Productivity, Cost Effectiveness and Profitability:

The CFO Mantra

A return to growth…

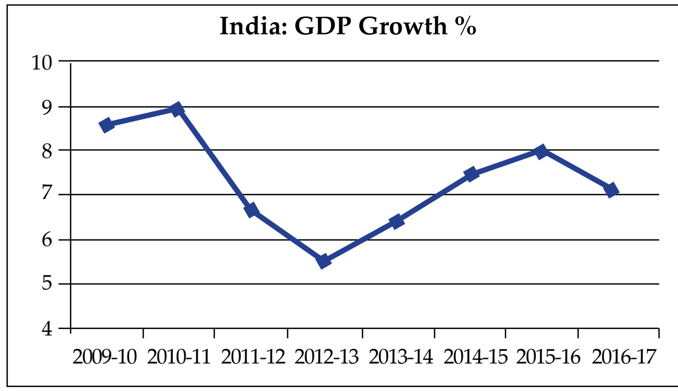
India's economic growth paradigm is on a sure footing. At 7.1 per ent in the fiscal year 2016-17, India is one of the world's fastest growing economies. FDI – USD 42 billion in fiscal 2016-17 - is at an all-time high and there is a sense of overall buoyancy across industry. A good monsoon should aid the return of demand in rural India, adding a further fillip to growth.

The uptick in growth has been caused by many elements, beginning with the first prerequisite – confidence, in India's economic resilience and in a government that the Centre that is seeking to unlock growth and balance the need for greater equity. Luck favours the prepared and an overall environment of benign inflation – CPI inflation is at an average of 4.5 per cent at the current juncture - has aided both government and country to sustain this return to growth. The government's focus on fiscal discipline is also lending itself to more tempered inflation.

…aided by a Central government focused on implementation

At the core of returning growth, however, is the BJP government's most formidable attribute: its skill in implementation. Successive publications have argued in favour of the prioritisation of a longer-term vision and the creation of a structurally stronger regulatory environment instead of a more 'execution based' focus. There can be no argument about the need for long-term policy reform and regulatory overhaul in multiple areas – the NDA government is taking steps on multiple elements on this score and GST is one of them. Whilst much remains to be done, the results of efforts undertaken should be visible in the next two years. From the limited perspective of lifting immediate term growth however, India's moribund trajectory needed an urgent and equal focus on execution, on the implementation of projects for the economy to kick-start itself. And that process is clearly underway.

According to data from CMIE, the previous UPA government instituted a surge of new investments in its first term (2004-2009). Projects ranging from Rs 1.6 trn to USD 2.0 trn were announced each year over 2006-2009. In turn, that yielded some fruit in UPA's second term, with projects in the region of Rs 3-4 trillion completed each year between 2011 and early-2014. On its own, that is impressive, when one bears in mind the fact that less than Rs 1 trillion worth of project investments were being completed each year prior to 2004. Sadly, the other side of the equation changes this rhetoric. As many as Rs 8-11 trillion



worth of investment projects were dropped (shelved/abandoned/stalled) each year in UPA II. New projects announced also fell to less than a fourth of the high of Rs 20 trillion per annum in its last two years in government.

In sharp contrast, the NDA government may not have kick-started as many new projects – Rs 10 trillion worth in 2014-15 and Rs 8 trillion each in 2015-16 and 2016-17, but its rates of completion are comparatively much better, going up to Rs 5.7 trillion in 2016-17, similar to the previous year, a ratio of almost 70% of those announced each year. Crucially, the NDA has revived a number of projects – Rs 1.9 trn, Rs 1.3 trn and Rs 1.7 trn in each of three successive years of its government. The UPA II level, if that is any benchmark, stood at Rs 0.48 trn and Rs 0.27 trn in its last two years. Projects under implementation too are better in the NDA regime at almost Rs 10 trn last year.

Industry is beginning to reflect greater buoyancy

IMA's quarterly Business Confidence and Performance Index (BCPI), which receives over 300 corporate responses each quarter, reflects this uptick. The BCPI had plunged from highs of 75-85 across sectors till late 2009/early 2010

Whilst there can be no argument about the need for long-term policy reform (GST is one of them) and regulatory overhaul in multiple areas, the fact is that India's moribund growth needed an urgent and equal focus on execution, on the implementation of projects for the economy to kick-start itself.

to a contractionary low of 46 by mid-2013 (50 is neutral, above it signals industry expansion; below contraction). The index jumped all the way back to 71 as the BJP-led NDA government came to power in 2014, and has stayed in the 65-70 range since. Having recovered from any demand destruction because demonetisation, IMA's first quarter BCPI for 2017-18 (see the On Your Mind section of this issue) remains reasonably bullish.

