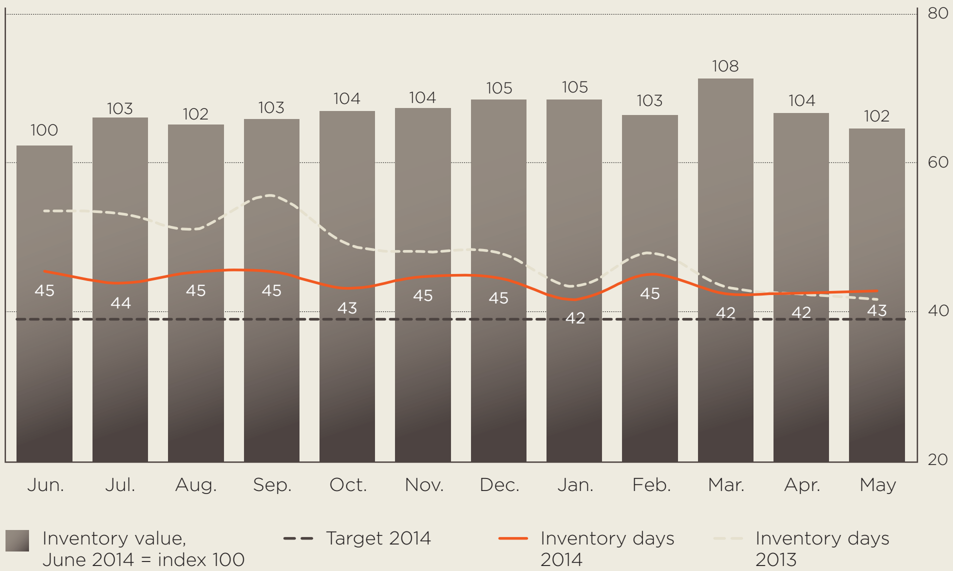

Figure 5

"Inventory levels were brought down, simply by addressing the buffer mentality head on from the start," Anders Beck Larsen explains. "We asked everyone – from sales to production – not to add the extra 5%, but to stick to forecasts. This simple initiative had immediate impact which stimulated motivation across the GCO organisation to do more."

Identifying particular Stock Killer initiatives for the individual sites, the flow mindset came up against Arla's production reality. Initiatives that would clearly be ideal to achieve even faster inventory reduction met constraints on site. Some imposed by the nature of dairy products – time to mature and lab time – and some by the nature of Arla's plants and production, which are based on economics of scale rather than flexibility.

"Arla is a supertanker. It takes time for it to change direction," Anders Beck Larsen explains. "So with a project like Stock Killer, it is a constant trade-off between what we know might create faster impact, and what is practically possible in our world. This has called for a great degree of adaptability on the part of the consultants to help us deliver results in a setting that is not only highly operational, but also somewhat traditional when it comes to operations mindset."

"That is exactly why Implement was the right partner for us," Line Hildebrandt Smith adds. "They have the necessary professional experience to tackle reality

> *" Reducing Arla's inventory is very much like being on an ascending escalator. The natural motion is up, but we're doing everything we can to climb down. And that's hard work …"*
>
> *Line Hildebrandt Smith, Project Manager, Arla GCO Trade & Planning*

REDUCTION IN "DAYS INVENTORY OUTSTANDING" (DIO)

Although the activity level in operations is changing during the year due to seasonality, the capital tied in stock is relatively decreasing as a direct consequence of "Stock Killer initiatives".

