



SUPPLY CHAIN & SOURCING INSIGHTS

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Sourcing and factory-direct economics have changed significantly over the past decade. Ten years ago, 50% or more of the world's total apparel sourcing was China-based. That percentage has shrunk substantially, to less than 40% today. We identified the following key trends as central to a supply chain management and sourcing dialogue :

- **Costs.** While labor and commodity costs are top of mind, what really matters is good old-fashioned supply/demand equilibrium.
- **Flexible, Strategic Supply Chains.** There are opportunities to extract cost from the supply chain by applying a quick chase model that blends smart strategic planning with data analytics.
- **Near and Onshoring.** These more flexible models are potential cost savers.
- **Omnichannel Investment.** Retailers are investing significant manpower and finances to develop their omnichannel strategies, cognizant they have far to go reach their objective.

Supply Chain Cost Equation Is Shifting

Much of the decline in China's position in global apparel sourcing has coincided with the 13% increase in annual wages mandated by the country's Five-Year Plan. This has been offset by the phenomenal growth of fast fashion in recent years, which triggered a second wave of business to China, as speed to market and flexibility are key to this model's success. Garment quality becomes secondary to the latest fashion trends and getting it now. The price/value proposition for the consumer has changed.

As China has lost share, new outsourcing manufacturing centers have emerged in Bangladesh, Indonesia and Kenya. Governments in these countries are working to repair past infrastructure and transportation concerns. Although China remains the most efficient producer, these countries serve as alternatives for value-added products. Retailers and brands sourcing globally must grapple with the increasing complexities of dealing with multiple markets, factories and tariffs, etc. Industry experts estimate that 90% of retailers that claim they are direct sourcing are in fact using a combination of direct factories, trading companies and agents. Sourcing agencies cover every function that any possible purchaser of products would possibly need.

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Labor inflation has been rampant in the past few years—running at, for example, 100% or more in Bangladesh, 100% in Vietnam, 13% every year in China. However, labor isn't the most important cost factor. Most brands and retailers, and their sourcing agents, strive to look at costs holistically, encompassing labor, fabrics, dying and currency

effects. But demand trends remain a major concern, especially given lingering economic weakness in Europe and slowing growth in China. In determining price stability, issues of supply and demand trump trends in cost inputs.

In China, factories are moving from a mass-production model to a modular model, which enables flexibility. Factories are increasingly shifting from coastal areas to inland markets, where costs (labor and real estate) are lower and provide greater work force stability.

A Flexible Supply Chain Is Required

While the media fixates on such esoteric new technologies as 3D printing and its impact on retailing and the apparel supply chain, retailers are increasingly facing the need to think strategically for both the short and long term as they adjust to shifting consumer tastes and shopping preferences. The retailer's role is to provide more optionality to their customers in terms of product, shopping location and delivery. By offering more optionality, retailers limit the risk of severe markdowns that can arise from being "too deep" in a single style. However, adopting this strategy also limits the possibility of an over-plan upside merchandise win. Retailers have to act small and get more local. Demand in some sectors have moved from traditional brands to specialized niche products, sometimes only available online.

US retailers worked on a chase model until 2009, accounting for up to 10%-15% of their volume in season. Chase is no longer a major part of the business for many chains, a trend that has helped to reduce total airfreight spend. The decline in chase reflects the growing shift to fast-fashion models, and in part explains the changes in specialty teen retailer business models. Fast-fashion chains such as Forever 21 and Zara move from one trend to the next, without replenishing product repetitively. Generally, the US market is moving to a more flexible, quick turn, fast-fashion model. This is an organizational modus operandi that is not implemented easily or quickly.

Today, sourcing and speed to market go hand in hand. Retailers require flexibility and the ability to get what they need and when they need it. To get this agility at the factory level, retailers have to commit to some items such as raw materials (for example, to own the denim at the factory). Every US retail sector is looking at mirroring some of Zara's successful processes in this regard.

How do retailers act small? How can they move to FOB 60 days from 120? And which sectors can adapt easily?

There's always a tradeoff; you need to take process out of the system. Redundant processes that were set up to protect retailers from merchandise mistakes also slow speed to market. Major retailers and brands are working to apply quick chase models, or to source with flexibility and optionality. The industry needs to think big and small and flexible simultaneously. It needs to offer broad assortments to a customer who increasingly wants to express his/her uniqueness via apparel choices. The "uniform" or carbon-copy look is outmoded. These are issues that retailers and brands will wrestle with today and in future. The answers aren't simple. The market will evolve. Through trial and error, the industry will develop a response that will work for every consumer group. Flexibility and smaller runs are not just applied to the higher-end luxury companies but represent a model to be flowed into every price point and market segment.

Onshoring and Near Shoring Are Gaining Ground

That said, the industry still needs to find ways to wring out the significant waste in product costs. Each retailer and brand approaches this issue differently, but there are ways to reduce supply chain waste, which can in turn help offset inflation in other inputs, such as in labor. To do this takes a long-term strategic approach to supply chain needs. For many retailers and vendors, onshore or near-shore manufacturing and supply models top the list of solutions, as a way to achieve greater flexibility and potentially lower costs. Remember, every markdown avoided is a cost saved. Speed and flexibility enables the retailer or brand to invest more on product, but can also improve their profitability by minimizing or eliminating markdowns. The win-win situation is when they can eliminate markdown risk and maintain the upside opportunity.

A small amount of manufacturing is returning to the US, but this is not a major trend and will not likely upset the global sourcing marketplace. Notably, Central America is likely to be a region of choice for retailers seeking fast turnover. Generally, as US retailers go global, they will have to source differently. They will need to look beyond labor costs as they target efficiency and speed.

Focus on Omnichannel Is Driving Change

Still in the early stages of its evolution, omnichannel is the focus of every brand strategist. Many retailers are investing in technology, using accelerators and incubators for new ideas and processes. Retailers are testing smaller runs and taking more aggressive fashion bets online. Most retailers use the Internet and fulfillment centers for a larger assortment; this is great for consumer choice.

The online channel offers retailers the opportunity to experiment with new things, fashion, sizing and new categories, to name a few. In an omnichannel strategy, you can target smaller customer demographics and really meet consumer needs. Retailers of all stripes could learn a lot from the practices of off-price retailers, where the buy is frequently as small as 500 pieces (because units are subject to lot availability), and getting the merchandise to the right store location for the target customer is paramount.

A Final Comment on Sustainability

Sustainability and safety are of major importance to the apparel supply chain, from the factory floor to the consumer making a purchase and all points between. Building factories to be sustainable isn't necessarily a cost given the reduced waste and increased efficiency gained. Over time, these benefits will make up for the higher initial cost, which should really be viewed as an investment. Best practices are being shared among industry participants, with transparency and cooperation across multiple companies breaking down past barriers. Sustainability efforts are critical to making the supply chain safe for every worker anywhere in the world.

This report was excerpted from a presentation given by Deborah Weinswig, EVP – Head Global Retail Research & Intelligence of Fung Group, and Jason Kra, EVP of Foreign Resources Corporation (FRC), a division of Li & Fung, at JPMorgan's Sourcing Outlook breakfast meeting, hosted by Matt Boss, Broadlines & Department Stores analyst at JPMorgan on October 1st, 2014.