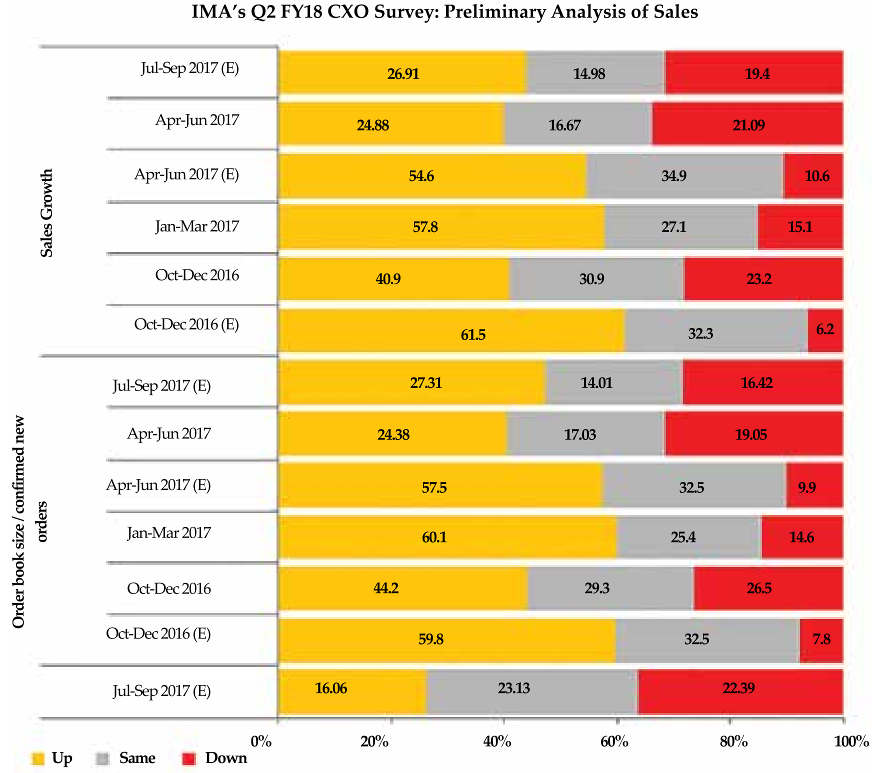
In the October-December 2016 'demonetisation' quarter, median revenue growth stood short of 7 per cent for the respondent base, with 20 per cent of firms de-growing revenue (with sectoral variations of course). Profits were harder hit, with median profit growth at just 5 per cent (despite very low inflation) and 30 per cent of firms either de-growing (over 20 per cent) or staying static. The government's Q3 assessment of GDP growth at about 6 per cent reflected this pressure.

BCPI respondents for the subsequent Q4 (Jan-Mar) reflected a clear improvement with median revenue rising to 10 per cent and median profit improving also to about 7 per cent. There is a gentle but continued upswing from that level – the new fiscal's Q1 BCPI now reflects median revenue above 10 per cent and while profit growth may not have improved over last year's Q4, the number of firms de-growing profits has dropped. The business performance index for Q1 is at a buoyant 68, led by sales and new orders at 71 and 73 (50 is the neutral point so clearly, both expectations and reality are on an upswing this year) and capacity utilisation also improving to 68.

Uncertainty and volatility remain a challenge...

For the CFO, these are all heartening signs. Of equal note however, is the fact that whilst we stand well poised to grow well this year, the going will be volatile and will demand a razor-sharp focus on efficiency and effectiveness. Illustratively, early stage analysis of IMA's most recent BCPI survey for Q2 underway amongst IMA's CXO member community as this edition of CFO Connect goes to print reveals the difficulty in planning and forecasting. Anecdotal evidence suggests a sharp recovery from demonetisation, but few in industry could forecast quarter-end results. For instance, 61 per cent of IMA's Q2FY17 BCPI respondent base expected sales growth to increase in Q3. Only 40 per cent managed that increase. One would presume that the current year would prove more predictable but that too, appears unlikely. While 55 per cent of the survey's first flush respondent base expected higher year-on-year growth in this first quarter; less than half have accomplished the same because a lack of new orders materialising.

