

Embracing efficiency and agility through the Hybrid Operating Model

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Operating models an enabler for future success or a barrier to agility?

For organisations to thrive and succeed in today's ever changing market landscape, they must implement an operating model that can deliver both agility – to meet customer promises at the right levels of quality, and efficiency – to ensure their products and services are delivered at the lowest possible cost.

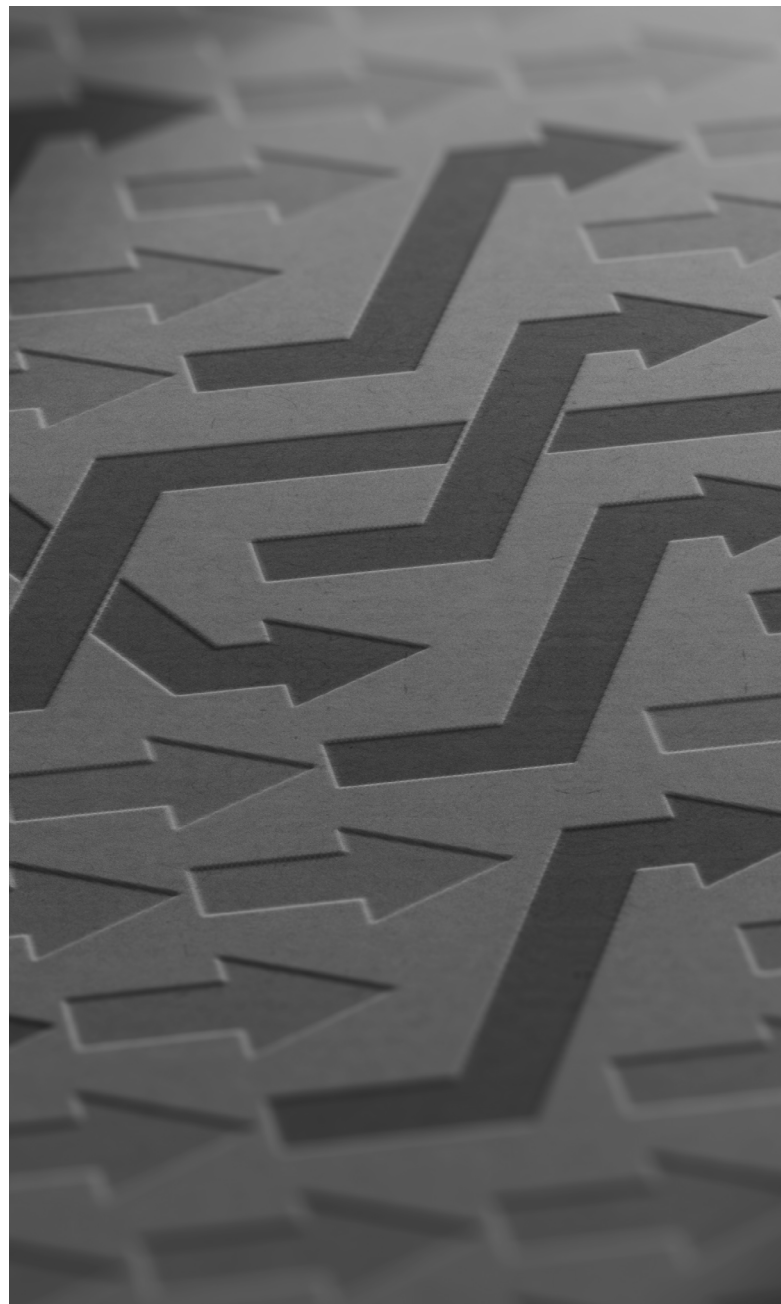
An operating model, simply put, depicts how value is created and delivered by an organisation to its customers. Often through visual representations, the operating model facilitates an understanding of:

- 1. Structure:** Describes organisational hierarchy, roles, and responsibilities, often expressed as RACI
- 2. Processes:** Describes steps taken to deliver value to customers
- 3. Human Capital:** Describes skills and competences needed within the organisation, and
- 4. Technology:** Describes tools and systems need to support the organisation and its operation

In doing so it provides a clear means of decoding how business strategy translates to execution.

When it comes to delivering products and services at the lowest possible cost, managing variability of demand is one of the biggest operating model challenges that supply chains face. This becomes amplified when trying to satisfy their customers on time and while being profitable. "Because of the distinctive characteristics of the service industry (i.e., intangibility, simultaneity, heterogeneity, and perishability), service firms are especially likely to face greater variability than other types of businesses"¹. Variability can manifest.

To understand how this manifests and how a global agri-business re-invented its operating model to address this challenge, let's look at the following case study.



