Responding to New Challenges in the Branded Apparel Industry

A Verity Partners LLC White Paper

AN OVERVIEW

Branded apparel manufacturers have faced severe pressures from new sources over the last few years, including mass merchants, retail private label brands and agile vertical retailers. Each one threatens to further erode prices and margins, while demanding faster sell-through as well as increased speed and flexibility.

To combat these new threats, branded manufacturers must adopt three core competencies that will help them to better plan assortments at the store level, understand in-season trends, and support in season replenishment and VMI. The three core competencies involve:

- Creating a timely and accurate "one-number plan" that drives all business functions and enables planning initial assortments at the store level;
- Identifying in-season trends at the store level in real-time to determine how best to maximize sell-through;
- Developing synchronized supply chain competencies to react to trends and real-time market opportunities.

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Introduction

The apparel industry has seen challenging times and more than a few new threats over the past several years. While the late 1990s brought a period of strong growth for branded apparel manufacturers such as Liz Claiborne, Intimate Brands and Nike, as well as vertical retailers such as The Gap and The Limited, this period of prosperity did not last long. The 21st Century ushered in several unique challenges for apparel brands in addition to a depressed economy and deflated apparel spending. While these areas are often cited as the primary reasons for poor performance, several other trends could prove more troubling in the long run. The increased dominance of mass merchants, an increased emphasis of retail private labeling, and a new type of lean apparel retailer that leverages technology to accelerate the concept-to-cash cycle will continue to present difficult challenges for branded manufacturers, which, as an industry, has seen sales dip below 1996 levels.

We will begin with a look at trends and the effects that they have on the branded manufacturer:

Trends & Pressures Faced by Branded Manufacturers

Dominance of Mass Merchants

Suburban malls have long been the safe haven of department stores and specialty merchants. This situation has changed, however, as in recent months, Wal-Mart has opened stores in two such malls in New York and Los Angeles, with the mall space in Los Angeles formally occupied by Macy's West. Target is also moving into malls at a similar rate. In a recent *BusinessWeek* article, Goldman Sachs analyst George Strachan predicts that discounters could take over 300 such anchor mall spots in the next decade. While the addition of mass merchants in malls may drive overall traffic, there is the real threat that they will cannibalize apparel sales from the specialty and department stores and continue their growth in the apparel segments. The assortments and price points may not directly compete with more upscale retailers, but it is clear that the mass merchants are growing and gaining momentum in apparel categories. According to *NPDFashionworld*, 21% of apparel sales came from discounters in 2001 (second only to specialty), and this number is expected to grow – at the expense of specialty merchants and department stores.

History has shown that as mass merchants gained momentum in consumer goods categories, retail prices and margins for those products have declined, with the manufacturers taking the brunt of the impact.

Increased Focus on Private Label

May Department Stores is growing its private label business from 17% to 21% in the near term and to 25% in the long term, according to Gene Kahn, May's chairman and CEO. And, the company is not alone. Retailers in all formats are increasing their emphasis on private label apparel. From department stores such as Federated to the mass merchants, retailers are increasing their private label programs to raise margins, and in many cases, to combat underperformance of branded labels. This trend is not only apparent in the aggregate increase in private label sales, but is also evident because private label brands are commanding better floor space, more prominent promotions, and, most importantly, growing retail commitment to build stronger brand image. Retailers are treating their private labels like national brands and it shows. For example, visit any Target store and notice how prominently Mossimo is showcased; or look at the success that the Mary Kate and Ashley brands have in Wal-Mart.

Emergence of Agile Vertical Retailers

Not long ago when Zara was mentioned, people had no idea who or what "Zara" was. Today, they do. Zara, and its parent company, Inditex, are redefining the vertical retail apparel supply chain with a business model that stresses speed and integration of store operations with the design, sourcing and manufacturing operations. Through technology, Zara quickly identifies trends and items that sell or don't sell at a store level, and then makes appropriate sourcing, manufacturing, and replenishment decisions to maximize sell-through, minimize stockouts, and drive overall in-season performance.

Zara uses small-batch manufacturing and holds strategic inventory in fabrics rather than finished goods which increase their flexibility and speed-to-market. Using technology, strong design and sourcing strategies brought together by supply chain connectivity, it is not unusual for new concepts to go from the drawing board to the sales floor in under one month, or to have hot selling items replenished to stores the next day.