IMA's Q2 FY18 CXO Survey: Preliminary Analysis of Sales

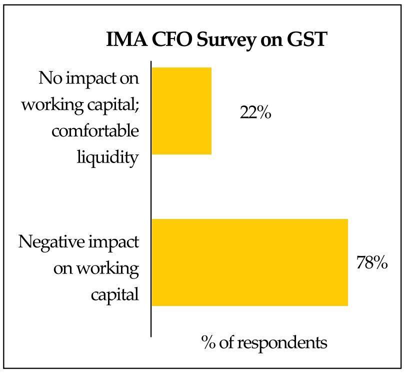


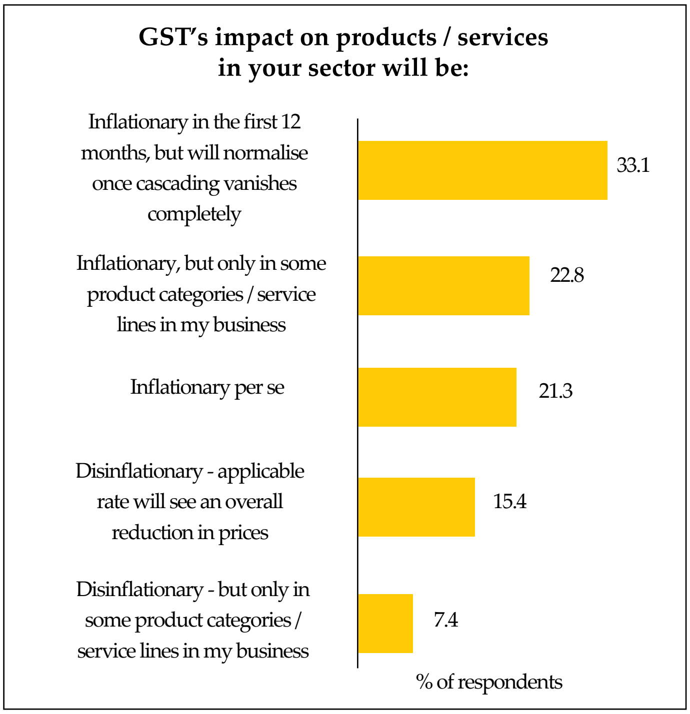
It falls then to India's CFOs to ensure a focus on productivity and profitability given this limitation to project growth in a linear fashion.

At the wider, macro-economic level too, there are challenges, including the transition to GST. Critically, India's banking sector remains stressed, and whilst bond markets have begun to play a much larger role , the availability of banking credit is still fundamental for businesses at large but most so, for India's smaller scale industries. A strained and terribly risk-averse banking sector will see only incremental improvements in the near term.

GST's positive impact is prospective...

GST itself will create some challenge in the near term on





the count of working capital and possibly lead to a temporary spurt in inflation in specific sectors. An IMA CFO Forum spot poll responded to by over 130 CFOs in May 2017 reflected concerns on strain on working capital – almost 80 per cent expect the same as well as higher inflation in the current fiscal (over 75 per cent expect the same, albeit largely temporarily). Stress within the supply chain is also expected, which could in turn yield some pullback in inventories as well as a rationalisation of vendor bases. Resultantly, that will create some upheaval in demand. A quarter of the respondents are deferring green-field investments; almost a third of manufacturing firms are doing so until the impact of GST is clearer.

That said, industry is upbeat about the new GST regime per se – almost a 100 per cent of IMA's 2,000 strong CXO member community believes that the GST regime, once stable, will yield gains in efficiency of both operations and eventual tax impact, even as compliance complexity will increase. In the near term, however, it is the uncertainty of how things will play out in the next six months that will vex CFOs.

...and currently unknown...

Early-stage data from IMA's Q2 BCPI survey suggests that over 30 per cent of respondents are still not prepared for GST, and a fifth are uncertain about its impact on individual businesses. The latter is no surprise, because the change is landmark, not just because taxation, but also for how businesses will now operate. This time of transition to GST will necessarily demand the highest calibre of focus on profit and cash flow conservation as businesses come to terms with new ways of operation and as rates and rules are institutionalised. The risk may well be on the upside, but it is best to be prepared.

Volatility is here to stay...

Wider trends in the global environment are equally sudden – the Trump administration's thrust on domestic employment is forcing a change in the pharma, IT and ITeS sectors' strategies; the latter are already seeing a landmark shift in core competencies with the advent of the digital world.