Our client, a global food ingredients and agri-business organisation had seen their margins decline in the last 3-4 years after European milk quotas were removed. The removal of quotas led to a 3-fold increase in annual milk intake which had to be processed and commercialised. This higher milk intake had to be sold, and led to the rapid increase to the variety of products and adoption of new clients, sometimes in much smaller average volumes per

product and per client than before. This resulted in an increased complexity of the operations, difficulties at operational management, misalignments with the pricing strategy and significant margin erosion.

The company leadership bought in the diagnosis, design and plan for a much-simplified operation which was based on the operational segmentation of 3 key segments:

- 1.** A high volume, continuous flow and very cost-efficient segment, with a push strategy that will deliver high margin by selling standard products at the lowest production cost in commodity markets. This segment consists of c. 40%-50% of production volume
- 2.** A high volume, continuous flow and very cost-efficient segment with a push-pull strategy that will deliver high margin by selling a limited number of high volume, semi-customized products to a small number of strategic partners that will benefit from a significant level of integration with their own supply chains. This segment consists of c. 35%-45% of production volume
- 3.** A made to order segment with a made to order sales strategy that will deliver high margin by selling premium products at premium margins to a small number of clients. The purpose of this segment is to accrue benefits from high margin opportunities of premium products, as well as to test products that may convert in the future into segments 1 or 2 products. This segment consists of no more than 10%-15% production volume

The high-volume segments delivered c. 30% in margin improvement derived from less changeovers, cost recovery by aligning cost incurred vs client invoicing and reduced lead time from production to dispatch due to reduction in QA and testing processes from c. 60-90 days to c. 18 days, all supported by simplified, dedicated value chains.



The customized segment improved margins by a similar amount also through cost recovery empowered by visibility of costs previously hidden, and by identifying and pricing the cost impact of mixing low volume product into production lines now dedicated mostly to high volume products. Overall, the new operating model allowed the Agribusiness to improve their operating margin by c. 30%

The strategic and operational challenge at hand was how to balance the need for flexibility while minimising product and service delivery costs. In the example above, the agribusiness reshaped its

value chain by rebalancing the variability of products and services it offered while it matched their offering with a segmented and aligned set of operational processes. It recognised that the bulk of its products and services could be served with a high volume and low cost process, while it could service some of the levels of customisation the customers required as long as the costs incurred where recovered through the matching commercial model. One characteristic of this approach that sets it apart is that it extends the segregation of the value chains beyond the operational processes to also include the segregation of supporting

processes, overheads and the control mechanisms like reporting systems and P&L statements. This full segregation approach is used to bring full visibility of costs incurred per process and to facilitate the identification and elimination of unnecessary costs.

Before we delve deep into how you can segregate value chains and implement hybrid operating models, it is imperative to understand traditional models and their shortcomings, which accentuate the need for a hybrid operating model.