This model is revolutionary, and the results speak for themselves. Zara's 2002 sales were approximately $2.8 billion, an increase of 16% from 2001. More impressively, net income was $293 million, a 22% jump from 2001. Net margin was approximately 11%, compared to 2002 net margin of The Gap at approximately 3%. Even in a today's challenging economy, Zara has seen exemplary performance in sales, comparable store sales and margins.

The branded apparel industry has been slow to adopt technology, with many branded manufacturers content to introduce two selling seasons per year, and operate with inventory turns between two and three per year. Zara and similar companies are shattering long-held industry perceptions, and are injecting a new level of competition in much the same way that Dell changed the personal computer industry.

Branded Manufacturers Need Three Key Competencies

Separately, each of the trends listed above puts increasing pressure on branded manufacturers. When combined, these trends could reshape the industry to a degree that many branded manufacturers may no longer compete profitably. These trends will push already thin margins even lower, while forcing the brands to maximize sell-in and sell-through at the retailers. Quite simply, many branded manufacturers will have to change the way they do business. Failure to do so means being acquired at a discounted stock price, or worse.

To succeed, branded manufacturers must excel in three critical competencies:

- Create a timely and accurate "one-number plan" that drives all business functions;
- Identify in-season trends at the store level in real-time to maximize sell-through;
- Develop a synchronized supply chain to optimize inventory investments, react to trends and exploit real-time market opportunities.

Furthermore, branded manufacturers must integrate these competencies into a holistic business processes. To maintain market share, branded manufacturers must incorporate ***all*** of these competencies, maximizing sell-in and sell-through, accelerating the concept-to-cash cycle, and reducing supply chain costs.

We will address each of these competencies individually and then discuss how to integrate them into the holistic processes.

Create a Timely and Accurate One-Number Plan

Given the (currently) long concept-to-store cycle time, there is a strong impetus to generate a demand plan (or forecast) many months in advance of each season. As fashion trends, weather patterns, world events, and regional influences greatly impact the demand plan and forecast, it's easy to understand why such plans typically have a high degree of inaccuracy. Compounding the problem, organizational silos often enable departments to create their own forecasts. For example:

- Specific account sales teams want to ensure that they have enough products to fulfill contractual service levels (and hence guarantee their bonuses) so they increase their forecasts, even though that account has not historically purchased in such volumes.

- The sourcing organization has to reserve capacity requirements early in the planning process and often have to create their own forecast. When a sales forecast is available, they don't trust it, so they often "tweak it."
- The financial and accounting organization frequently creates its own forecast, which corresponds to the long-range plan instead of real world market and operational conditions.

- The end result is the creation of several different forecasts by several different departments, with each forecast driving a different process; resulting in too much or too little material, capacity, or labor, and more importantly, a fractured supply chain that cannot react profitably to changes in supply or demand.

