The CEO’s Dilemma

Building Resilience Through Competitive Cost Position

November 2022
Introduction to this document

COVID-19, followed by the war in Ukraine, has brought general changes in customer demand (from services to products, for example), commodity price growth, inconsistent supply due to supply chain distress, and the highest inflation since the 1970s crisis.

It is therefore imperative for businesses to optimize their cost position to stay afloat or create competitive advantage.

The best organizations know how to turn uncertainty into opportunity. This document focuses on how organizations can build a playbook that drives cost reduction through operational and organizational lenses.

In this BCG Executive Perspectives edition, we address how to respond to uncertainty and build resilience through competitive cost advantage.
The time to act is now

Recent global disruptions have brought general uncertainty, testing companies' ability to handle labor shortages, high inflation, eroding demand, broken supply chains, and surging commodity prices.

Our global economy makes instability contagious across borders, so adaptability is vital for any company, regardless of financial position and industry condition.

Our research shows "winners" must programmatically reduce cost to preserve margin/flexibility while investing freed funds to transform, build capabilities, and develop more agile teams. Reducing costs now frees resources and reorients companies for any uncertain future, creating opportunities from instability.

Options to achieve and sustain value

By understanding their strategic starting point and objectives through rapid assessments, organizations can diagnose inefficiencies and gauge savings potential. These evaluations guide organizations to levers for achieving a competitively advantaged cost position. While companies may employ different sets of levers, our research suggests they are typically combined in one of four common pathways:

1. **Organizational streamlining**: Simplifying structure and reducing overhead cost.
2. **Direct/indirect materials optimization**: Reducing costs and cost variance through improved procurement.
3. **Operating model and process redesign**: Holistically optimizing work, processes, and organization.
4. **Full strategic operations transformation**: Processing end-to-end value chain looking at inefficiencies in each step of the process.
AGENDA

A view of the world

- The time to act is now
- Options to achieve and sustain value
Inflation and volatility are becoming the “new reality” across the globe

Drop in demand and general uncertainty
-25 pp. (from 83% to 58%) drop in consumer sentiment index\(^1\)
+8.6% estimated to be global inflation in 2022\(^2\)
Layoffs and hiring freezes are being announced\(^3\)

Supply chain distress
111 days (+34% y/y) new freight time to US from China
+25% rise in ocean freight price index

Volatility in global markets
~2 times higher S&P 500 volatility than in 2021
~15-35% drop in major global stock market indexes including US, Germany, and China
Up to 40% commodity price growth (mostly energy, metals, and agrifoods)

Central banks fight with consequences
Investors expect central banks to raise global monetary-policy rates to almost 4% through 2023\(^4\)
Nearly 4 dozen countries (e.g., US, UK, Saudi Arabia, India) have raised rates ranging from 0.5% to 4% in the last 6 months\(^5\)

Varying government support for COVID-19
Removal of foreclosure and eviction moratoriums, rental assistance, and stimulus payments in the US
New wave of government lockdowns imposed in China affecting millions, including labor markets
Despite increasing infections in Europe, major central banks withdrawing stimulus packages

Global macro update | Economic snapshot for October

### Global growth outlook

**GDP forecasts** *(Real GDP YoY)*

<table>
<thead>
<tr>
<th></th>
<th>2021A</th>
<th>2022E</th>
<th>2023E</th>
<th>2024E</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>5.9%</td>
<td>1.7%</td>
<td>0.4%</td>
<td>1.4%</td>
</tr>
<tr>
<td>Eurozone</td>
<td>5.3%</td>
<td>3.0%</td>
<td>-0.1%</td>
<td>1.5%</td>
</tr>
<tr>
<td>Global</td>
<td>6.0%</td>
<td>2.9%</td>
<td>2.3%</td>
<td>2.9%</td>
</tr>
</tbody>
</table>

### Commodity prices and inflation

**Commodity prices**

<table>
<thead>
<tr>
<th></th>
<th>Jul ‘22</th>
<th>Aug ‘22</th>
<th>Sep ‘22</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>Brent oil</td>
<td>98.6</td>
<td>89.6</td>
<td>79.5</td>
<td>-11.2%</td>
</tr>
<tr>
<td>Natural gas</td>
<td>8.2</td>
<td>9.1</td>
<td>6.8</td>
<td>-25.9%</td>
</tr>
<tr>
<td>US</td>
<td>194.7</td>
<td>228.9</td>
<td>165.0</td>
<td>-27.9%</td>
</tr>
<tr>
<td>Eurozone</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