Traditional Operating Model

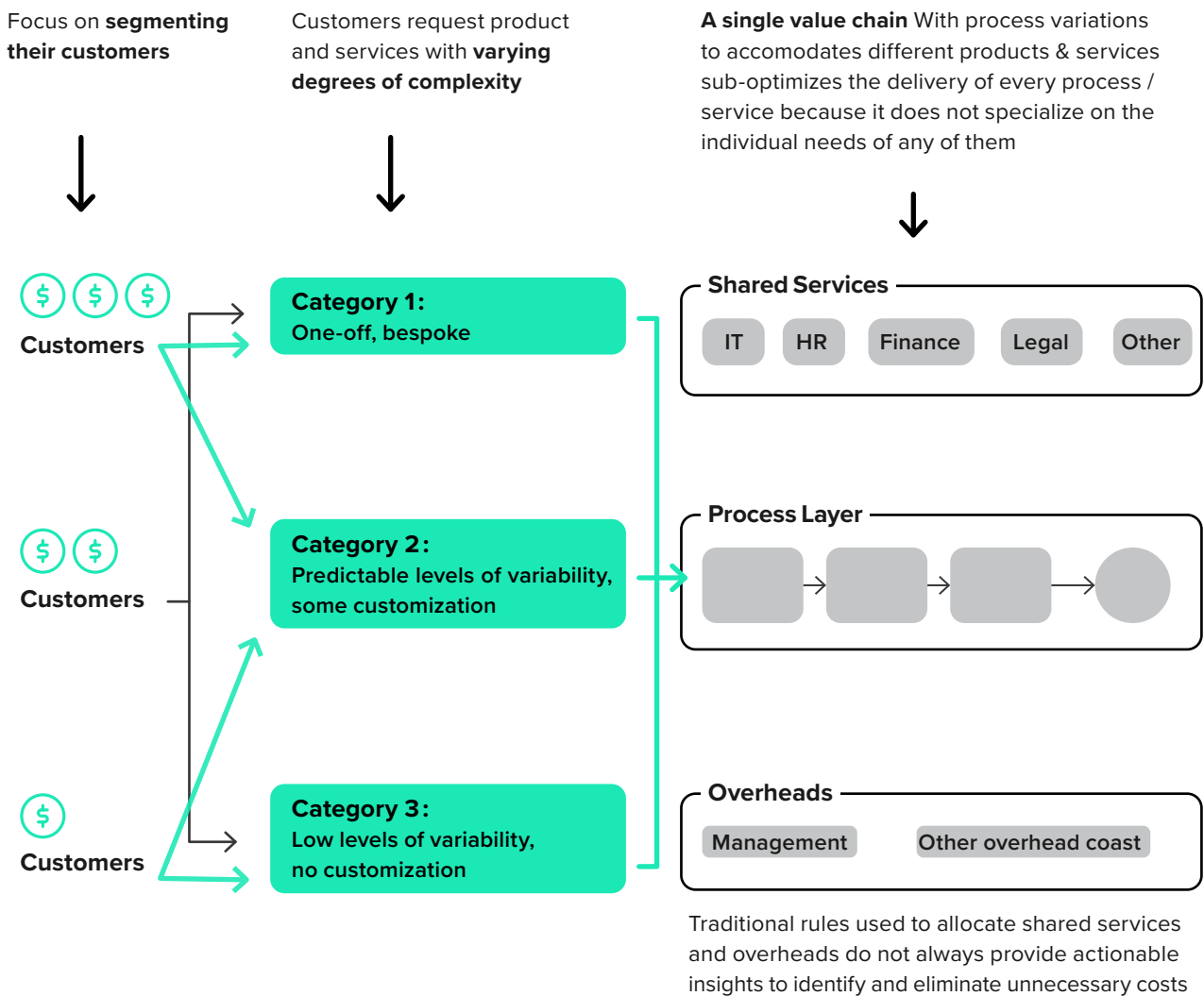


Figure 1#: How traditional operating models are built around generic value chains for a diverse range of products and services.

A closer look at traditional operating models

The traditional philosophy with operating models has been to design generic value chains that are expected to flex to the needs of products and services. As a result, simple and standard products and services are delivered at excessive costs and with longer than optimal turnaround times when delivered together with higher complexity products and services.

While not exhaustive, the following four categories provide an overview of the uses, strengths and weaknesses of traditional operating models.

Integrated operating model: A very involved type of operating model which assumes that highly intertwined and standardized business practices result in maximum efficiency.

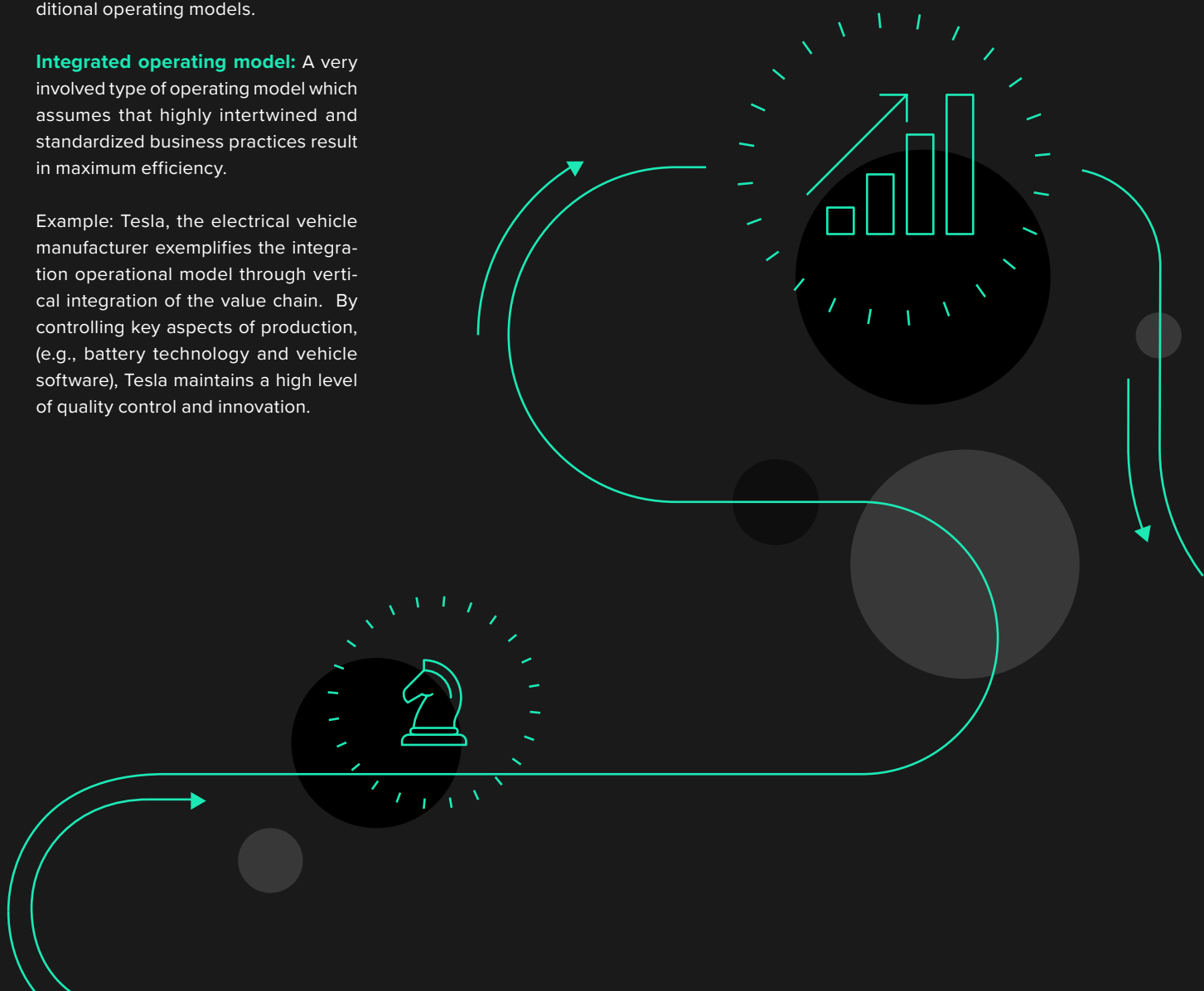
Example: Tesla, the electrical vehicle manufacturer exemplifies the integration operational model through vertical integration of the value chain. By controlling key aspects of production, (e.g., battery technology and vehicle software), Tesla maintains a high level of quality control and innovation.