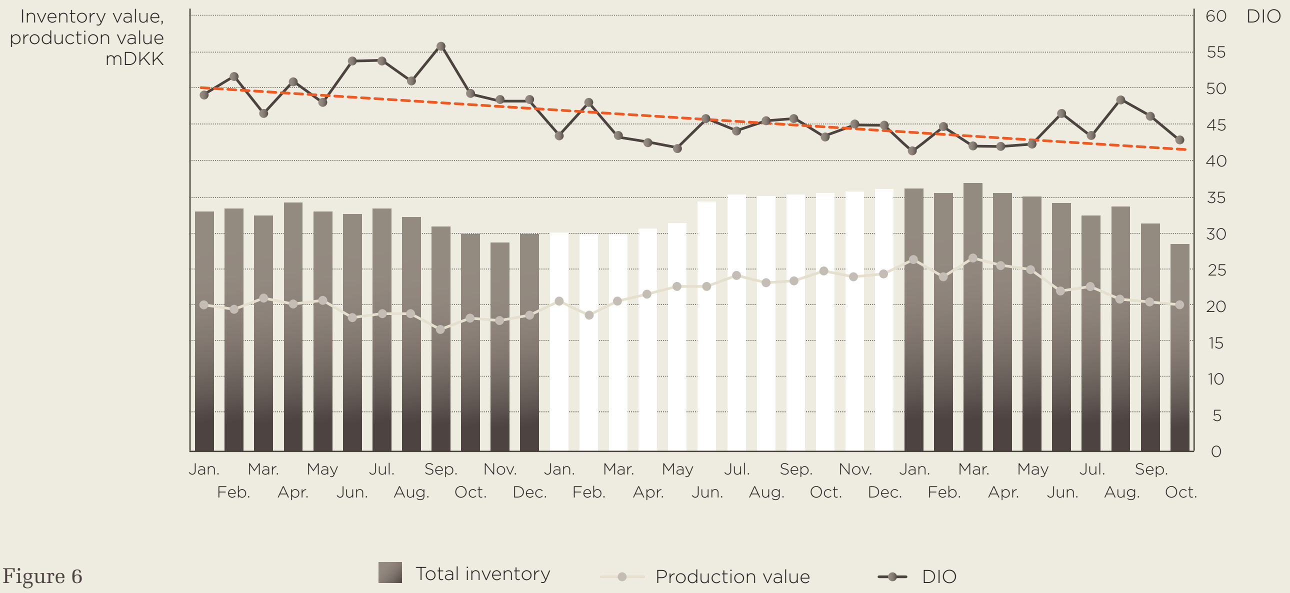

Figure 6

on site, engaging positively and proactively with our supply chain colleagues and showing a keen understanding of their practical reality. We have been able to call on their expertise throughout the project – to help us solve local Stock Killer challenges as well as provide high-level input to various groups of stakeholders."

Killing stock?

A name like Stock Killer obviously begs the question: how much of Arla's stock have actually been killed?

With implementation underway at the various sites, it is still too early to quote exact figures. But according to Thomas Carstensen, the project has already delivered significant results (see figure 6).

"Stock Killer has created transparency where we had none. With the data generated by the Stock Monitor, we now have a clear overview of inventory levels and can pinpoint exactly where we need to focus our inventory efforts and which targets would be relevant to aim for. Our reporting framework allows us to track progress and even identify why things might not be moving in the right direction at a given site. That is hugely important."

Then there is the mindset issue. To release more working capital, the Stock Killer project attacks Arla's safety zone of inventory buffers. The buffer mentality must be kept in check, and the Stock Killer team can see clear indications that the message has got through. Local initiatives already show that it is possible to reduce inventory whilst still meeting Arla's delivery and quality standards.

Another important realisation has come out of this project according to CFO, Mogens Kaspersen. "To really deliver large-scale results, we need more than site-specific activities. We need a sales pull from the rest of the organisation – a sharing of responsibility across Arla's business units – where everyone keeps the sales/inventory balance top-of-mind through more accurate forecasting and optimal planning procedures. Stock Killer is already incorporated in the KPIs for the GCO division, but it needs to travel to the rest of the organisation as well.”

“What we hope to demonstrate with a project of this nature,” explains Jan Lythcke-Jørgensen, “is that by systematically focusing on the organisation’s operational DNA, you not only release working capital, but optimise operations in the process – without compromising product quality or increasing production costs. In other words, the clue to successful business performance is a “both/and” approach where you maintain high-profit levels while optimising operations to release working capital for new investments.

“We probably won’t kill stock entirely,” Thomas Carstensen admits. “But we will become far better at defining targets and keeping inventory to a minimum across the organisation. For me, the greatest outcome from Stock Killer would be if it were to develop from a project to a mindset. So that the focus on inventory levels becomes as ingrained as our quality and delivery standards.”

> *”Reducing inventory called for external tools and expertise. Most importantly, it called for people who could provide a different perspective. Stimulate motivation and drive momentum…”*
>
> *Thomas Carstensen, Senior VP, GCO Trade & Planning*

KEY DELIVERABLES

The Stock Killer project

- Focus and alignment: We defined the burning platform at management level and outlined the scope of the project
- Overview and transparency: We analysed all available data on inventory throughout the supply chain to identify inventory reduction potential
- Framework: In collaboration with Arla’s management team in GCO (Global Categories and Operations), we created the conceptual framework for new operational planning procedures
- Stock Killer initiatives: Working closely with Arla’s project team, we defined specific Stock Killer initiatives and helped them set site-specific reduction targets
- Traceability: We developed a set of stock monitoring reporting tools to continuously export transaction data from SAP to a data warehouse in order to create a KPI hierarchy with financial data to determine local product and factory performance

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