Volatility then is the new normal and in this, CFO capability to balance revenue and cost and build mantras of profitability is the need of the hour. CFOs are prioritising expense management at par with revenue growth, focusing not just on minimising wasteful expenditure but on making expenditure more effective per se.

...and cost management and profitability maximisation is fundamental

This is clearly not the time to cut costs across the board. A more aggressive growth paradigm that seeks to create demand demands cost cutting

In the current year, GST itself could also create some challenge on the count of working capital and lead possibly to a temporary spurt in inflation in specific sectors.

whilst ensuring that each initiative is aligned to the wider corporate strategy and crucially, ingrained in corporate culture. Embedding cost discipline within the business together with ongoing monitoring of costs is fundamental. On this score, rather than run going after low hanging fruit and cutting costs rapidly and in a large-scale fashion, leading companies define granular cost-cutting objectives, monitor results continuously, and create incentives for staff to achieve cost reductions. They identify root causes of costs in order to separate good costs from bad. Importantly, regular cost assessments enable them to identify non-obvious costs and complexity, better align cost metrics to corporate strategy, and become more decisive on whether products or services should be re-sourced, re-designed or re-invested in.

Crucially, whilst tracking cost metrics over time is a critical element of sustained cost management, real sustainability lies in the hearts and minds of frontline managers and employees. If the people at the front do not begin to act and behave differently, any initial cost savings will not last. A company that hopes to encourage new attitudes and actions must address employees' concerns directly, and find ways to mitigate them. It must also involve the front line in creating and maintaining the change. Thus, by promoting a bottom-up cost cutting culture, leading companies limit the impact of cost cutting on their growth prospects.

TVS Motor and Ashok Leyland have developed strategic competencies in managing cost that have held both organisations in good stead. Their case studies, as evinced through detailed interviews with SG Murali, Chief Financial Officer and Executive Vice President, TVS Motor Company and Sundaram Clayton and Gopal Mahadevan, Chief Financial Officer of Ashok Leyland, offer insight into strategies with many common elements, despite very different contexts.

Both organisations operate in very competitive sectors; both have lived through a period of dull growth. Ashok Leyland, in fact, through a period of crisis as the economic slowdown of 2011-13 hit India's commercial vehicle segment ferociously. The firm's return to growth was enabled through the most categorical focus on managing cost and profitability through deeply thought through, insightful and courageous strategies.

Both firms have common and deeply insightful lessons to offer.

Closely assess your cost structure: For TVS, an annual budgeting exercise is centred on identifying opportunities to eliminate waste and reduce costs. A company-wide programme analyses key cost drivers and prioritises improvement opportunities for each business unit. Ashok Leyland, when hit by a perfect storm in 2013 by a weak economy and a deep slowdown in infrastructure-related sectors, reported its first-ever quarterly loss of Rs 141 crores in its history. Its multi-pronged effort to win back profitable growth began with reducing cash leaks. A dedicated, cross-functional team of 25-30 high quality employees were mandated to cut Rs 1,500 crores worth of costs, which reviewed every single component of cost, ranging from interest and depreciation to team sizes and productivity.

Engage and involve the entire organisation: This helps not just to co-opt the entire organisation into the effort but also crucially, to build a culture of sensitivity to waste and cost. At Ashok Leyland, a systematic knowledge-management structure was set up to invite cost-cutting ideas from across the organisation, and to track implementation. Each idea went through three stages and was validated by the Finance team. Bearing in mind the need to align effort and business need, the Ashok Leyland strategy centred on three critical metrics – market share, operating working capital and EBITDA margins – to which all targets and goals were tracked. MIS systems were revised to include the new metrics along with the profitability numbers for front line staff to be more involved in intended outcomes. Despite concerns on information confidentiality, the move to share sensitive information with employees had a dual effect – it created urgency and clarity on goals at the front end and also built greater confidence through the display of categorical trust in employees. The proof of the pudding: Rs 750 crores worth of cost reduced over seven months of rigorous effort.

Core to success in any bid for transformation and crucially, sustained excellence, is the ability to communicate openly and consistently with all stakeholders – investors, shareholders, vendor eco-systems and employees. This is most crucial

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Gopal Mahadevan, Chief Financial Officer, Ashok Leyland

SG Murali, Chief Financial Officer and Executive Vice President, TVS Motor Company and Sundaram Clayton

in times of change, whether external or internal. The importance of explaining the rationale behind decisions and seeking feedback transparently cannot be underscored.