Strengths

- Cost savings are achieved through standardization and coordination across different processes and divisions
- Processes are replicated and scaled up easily across locations and business units, all under the organisation's control.
- Control and governance structure is facilitated through centralised structures, roles and responsibilities

Weaknesses

- It may lack adaptability due to a view of 'one-size-fits-all' structures and standards
- Centralised approach results in limited autonomy and adaptability within teams and regions
- Limited autonomy across the organisation may lead to resistance to change and increased difficulty to implement change.
- Centralized processes can bottleneck decision making



Coordination operating model: Relies on shared access to information, high levels of integration, but low standardization. Many key parts of the business are integrated with one another, albeit with customised internal processes.

Example: Zappos, an online shoe and clothing retailer, emphasizes collaboration across departments to provide exceptional customer service. Their customer service team works closely with the warehouse and logistics teams to ensure seamless order fulfilment and timely delivery.

Strengths

- Adapts solutions to each business unit with flexibility and ability to customize more easily unit while independently defining their objectives and methods.
- Encourages cooperation and understanding between each part of the business

Weaknesses

- Lack of consistency between teams
- Increased complexity for solving problems and implementing company-wide initiatives due to process divergence across business units.
- Risk of knowledge silos
- Difficult to promote and scale up best practices

Replication operating model:

Ensures different business units have high degree of standardization over their operations with some degree of autonomy.

Example: McDonald's are exemplars of the replication operational model. The company has perfected a standardized business model for its fast-food restaurants, which can be replicated across different locations worldwide. McDonald's focuses on consistency in menu items, store layout, and operational procedures, ensuring that customers can expect a similar experience at any of their outlets.

Strengths

- Benefits of standardization are achieved while still maintaining a level of autonomy
- Streamlined Admin processes within business units eliminates some bureaucracy
- Best practices shared easily across organization.

Weaknesses

- Difficult to adapt to local needs if the global process doesn't benefit the market in question
- The required replication of the same operating models across business units can stifle locally driven innovation.
- Often having to navigate balance between autonomy and alignment.