**Consumer price inflation** *(YoY)*

<table>
<thead>
<tr>
<th></th>
<th>Jul ‘22</th>
<th>Aug ‘22</th>
<th>Sep ‘22</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>8.5%</td>
<td>8.3%</td>
<td>8.2%</td>
<td>-0.1pppts</td>
</tr>
<tr>
<td>Eurozone</td>
<td>8.9%</td>
<td>9.1%</td>
<td>9.9%</td>
<td>+0.8pppts</td>
</tr>
</tbody>
</table>

### Financial markets

**Equity market performance** *(YTD change)*

<table>
<thead>
<tr>
<th></th>
<th>Jul ‘22</th>
<th>Aug ‘22</th>
<th>Sep ‘22</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>S&amp;P 500</td>
<td>-13.3%</td>
<td>-17.0%</td>
<td>-24.8%</td>
<td></td>
</tr>
<tr>
<td>Eurostoxx 50</td>
<td>-13.7%</td>
<td>-18.2%</td>
<td>-22.8%</td>
<td></td>
</tr>
</tbody>
</table>

**Corporate spreads** *(High Yield)*

<table>
<thead>
<tr>
<th></th>
<th>Jul ‘22</th>
<th>Aug ‘22</th>
<th>Sep ‘22</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>4.69%</td>
<td>4.84%</td>
<td>5.52%</td>
<td>+68bps</td>
</tr>
<tr>
<td>Eurozone</td>
<td>5.90%</td>
<td>5.60%</td>
<td>6.31%</td>
<td>+71bps</td>
</tr>
</tbody>
</table>

### Monetary policy

**Monetary policy rates**

<table>
<thead>
<tr>
<th></th>
<th>Jul ‘22</th>
<th>Aug ‘22</th>
<th>Sep ‘22</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>2.5%</td>
<td>2.5%</td>
<td>3.25%</td>
<td>+75bps</td>
</tr>
<tr>
<td>Eurozone</td>
<td>0.5%</td>
<td>0.5%</td>
<td>1.25%</td>
<td>+75bps</td>
</tr>
</tbody>
</table>

### Labor market

**Job openings rate**

<table>
<thead>
<tr>
<th></th>
<th>Q1 ‘22</th>
<th>Q2 ‘22</th>
<th>Q3 ‘22</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>7.3%</td>
<td>6.8%</td>
<td>6.5%</td>
<td>-0.3pppts</td>
</tr>
<tr>
<td>Eurozone</td>
<td>3.1%</td>
<td>3.2%</td>
<td>-</td>
<td>+0.1pppts</td>
</tr>
</tbody>
</table>

**Unemployment rate**

<table>
<thead>
<tr>
<th></th>
<th>Jul ‘22</th>
<th>Aug ‘22</th>
<th>Sep ‘22</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>3.5%</td>
<td>3.7%</td>
<td>3.5%</td>
<td>-0.2pppts</td>
</tr>
<tr>
<td>Germany</td>
<td>3.0%</td>
<td>3.0%</td>
<td>-</td>
<td>0pppts</td>
</tr>
<tr>
<td>France</td>
<td>7.4%</td>
<td>7.3%</td>
<td>-</td>
<td>-0.1pppts</td>
</tr>
</tbody>
</table>

### Manufacturing

**PMI manufacturing** *(<50 = contraction)*

<table>
<thead>
<tr>
<th></th>
<th>Jul ‘22</th>
<th>Aug ‘22</th>
<th>Sep ‘22</th>
<th>Change</th>
</tr>
</thead>
<tbody>
<tr>
<td>US</td>
<td>52.8</td>
<td>52.8</td>
<td>50.9</td>
<td>-3.6%</td>
</tr>
<tr>
<td>Eurozone</td>
<td>49.8</td>
<td>49.6</td>
<td>48.4</td>
<td>-2.4%</td>
</tr>
</tbody>
</table>

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A view of the world

The time to act is now

Options to achieve and sustain value
The time to act is now | Companies that build resilience rapidly in changing environments have a much higher chance of success.

Developing resilience is a key way for companies to create significant long-term value by increasing preparedness to hedge against external shocks and disruptions.