This held the Ashok Leyland team in very good stead as it fought back to its leadership position in the market. Despite multiple challenges, the ability of the team to communicate openly and consistently on strategies being adopted and steps taken saw the stock rise from Rs 11 to nearly Rs 110. A QIP of Rs 667 crores (achieved in just three weeks – India's shortest QIP) was undertaken just ten months after the crisis at Rs 36 (when the share was languishing at Rs 11).

Accelerate focus on productivity: Across the country, corporations are centring on productivity maximisation. Whilst mechanisation and automation technologies are being invested in, at the other end is investment in top talent, involving much higher differentiation in top performers. IMA's Annual HR Survey places increment differentials for the year 2017-18 as high as 40 per cent for top performers and standard performers. In equal focus is the need to drive down employee costs. Low-performing employees are now being more categorically weeded out of systems and individual productivity is being increased at every level. At Ashok Leyland, despite a doubling of revenue over a four-year time frame till mid-2016, the Finance team's headcount has come down from 287 to just over 205.

Reduce material costs and complexity: At another level, productivity assessments must also extend to products. Deep drill downs of every service/product line are crucial today in order to identify those products that lend themselves to profitable growth, and those that do not. At Ashok Leyland, in-depth analysis revealed that a segment of the firm's product line delivered a negative contribution to margins. In recognition

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that even holy cows must be sacrificed for the gain of sustainable growth, the firm stopped producing those products.

At TVS, the concept of lean manufacturing is also a clear mandate and the risk of over-engineering is avoided at all times. Considering the same, even the addition of any SKU or spare part requires strong justification at TVS. There is a categorical focus on fixed asset productivity – a key 'good cost' then is spends on proper maintenance of equipment. The third prong of this triad is complexity reduction, given the nature of complex processes lending themselves both to hidden costs and obsolescence.

TVS Motors' ability to link the entire network of suppliers as well as distributors through their system enables 'just in time' management of inventory that frees up working capital and enables lean manufacturing as a best in class.

Differentiate good costs from bad costs: Both Mr Murali and Mr Mahadevan are clear that costs that drive performance must continually be invested in, regardless of circumstance. Non-strategic areas must be identified and spends moderated. TVS Motor views spend on R&D and new product development as costs that must be preserved. R&D spends have gone up by over 40 per cent over a two-year time span, profits have maintained a similar trajectory. Ashok Leyland aggressively expanded its sales, service and spare-parts network in a bid to build demand

The Ashok Leyland strategy centred on three critical metrics – market share, operating working capital and EBITDA margins – to which all targets and goals were tracked.

and create a pan-India presence to diversify risk. The CV manufacturer's sales network grew four times over four years; it continues to spend over Rs 1,000 crores annually on Capex and commands a share of over 20 per cent in each market. Exports are also in clear focus as an area of expansion.

Enhance the focus on quality – and on the Cost of Poor Quality (COPQ): Like many leading corporations, TVS Motor and Ashok Leyland both control for avoidable losses, such as those arising from delays or wastage. TVS Motors goes so far as to quantify the losses and creates a sense of urgency around them. This is critical in manufacturing but would apply equally to the service industry. The cost of poor quality is quantified in monetary terms once avoidable losses are identified and results, including the opportunity loss are shared with plan managers to quickly understand the extent of unfavourable variance and focus improvement efforts. Simultaneously, all good costs are segregated based on their impact on sales, whether it is customer centric new product development cost (including to create entry barriers in a competitive market), investment in innovation, creation of mega brands, costs of compliance and high levels of governance and competency development.

For Ashok Leyland, a stringent process is in place to improve its forecasting accuracy on product development, manufacturing and sales. A disruptive focus on quality has brought down defects from 7.5 to 0.32 in four years. Process improvement initiatives are spear headed by Finance to reengineer processes across functions such as HR, Finance and Quality. The goal is to eliminate redundancies, automate processes and outsource areas where both cost saving and core focus is aided.

Integrate and involve suppliers into core business processes: The TVS mantra of an end-to-end supply chain approach to cost saving integrates suppliers into business processes. Mr Murali believes in engaging with vendors as a true partner, and TVS offers its cost management expertise to supplier teams, helping them to improve their cost structures and processes. The firm also leverages its own banking relations extensively to provide suppliers with access to relatively low-cost capital. The virtuous cycle is clear. Improved capital and cost efficiency at the supplier-end helps to reduce cost inputs to the company. Moreover, close relationships with suppliers allow it to leverage supplier expertise in vehicle design, a major component of overall cost. There is much greater certainty regarding delivery time, cost and/or quality. With the onset of GST, these strongly interdependent relationships will hold any company in good stead as greater transparency and timely execution across the supply chain become fundamental to the smooth

flow of input tax credits.