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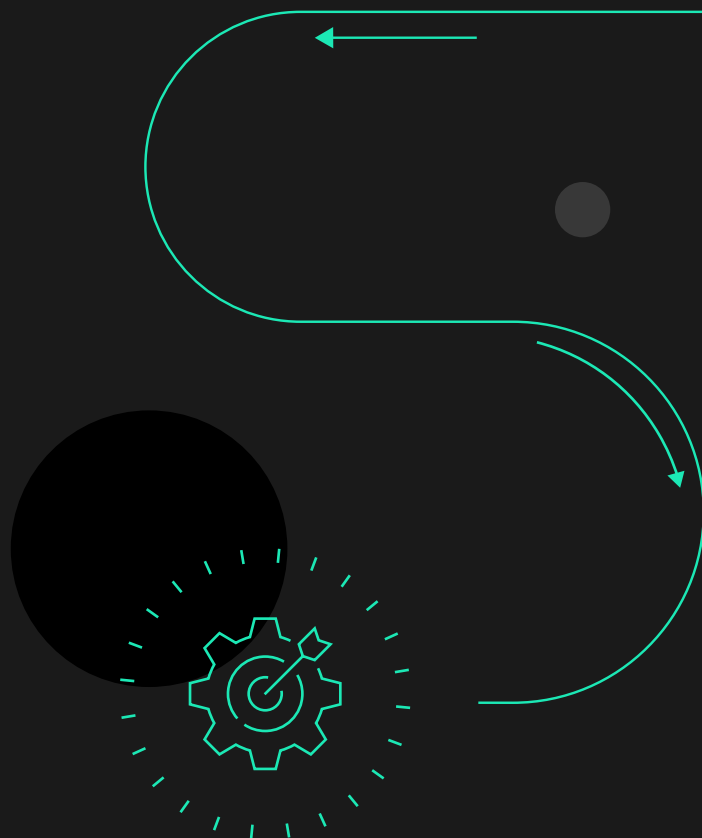
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Diversification operating model:

Applies to companies that have few shared customers, suppliers, or ways of doing business. This model helps companies diversify their products and services to different customers and does not centralize control.

Example: Alphabet Inc., the parent company of Google demonstrates the diversification operational model through a wide range of products and services, including search engines, advertising platforms, hardware (e.g., Pixel phones), and cloud computing. Alphabet diversifies its offerings across various market segments, reducing dependence on a single product or service while allowing Alphabet capture different revenue streams.

Strengths

- Variety of products and services lead to a broad market reach
- It reduces the overdependence in a small number of suppliers, customers or business models, providing a wider platform for the generation of current and future growth and avoids the risk of single failure points (where the failure of a single component of the value chain puts at risk the entire organisation),
- Every business unit benefit from the ability to tailor practices to their needs and is flexible enough to pivot as needed.

Weaknesses

- Business units may lack synergy due to varying customers, practices, resources, etc.
- Single business units working independently may not avail of economies of scale or negotiating power compared with competitors that are more tightly integrated.

In our agribusiness case study, the company was organised through a mix of the Integrated and Coordination operating modes:

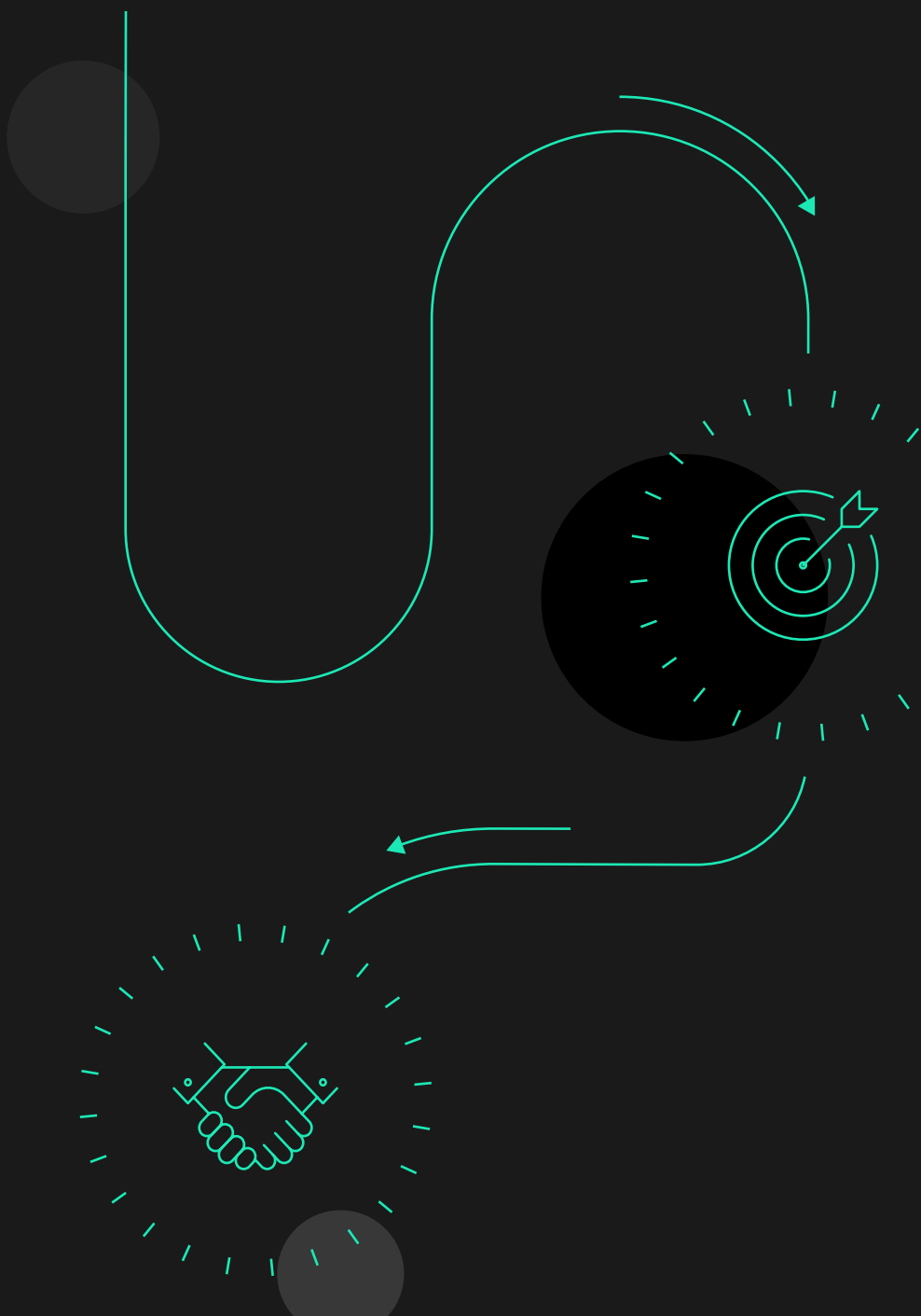
- Its value chain integrated the setting up of standards with milk suppliers,