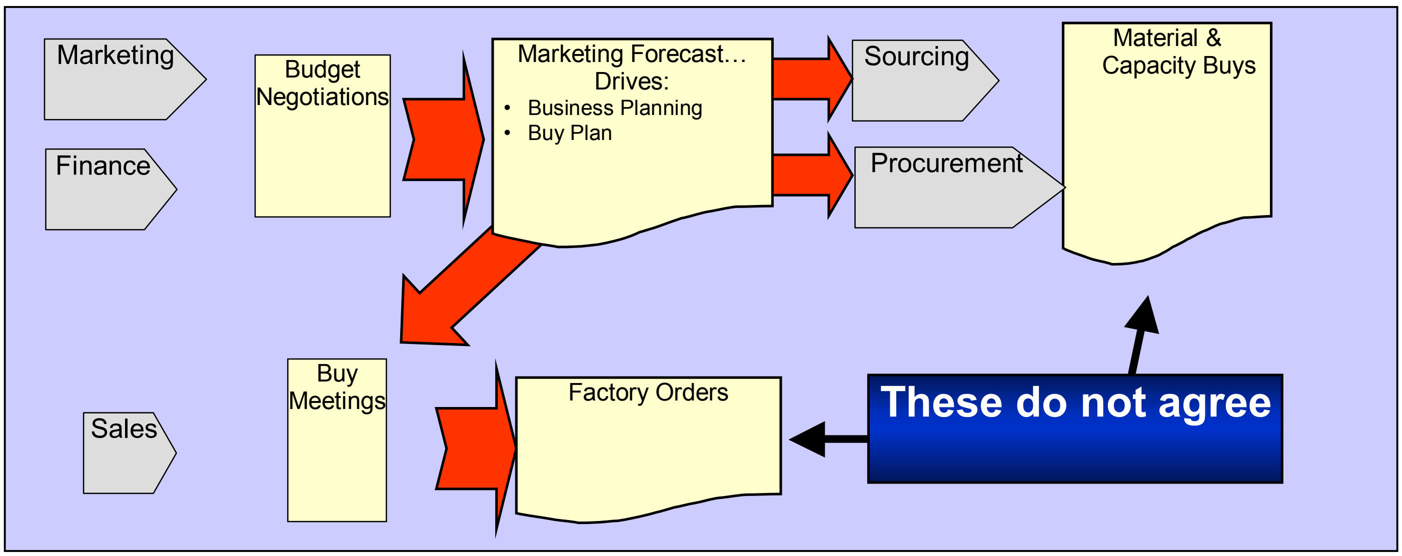

Figure 1. Example of multiple organizations developing separate forecasts

The solution is a consensus-driven forecast, based on strong analytics and proven forecasting techniques, that uses both top-down and bottom-up input, along with historic sales data, past forecast accuracy, historical size curves, color trends, weather patterns, fashion trends, and other pertinent data, to create a "one-number" plan that drives the entire organization to make both upstream decisions and operational adjustments. This integrated approach must be supported by a documented, collaborative process so that the plan is created to support the needs of all parties and is repeatable month after month, season after season and year after year. Typically, the net effect of a "one-number" plan is to improve margins through an increase in sell-in at the retail level combined with a decrease in inventory.

Establish In-Season Excellence to Maximize Sell-Through

Over the past 15 years, markdowns have increased across all segments of retail, and reportedly products sold at markdown exceed 30% of all products sold for many retailers. This trend clearly demonstrates that the retailers and branded manufacturers are not doing a good job of linking supply with demand. In reality, neither party can afford the margin loss that occurs from markdowns and allowance dollars, or lost sales caused by stockouts, which are rarely measured.

Clearly, for those companies who can improve in-season performance, both by increasing availability of fast-moving items and by reducing liability on slow movers, the rewards are great. According to Marshall Fisher in _Rocket Science Retailing_, companies that can reduce stockouts and markdowns have the opportunity to double their profits.

How do leading branded manufacturers accomplish these feats? The ones who do it correctly use point-of-sale (POS) data and tools to analyze sales data and quickly gather trend information. For those items that are selling better than expected in season, the emphasis is on in-season replenishment. For items that are selling slower than predicted, the emphasis is on quickly reducing risk through early markdowns and promotions, and by reducing (or eliminating) additional replenishment quantities, thus freeing up budgets, production capacities and open-to-buy dollars for those products that are selling well. These analytics are useful early in a selling season to quickly identify how a product is performing against its forecast.