Building resilience creates competitive advantages and allows companies to rise above their peers:

1. Rapid execution of no-regret actions to absorb the shock
2. Adapt to new circumstances and ensure a high-speed recovery
3. Reimagine their business to the new circumstances in the 12 months following the shock

Transformations improved performance\(^1\) by…

- For top quartile of resilience built: +25pp
- For bottom quartile of resilience built: -20pp

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1. Performance relative to industry in response to future crises, i.e., successful resilient transformations enhance company performance by 25%; Source: Press; BCG Henderson analysis
Cost pressure is increasing globally, exacerbated by an unprecedented labor market disruption

### Evolving skill needs leave talent shortages in key areas

- **1B** Jobs reconfigured in the next 10 years
- **<5y** Half-life of skills
- **90%** Orgs expected to be affected by digital skill shortages by 2025

### Existing employees are looking for new opportunities...

- Of knowledge workers open to considering other positions in the next year with 20% actively looking for a new role next year

### …and some have left the workforce altogether

- Global workforce participation is 3pp below the pre-pandemic average

### …culminating in labor bottlenecks as demand outpaces supply, recruiting struggles

- Monthly US job openings (millions) as of August 2022

### Talent shortage is especially pronounced in digital roles

- Demand intensity index (# of job postings/talent supply)

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Sources: Job switch data from Future Forum Pulse Survey, conducted January 27-February 12, 2022. Number of respondents = 10,818 knowledge workers across US, Australia, Germany, Japan, France, and the UK; For labor force quits, participation and job openings: International Labour Organization, BLS, BHI Center for Macroeconomic, Federal Reserve, press search; Quit rates are computed by dividing number of quits by employment and multiplying that quotient by 100; includes non-farm industries
Companies have ~doubled their SG&A costs since last crisis and successfully passed it to consumers; that will no longer be possible in a recession.

SG&A¹ costs have grown 1.9x since 2009; that didn't affect margin due to price increases

![Graph showing normalized volume, index (2009 = 100) with SG&A, Revenue, and Margin growth]  

Δ, 2009-2021

<table>
<thead>
<tr>
<th>Year</th>
<th>SG&amp;A</th>
<th>Revenue</th>
<th>Margin</th>
</tr>
</thead>
<tbody>
<tr>
<td>2009</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2011</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2013</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2015</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2017</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2019</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2021</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

EBIT margin¹

<table>
<thead>
<tr>
<th>Quarter</th>
<th>2021</th>
<th>2022</th>
</tr>
</thead>
<tbody>
<tr>
<td>3Q</td>
<td>17.2%</td>
<td></td>
</tr>
<tr>
<td>4Q</td>
<td>15.6%</td>
<td>15.2%</td>
</tr>
<tr>
<td>1Q</td>
<td></td>
<td>14.1%</td>
</tr>
<tr>
<td>2Q</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

But over the past 4 quarters, we see much higher margin pressure

¹ S&P 500 companies. Note: SG&A and revenue values were turned into indexes; 2009 value equals 100%
Source: S&P Capital IQ; Federal Reserve Bank of Minneapolis; Social Security Administration
BCG Executive Perspectives

AGENDA

- A view of the world
- The time to act is now
- Options to achieve and sustain value
Contributors to cost are numerous and complex – companies must pull various levers to achieve a competitively advantaged cost position

Functional impact levers/sources of efficiency

% savings potential on relevant baseline

<table>
<thead>
<tr>
<th>R&amp;D &amp; engineering</th>
<th>Procurement</th>
<th>Manufacturing</th>
<th>Sales, (bid) project mgmt.</th>
<th>SCM logistics</th>
<th>After sales and services</th>
</tr>
</thead>
<tbody>
<tr>
<td>Design for value</td>
<td>Syst. supplier review</td>
<td>Plant consolidation</td>
<td>Field force optimiz.</td>
<td>Warehouse optimiz.</td>
<td>Smart dispatching</td>
</tr>
<tr>
<td>Tool development</td>
<td>Demand management</td>
<td>Utilization increase</td>
<td>Lease manufact.</td>
<td>Digital supply optimiz.</td>
<td>Field network optimiz.</td>
</tr>
<tr>
<td>Product quality increase</td>
<td>Make or buy optimiz.</td>
<td>Network cost reduction</td>
<td>Equip. asset optimiz.</td>
<td>Service level adjust.</td>
<td>Parts availability</td>
</tr>
<tr>
<td></td>
<td>Best country sourcing</td>
<td>Strategic sourcing</td>
<td>Logistics optimization</td>
<td>Inventory mgmt.</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td>Industry 4.0 leverage</td>
<td>Complexity optimiz.</td>
<td></td>
</tr>
</tbody>
</table>

|               |               |               |               |               |               |
| ~5-15%        | ~5-10%        | ~10-15%       | ~20-25%       | ~5-15%        | ~15-20%       |