transport logistics, planning and production facilities, storage facilities and managed business partner's storage facilities. However, the standards and data sharing between the areas was not fully coherent and integrated.

It shared characteristics with the Coordination operating model because the standards and operational practices across business areas was not fully integrated

Additionally, the production costs for standard, large volume products had been affected by interruption and set-up costs caused by the intro-

duction of lower volume, customised products in shared production lines. At the same time, non-standard, complex products and services suffer from quality issues and delays since the generic value chains used to deliver them do not always have the right levels of capability and expertise required. Additionally, mixing the delivery of products and services with diverse resource needs, makes it difficult to ascertain the actual resource usage and cost that goes into each product or service, leading to cross-subsidizing and wrong pricing decisions and allowing unnecessary costs to be hidden, affecting margin and competitiveness.





Future-proofing your operating model

As we have seen, organisations typically design their operating models using one or a combination of the operating model types for them to work in a pre-determined set of environmental circumstances and to produce a predefined set of products and services. The needs for changes in products and services are usually addressed by incremental changes in product specs and through changes in processes within the existing operating models and value chain.

While this approach can deliver results in the short term, over time it results in increasing complexity in the operations, leading to a scenario where the processing of some product lines creates negative effects in other product lines, resulting in an overall environment where different product lines compete for shared resources, and where the tracking of the use of resources and cost tracking per product becomes unwieldy.

The approach to resolving these problems usually leads to bouts of product and process rationalisation and re-engineering, which leads to a cleaner operation model, but since the root cause of the increasing complexity is not addressed, this only results in a new cycle of complexity creep.