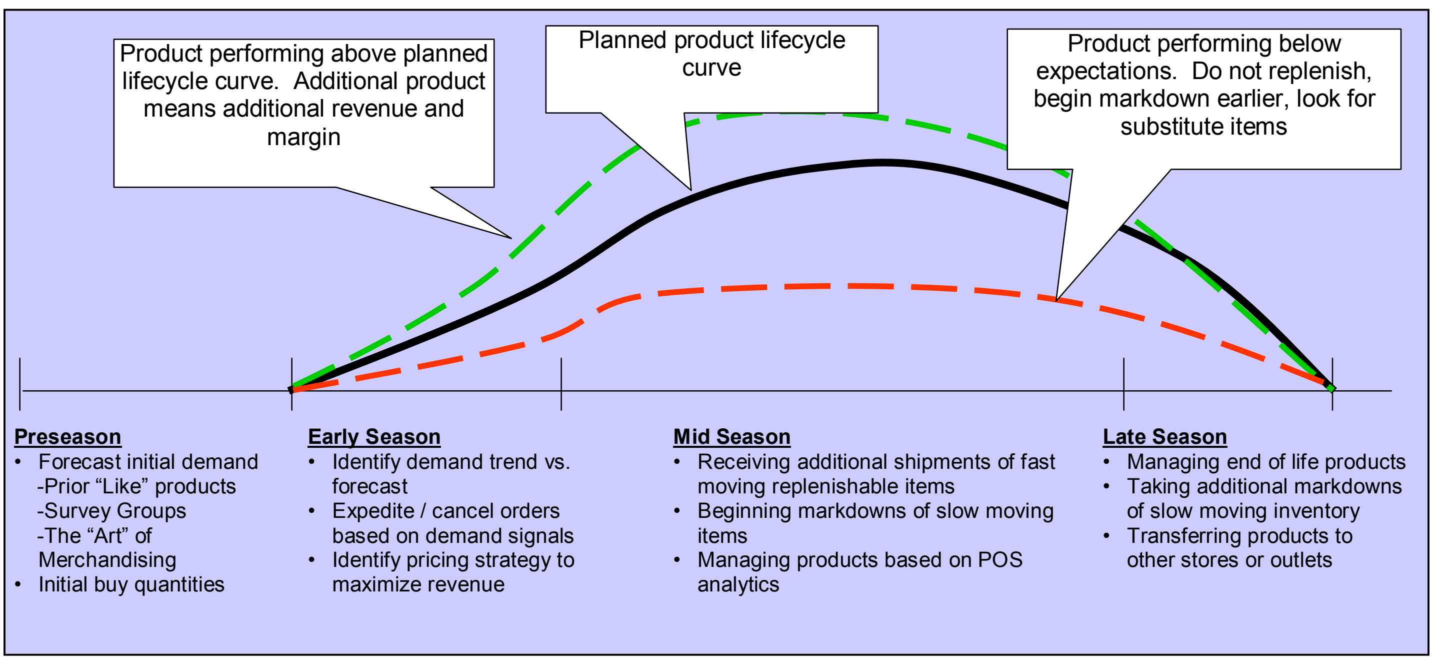

Figure 2: Decision making criteria in-season using POS data, data warehouses and analytic tools

With the arrival of modern POS systems, data warehouses and strong data analytic tools, this type of analysis is within the reach of most branded manufacturers. The lone lingering issue identified by brand manufacturers, then, is to get retailers to share the necessary information. While not all retailers may be ready to share the needed information in a timely manner, branded manufacturers must start emphasizing this need now. The branded manufacturers that will be the most successful are the ones that can confidently and accurately articulate and demonstrate the benefits for the retailers who provide POS data. Clearly, innovative companies such as VF Corporation have generated strong benefits for themselves and their customers who have shared information by implementing vendor managed inventory (VMI) and retail replenishment programs.

Develop A Synchronized Supply Chain

A reliable "one-number plan" sets a strong foundation for demand-driven supply chain performance. Whether a branded manufacturer has its own cut, sew and distribution facilities; contracts for full packaged goods; or uses a hybrid approach; the goal is to maximize sell-through and margin. Given the proliferation of stock keeping units (SKUs), customers, sourcing, manufacturing, packaging and shipping combinations, this is often easier said than done, though the tradeoff typically comes down to sourcing production to longer lead-time/lower cost off-shore manufacturing, or shorter lead-time/higher cost domestic or 807 manufacturing.

Fundamental sourcing decisions must be based on maximizing full priced sales while minimizing inventory risk. Without adequate analysis, planning to capture 100% of demand may drive excessive inventory investments and result in negative margins. Therefore, the optimal sourcing decision needs to consider inventory risk, customer service goals, demand variability at the SKU level and supply chain responsiveness. This decision must take into account not just manufacturing costs, but total landed cost. Clearly, in many situations, in season replenishment may only be possible through the higher cost, local supplier, which is as acceptable if a the higher margin sales or increased market share opportunity exists.

With a "one-number plan" as the foundation for a supply chain, synchronizing sourcing, production, logistics and replenishment activities creates a responsive organization that minimizes the "bullwhip effect." The bullwhip effect manifests itself in excess inventory, poor customer service, uncertain production, and excessively large lot sizes. It is caused by order batching, monthly planning processes/manufacturing resource planning (MRP) runs, economies of scale, and ultimately, not getting granular real-time information.