G&A and organization and process redesign

Spans and layers
Reducing low-value work/’Products’
Leveraging cloud services
Resource control & accountability optimization
Technology landscape simplification
Rationalizing geo location/sourcing model
Automation and AI in selected workflows
Detailed process optimization
GBS Implementation

~15-30%

Note: Percentages refer to savings on relevant baseline. Savings levers are not additive yet interlinked
Organizations should consider their strategic and immediate needs and pull a set of levers that fit one of four common cost transformation pathways.

In deciding which cost transformation pathway to pursue…

1. **Organizational streamlining**
   - Company needs to secure significant labor savings and enhance organizational effectiveness, fast.

2. **Direct/indirect materials optimization**
   - Company intends to quickly reduce outside spending and improve procurement processes, without meaningful organization changes.

3. **Operating model and process redesign**
   - Company with very ambitious savings goals enhances operating model and optimizes processes to significantly improve capabilities and cost posture.

4. **Full strategic cost transformation**
   - Company is prioritizing longer-term impacts across all strategic dimensions (labor, direct and indirect procurement).

...organizations should consider their needs across these strategic dimensions:

- **Magnitude of savings required**
  - 1: Relatively moderate
  - 2: Magnitude of savings required
  - 3: Ambitious savings targets

- **Urgency to bottom line**
  - 1: 3-6 mos.
  - 2: 6-24 mos.

- **Readiness to address direct (e.g., blue-collar) labor costs**
  - 1: Low
  - 2: High ambition

- **Viability of short-term procurement levers**
  - 1: Relatively low dependence
  - 2: High dependence
  - 3: Procurement levers not relevant

- **Willingness to invest to break cost/capability tradeoff**
  - 1: Relatively low
  - 2: High ambition

*Procurement levers not relevant*
These four common pathways employ levers designed to address different cost buckets and savings potentials.
Pathway 1 | Organizational streamlining helps US-based airline reduce costs while improving effectiveness

Example of network airline streamlining white-collar employees

An airline committed to a major restructuring, redesigning the organization for improved accountability and customer service while significantly reducing costs and creating a talent-selection process that improved overall talent levels.

Top-level realignment
Designed of “top of house” operating model, including degree of function centralization/decentralization

Improve talent selection
Built target organizations based on positions, influencing negotiation with employees and final staffing plan

Optimize spans and layers
Decreased layers within organization, speeding up planning, decision making, and execution

Leading to significant impact

- **15-20%** reduced costs from white-collar jobs
- **2 layers** removed, improved median span of control by 1
- **>5%** of team members promoted or staffed in new functions

Improved overall talent profile

Source: BCG analysis
Example of auto equipment manufacturer improving procurement

After a successful launch of a new project portfolio, the international auto equipment manufacturer set ambitious goals for material cost optimization, hoping to cut spending through procurement optimization without sacrificing input quality.

**Pathway 2 | Direct cost optimization for a global automotive original equipment manufacturer**

**Leading to significant impact**

- ~12% direct product cost improvement, boosting margins
- ~2000 measures successfully implemented and safeguarded

**Cross-functional team enabled and anchored in the organization**

1. **Systematic supplier review**
   - Implemented regular analysis of the market and collection of statistical data on suppliers, materials, and equipment

2. **Procurement digitization**
   - Utilized AI-coach-provided tips on power balance, relevant market data, and useful procurement tools before negotiation

3. **Renegotiation/management of contracts**
   - Leveraged value-chain and pricing power understanding to allow contract renegotiation with win-win rationale

Source: BCG analysis
Leading to significant impact

~$1.25B in total costs cut within 9 months

~$350M reduction in spending with third-party vendors

Exited low-value businesses, using savings to invest in better projects

Example of health care company rewiring operating model and processes

After struggling to hit growth targets and earnings goals, a leading health care company required a major cost restructuring focused on increasing efficiency while cutting costs to free up resources for investments in products, marketing, and sales.