Proposed Hybrid Operating Model

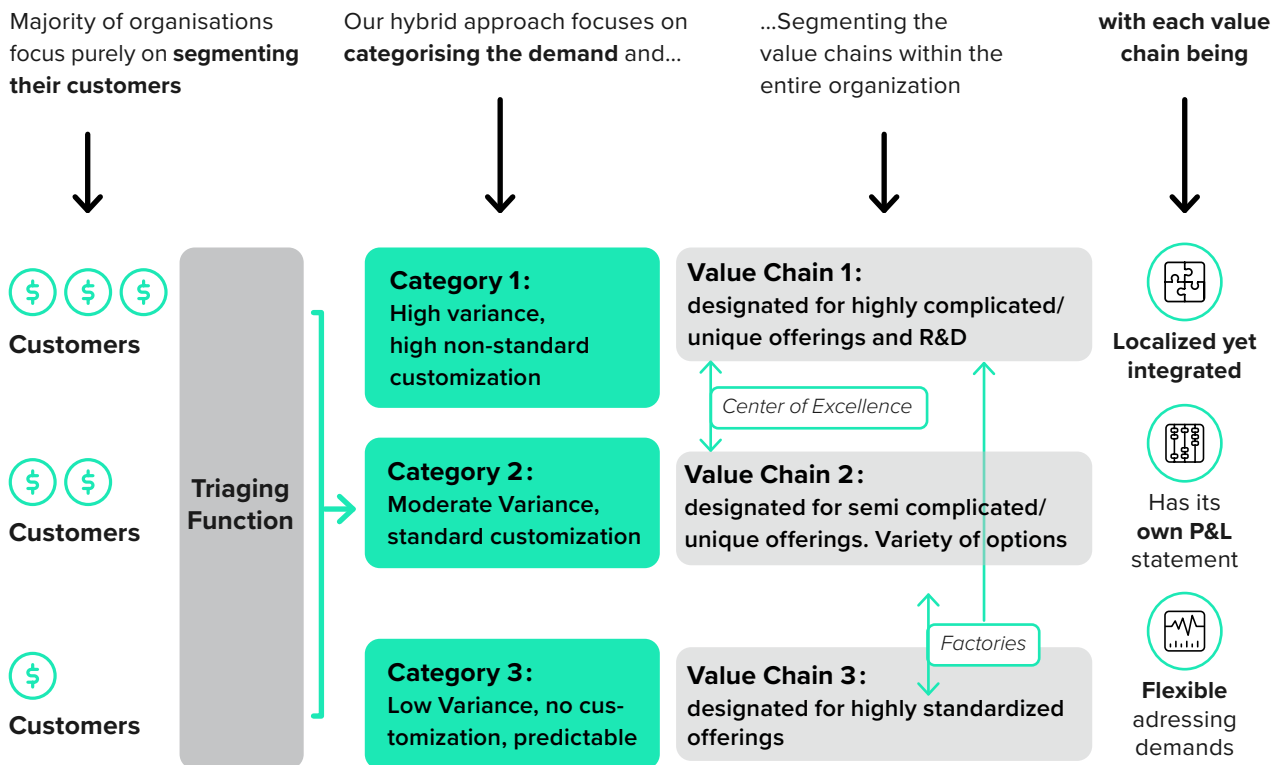


Figure 2: Hybrid or segregated operating model

In today's environment where the speed of change and the agility of digital competitors has greatly increased, this cycle of increased complexity followed by reorganisation may not be sustainable or cost effective. A better, long-term solution is required that roots out the causes of the increased complexity.

Adopting a hybrid or segregated operating model is a strategic decision that addresses several of the shortcomings of most traditional operating models. The approach focuses on segregating the value chains and thus promoting the following benefits for organisations and their customers:

Profit Margin Improvement: By segregating the value chains within an organization, standard products/services will be produced at much higher levels of efficiency than against the alternative of having to compete for resources with more complex products.

Efficient allocation of resources to deliver complex products and services: Complex products/services are delivered by dedicated value chains equipped with exactly the right type and quantity of resources required to cater to their customised features and predictable levels of complexity and variation. This efficient and visible allocation of resources that are fully costed and aligned with the pricing strategy, results in better value for customers and the highest possible margins for the organisation.

Reducing overhead costs: Dedicating as many centralised resources as possible directly to the segregated value chains, like IT and Finance, and having segregated P&Ls for each value chain, allows to identify and precisely cost which overheads are critical for each value chain. This visibility allows to identify and weed out any unnecessary overhead costs.

The profit margin derived from the segregation of value chains can increase between 10%- 35%² depending on the initial status of the organisation.

Enhance customer experience: by having a specific value chain for each product category (e.g., standard, semi-complex, and bespoke), customers can be provided within an optimum timeframe that reduces the lead time by up to 96%³, without diminishing quality. This can be attributed to the following reasons:

- Standard products are by usually high in volume yet low in variation.
- By segregating the value chains, the standard products category will have a chain of processes and resources in continuous motion, delivering products. This alignment leads to resource specialisation which leads to higher quality, efficiency and faster work delivery.
- Semi-complex and bespoke products are usually produced on demand and are unique in nature. The value chain for each product category will be defined to address the continuous variation of products. Specific resources and expertise can thus be allocated to deliver the various products in time and in compliance with the quality standards.



Implementing the hybrid operating model

Designing and implementing a hybrid or segregated operating model is likely to be a strategic decision for any organisation. This is because the separation of the organisation in distinct end-to-end value chains is counterintuitive to the belief that shared operational and overhead resources leads to economies of scale and reduced costs, while in fact this can be the best strategy to achieve flexibility, margin improvements and long-term growth.