Integrating the Competencies into Holistic Business Processes

By developing the previous three capabilities, brand manufacturers can create a fundamentally sound "one-number plan" that is used by all departments, develop the mechanisms to better understand sales trends and changes at the retail store level, and develop a synchronized supply chain to enable greater flexibility. The final piece of the puzzle is how to bring these capabilities together to create a competitive advantage, enabling in-season excellence and improved sell-in and sell-through while reducing inventory and supply chain costs.

Executive-Level Recognition

The first step is to obtain top-level recognition of the threat or opportunity, and secure the commitment and involvement of executive management to address the issues at hand.

Performance Metrics

Integrated performance metrics are necessary to ensure expected behavior throughout the organization. As the old adage goes, "Tell me how someone is measured, and I'll tell you how he/she will act." The reality in many companies today is that key leaders are not measured and rewarded for the right behavior. For instance, in many cases sales managers are measured and rewarded on sales and service levels, but are not measured and rewarded on margins, allowances, GMROI or other holistic measures that truly reflect corporate success.

Sales & Operations Planning (S&OP)

To manage the integration of these core competencies, branded manufacturers need a robust and consistent Sales and Operations Planning (S&OP) process. An interactive S&OP process is vital for resolving issues that may positively or negatively impact the plan. To maximize the value of S&OP, two components are needed: a weekly tactical component to address short-term supply and demand mismatches (within the next month), and a strategic component to monitor issues that impact the long-range financial plan. With such an S&OP process, sales, marketing, planning, sourcing, development, and finance can interact weekly to resolve critical issues. The senior management team uses the same S&OP planning process model strategic plans and address future challenges and corporate objectives that may have a bigger impact on the overall business.