Reorganize org model (e.g., spans of control)

- Increased spans of control and reduced duplicative work across the organization by consolidating locations

Manage third-party spending

- Rationalized IT portfolio and reconsidered travel and expense policies to decrease low-value spending

Automate/implement AI in selected workflows

- Eliminated low-value work and optimized, outsourced, and automated processes for employees to focus on key tasks

~$1.25B in total costs cut within 9 months

Source: BCG analysis
Example of European beverage company transforming value chain

The beverage industry faced challenges due to a highly volatile market, increasing commodity prices, and evolving consumer tastes. A major beverage company that struggled to match its competitors in overall equipment effectiveness committed to a transformation of its strategic operations.

**Digitize/promote supply chain excellence**
- Introduced AI-based tools and implemented rapid digitization to improve demand forecasting, optimize footprint, and manage logistics

**Implement design to value**
- Made use of expertise by fostering cross-functional and collaborative processes when refining projects

**Simplify value chain**
- Reduced fragmentation of procurement purchases to scale advantages and lower transaction costs using digital tools

**Leading to significant impact**
- ~$500M of estimated impact from cost transformation program
- ~10% reduction in total supply chain costs from deep dives

**Aligned site plans** with financial targets and incentives to reduce conflicts

Source: BCG analysis
Prior to pursuing a cost transformation, companies can use a rapid assessment to shape their approach

<table>
<thead>
<tr>
<th>Organization</th>
<th>Groundwork for success established: Resources committed for the change mgmt. program</th>
</tr>
</thead>
<tbody>
<tr>
<td>Analysis-based change in progress: Internal data collected, including industry benchmarks for talent and material spending</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Identification of largest opportunities</th>
<th>Largest opportunities related to functional structure pinpointed: Org baseline (e.g., volume, locations, FTE, performance) identified, analyzed</th>
</tr>
</thead>
<tbody>
<tr>
<td>Resources focused on biggest priorities: Cost value drivers analysis complete &amp; bottlenecks in planning, sourcing, mfg., warehousing, etc., evaluated</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Quick wins and opportunity charters</th>
<th>High-level design principles drafted: Support functions / shared services externally benchmarked with long-term strategic focus</th>
</tr>
</thead>
<tbody>
<tr>
<td>Size, root causes, and feasibility of opportunities identified: Loss levers analyzed (e.g., procurement, contract services, labor productivity) and bottlenecks identified</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Recommendations on cost transformation pathway and roadmap forward</th>
<th>Roadmap built to achieve savings: Includes cascade-cycles, timeline, and finalized org design criteria with maximum savings based on high-level estimate of full potential</th>
</tr>
</thead>
<tbody>
<tr>
<td>Findings validated; senior leaders aligned on path forward</td>
<td></td>
</tr>
</tbody>
</table>
Learnings reveal imperatives for how to come out on top of today’s supply and demand mismatches despite the challenges

<table>
<thead>
<tr>
<th>Imperative</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>Anticipate evolving geopolitical and macro-economic uncertainty</td>
<td>by creating resilience within organization</td>
</tr>
<tr>
<td>Support growth</td>
<td>by engaging your supplier ecosystem and by &quot;owning&quot; value chains and product life cycles</td>
</tr>
<tr>
<td>Act now while flexibility to maneuver exists</td>
<td>and there is still freedom to invest</td>
</tr>
<tr>
<td>Prioritize sustainable cost reduction where capabilities are built</td>
<td>– cut for short-term survival and build capabilities for the longer term</td>
</tr>
<tr>
<td>Don’t take a business-as-usual approach</td>
<td>because the macroeconomic context requires transformation deep within the org</td>
</tr>
<tr>
<td>Be transparent with employees</td>
<td>to build trust, generate respect, strengthen cohesion, and create a sense of ownership</td>
</tr>
<tr>
<td>Emphasize getting the right people in roles</td>
<td>to make best use of capable and respected employees regardless of original position in organization</td>
</tr>
<tr>
<td>Address employee value proposition</td>
<td>and actively brand the program to reduce worry and effectively compete for prospective talent</td>
</tr>
</tbody>
</table>
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