The balancing of the characteristics of product and service offering, cost of production and delivery, and overall pricing strategy requires a deep understanding of the characteristics of demand for products and services, followed by the segmentation of the demand into specific value chains, each one optimising the delivery of each product and service segment. A solution based on a single operating model can only improve the delivery of some segments, to the detriment of others, while not optimising any. Under this approach, each value chain is designed optimally for the delivery of each product segment. The segmentation and optimisation of the value chain is end-to-end and should consider:

- Suppliers and procurement process
- Ordering process

- Production processes
- Provision and right-sizing of all required resources: people, machines, space, information systems
- Fulfilment, transport and delivery
- Invoicing
- Customer service
- Process controls, planning and scheduling (e.g. high volume, low complexity processes will require minimal planning resources)
- Cost and margin reporting
- Use of shared services (these should be as decentralized as possible)
- Allocation of overheads

While it may appear counterintuitive for many to consider that such levels of operational segmentation can be more efficient than a single operating model, this thinking can be challenged when the hidden inefficiencies of a combined operating model become visible – a key benefit that can be delivered by the segregated operating model. We can draw some examples of those inefficiencies from our agri-business example:

- Changeover times costed for the new customised products but not for the additional changeovers imposed on the existing large volume products running on the same production lines

- Planning and scheduling costs allocated through products according to volumes. However, the majority of the planning costs are driven by lower volume orders and are minimal for large volume, standard products

• Warehouse handling costs are created by the need to store and retrieve specific stocks of lower volume products which are unnecessary to store and deliver stocks of large volume, standard products. The additional manpower, machine and fuel costs are allocated by volume of sales across all products, therefore distorting reported margins across products.

- A similar situation happens with QC lab testing of finished products: additional changeovers of testing processes are caused by customised, lower volume products, but are distributed and reported across all products

To overcome these concerns and challenges in the segregation and reallocation of resources from a single operating model into the future modular models, and ensure there is no disruption to customers and end-users, the following time tested approach can be followed:

1. Ensure management buy-in:

The challenge for management to get fully onboard stem from two main causes: a) the risk aversion about committing to an unfamiliar design and challenging the status quo, and b) the change that the new model imposes above current functional priorities. In our experience, the risk aversion can be overcome by showcasing examples where the modular design has been implemented, with evidence of the benefits that it provides. The conflicting functional priorities can be overcome by the modular design itself, where the modular design also involves the allocation of new roles and responsibilities aligned with the objectives of each modular operating model.

2. Address the apparent loss of economies of scale:

this challenge can be overcome by the fact that each segregated operating model optimises the profits of each segment while minimising the dependencies with other parallel operating models. This addresses the “systems” rule that the optimisation of the parts suboptimizes the “whole”⁴ because each modular value chain is a new “whole” with minimal interactions with the other segregated models. The benefits of this approach can then be confirmed by the reporting and separate P&Ls per segment that are also part of the design.

3. Mitigate challenges caused by the separation of resources into each modular operating model:

what appears as a challenge can instead be viewed as a benefit, because the physical separation of resources allocated to each segment results in a much more precise determination of the resources required and used by each segment. This results in a better resource allocation, better utilisation and improved cost visibility which can result in better pricing and commercial strategies. Furthermore, this can provide an improved overall allocation of the resources where they are actually in need. The design also considers the provision of limited “factories” or “centres of excellence” whose services can be shared by different segments. They are justified when highly transactional activities benefit from overall economies of scale, or where highly skilled, expert resources cannot be maintained in separate “modules”.

4. Change risks to service level and revenues:

even though the process to achieve these changes can appear complex, following a structured approach which allows for a dedicated design and planning phase for the change, typically between 8 to 10 weeks, can help address the complexity. The implementation period of the changes will vary depending on the level of change, the time that operational leadership can dedicate to the change and the availability of change management resources.

« This can provide
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Conclusion

The pace of change has been accelerating faster than ever before with uncertainty and threat of disruption becoming the zeitgeist of our time. In this complex landscape, future success will belong to organisations that can innovate and break away from the norm in how they deliver value to customers. This calls for a fundamental rethink in how we look at operating models and shedding traditional models that hamper organisations from achieving strategic agility, resilience and efficiency.

By adopting a hybrid operating model, one that allows for segregated, modular value chains to work in harmony, not only can organisations achieve greater agility and efficiency but also realise improved margins and enhance customer experience. The hybrid model also lends greater inherent resilience to disruptions, enabling organisations to pivot to changing customer behaviours and demand patterns.

While this necessitates a substantial shift in current operational strategies and ways of working, the promise of long-term competitive advantage presents an unmistakable clarion call for change. Are you ready to embark on this change journey and embrace the hybrid operating model?

Your contacts

Gary O'Sullivan

Partner

Gary.osullivan@sia-partners.com

+35 3 86 82 41 241

Mohammad Abuhlimeh

Consultant

Mohammad.abuhlimeh@sia-partners.com

+ 971 58 596 9569

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