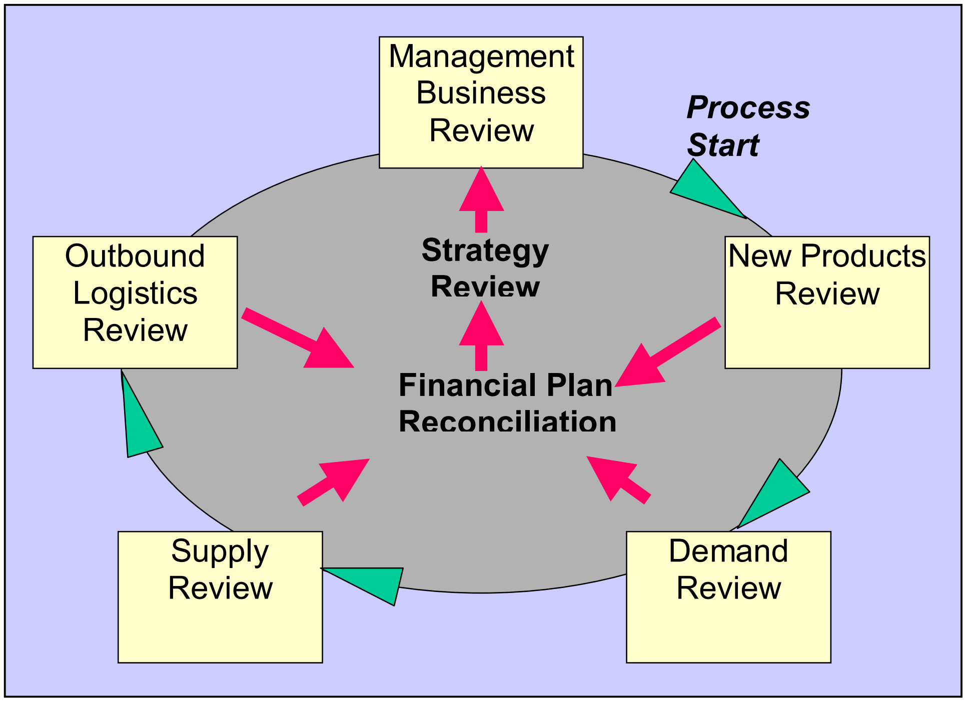

Figure 3. Monthly sales and operations planning process example

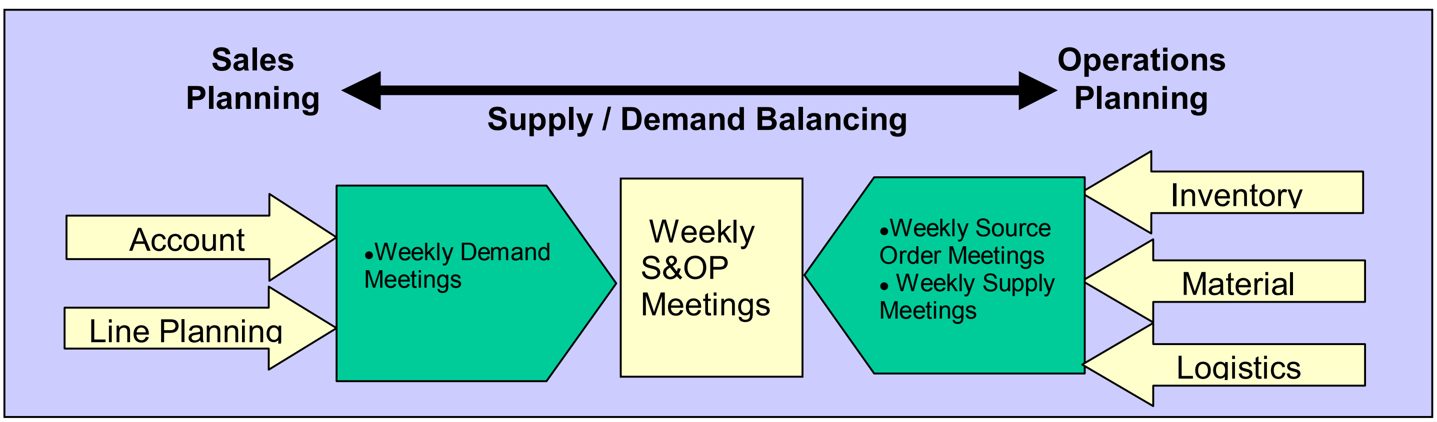

Figure 4. Weekly sales and operations planning process example

Conclusion

The branded apparel industry is at a crossroads. There are several new challenges and industry dynamics that will force the branded apparel industry to change and adapt, or lose relevance. Several leading companies have already begun to reshape the blueprint for success by implementing leading-edge supply chain capabilities combined with a holistic business process that dramatically reduces cycle times, increases visibility across the entire value chain, enables quick response to changes at retail, and ultimately delivers satisfaction to the consumer, in the form of the right product, at the right place and time, at the right price, and in the right size and color. But overall industry success and survival depends on each branded manufacturer's ability to radically change how business is done.

It is crucial for branded apparel companies to deploy the three key competencies – create a "one-number plan," maximize in-season excellence, and develop a synchronized supply chain – and integrate these competencies into holistic business processes.

Companies that have been successful in implementing and integrating these competencies have done so by addressing the business problems holistically, and realizing that success lies not just in an implementation of software functionality, but in implementing true business capabilities which require equal emphasis on People, Process, and Technology. History is rich with companies who bought software and shelved it because they didn't implement the processes needed to gain benefit from the technology, or didn't train and compensate their people appropriately. Verity Partners LLC brings a strong methodology for addressing all three of these levers, from helping to identify, select and implement the appropriate capabilities and technology solutions, to developing and implementing the needed Process Maps and Integrated Performance Metrics programs to developing "Train the Trainer" curriculums. Often, companies have already made large strategic investments in technology, but have no seen any benefit. Our partners bring strong capabilities to envision strategic threats and opportunities, diagnose the current environment, and help companies generate the positive ROI that they signed up for when they made the technology purchase. At the other end of the spectrum are companies that know they need to do something, but are not sure where to start, or cannot quantify the benefits. We have strong assessment tools and methodologies to quickly identify and prioritize opportunities, quantify the benefits, and develop roadmaps for success.

About Verity Partners LLC

Verity Partners LLC provides management consulting services with the simple purpose of helping its clients make more money and spend less of it. It accomplishes this feat through:

- Targeted improvements in operational processes, enabling technologies and human capital
- Leveraging world-class, industry expertise and combining with the knowledge of each client's best people
- Helping over 200 clients plan and deliver their most important business improvement projects

Verity Partners LLC knows the apparel industry. Our partners have worked with over 50 of the leading apparel, footwear, textile and apparel retail companies and have delivered tangible results and very real ROI and shareholder equity. For further information, please contact John Sailer @ (561) 637-2576 or jsailer@veritypartnersllc.com, or visit www.veritypartnersllc.com