Watch the pennies, the pounds will save themselves: On the same note, the tendency to focus on big, hairy goals of cost containment is laudable, because of the potential gain involved. However, volatile and uncertain times also demand an assessment of costs that are possibly smaller on the scale of total operating costs, but which are easier to control. Spends on advertising and travel are discretionary, but often more necessary to drive demand and customer engagement than in times of plenty. It falls to CFOs to identify the right questions, and often, the right partners who will rise to the expectation of a sharing of the vision of 'good spends'. Finance must also extend itself beyond its core to understand true value drivers. If the goal, for example, is to review marketing spends, then the better goal in these times may well be to improve marketing effectiveness rather than cut marketing spends. Whilst key questions to consider will of course centre on whether marketing costs are being leveraged through low-cost

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channels, Finance must also question whether the right channels are being used, whether the marketing message is targeted to the right customers and crucially, whether customer feedback is being received and feedback loops created.

Delegate accountability to business: As any CFO worth his salt will tell you, Finance can set frameworks and monitor progress. For real sustainability, the responsibility of cost management and profit maximisation must lie with operating business managers. Both Mr Mahadevan and Mr Murali follow this mantra. At Ashok Leyland, P&L responsibility has been delegated to each business vertical with employees empowered to make their own resourcing decisions and the corporate office offers support when required. Short-term incentive plans are linked to the key metrics and detailed systems capture both performance and inventory data in each location, helping to drive sound investment decisions and manage profitability at the dealer end.

Focus on the core: Over the last decade, winning CFOs have developed mindsets that enable them to cut through the clutter and identify areas of strong strategic advantage and need. Whilst identifying margin-contributing products/service lines has been discussed, these options will vary across businesses. For Mr Mahadevan, a core area of needed focus was working capital as Ashok Leyland turned its ship towards profitable growth. The Finance team instituted an automated review process that provided granular information to identify inefficiencies in the management of working capital, bringing down working capital to a sixth of previous requirements in less than six months. New methodologies are being continually developed to ensure ongoing improvements. Illustratively, a method to compute moving average working capital – akin to how banks calculate interest on capital used – is being tested in the last few months.

At the most strategic level, Ashok Leyland's bid to return to profitable growth was centred on selling all non-core assets and shutting down non-viable businesses. Crucially, all non-performing investments have been impaired down to realistic levels, strongly driving up ROCE. The ability to combine with an aggressive market growth strategy and focused reduction in operating costs has seen Ashok Leyland become the most profitable CV company in India.

In the case of TVS Motor, customer centricity and customer value is a similar core focus. The firm actively allows for costs that enhance the product's value delivery. Its Scooty model, for instance, is designed with a number of customer-centric features such as storage space under the seat and a battery charger. On the count of cost, the holistic focus on supply chain excellence centred on cost is evident at TVS Motor. Illustratively, a new product design that saw a 1 mm increase in length over the previous model should ideally have passed all innovation funnel gates at the firm and it did, in both the factory and at the design stage. However, a team member in logistics sounded a clear alarm on 'loadability' – the vehicle carriers would simply not be able to carry as many two-wheelers in one load, only because that single 1 mm change!

Align your board and top team: The starting step of this drive towards effectiveness of spends and profitable growth for the CFO, however, is an alignment of the organisation's top team on an end goal of profitable growth that looks at cost as a strategic value driver. Board members will have to be collectively and individually sensitised to today's context of volatility and linkages of cost strategies to sustainable shareholder value clearly illustrated. At the level of the executive, it must fall to the CFO to consistently and transparently communicate and engage with his/her partners on the top team on decisions being taken. Both believability and 'connect' are key, as is the ability to also openly receive feedback from investors, the Board and other CXOs, creating a virtuous cycle of information flow, ideas and decisions. A common goal must be built and continually invested in; it will not automatically be built and sustained. Those that can build value through a focus on productivity, efficiency and profitability in these times of uncertainty and yet, massive opportunity, stand to leave a globally competitive legacy that will survive a continuing vortex of transformative change that our economy will go through over the next decade. ■