Managing a Supply Chain of Proprietary Products

By Brooks Kitchel and Jonathan Mays

To avoid falling into the pit of competing solely on price, many retailers have been trying hard to distinguish themselves on a much different basis: selling unique offerings with significant consumer appeal. Whether that uniqueness is minor or major, it can attract significant consumer attention and give the retailer an edge. And whether they generate a fraction or the bulk of total sales, such proprietary offerings can have an outsized impact on customer loyalty, revenue growth and profitability. What's more, because these items can't be found at any other retailer, there is less competitive pricing pressure.

Yet, to bring a continual flow of attractive proprietary offerings to market, retailers must not only get the product innovation side of the equation right, they must also get their supply chain in order. That's because designing and developing products shifts the risks of materials, production and inventory management onto the retailer—risks that are far less severe when a merchant buys products from a supplier such as Kraft, Prada, Levi's or other national brand.

In this article, we explore the supply chain challenges for retailers who develop some of the products they sell. We then explain how several retailers have solved those challenges while becoming major "act vertical" success stories.

The Rise of Act Vertical Retailers

An increasing number of retailers have been "acting vertical"—designing and developing unique offerings whose production they outsource to third parties. We refer to such retailers as "act vertical" players because while they are vertically integrated into production, they don't own manufacturing resources. They are "acting" vertical without "being" vertical.

In an ongoing research effort involving more than 100 large U.S. retailers, we found that more than a third (36%) were generating the majority of their revenue from proprietary products, ie., private-label and exclusive offerings that were unique to their chains. (See Exhibit 1.) By 2013, that percentage is expected to grow to 41% of all retailers, fueled by department stores, mass merchants, superstores and grocery chains, all of which expect to increase their percentage of revenue from proprietary products. For example, Staples, the nation's largest office supplies retailer, generated 23% of revenue from private-label offerings

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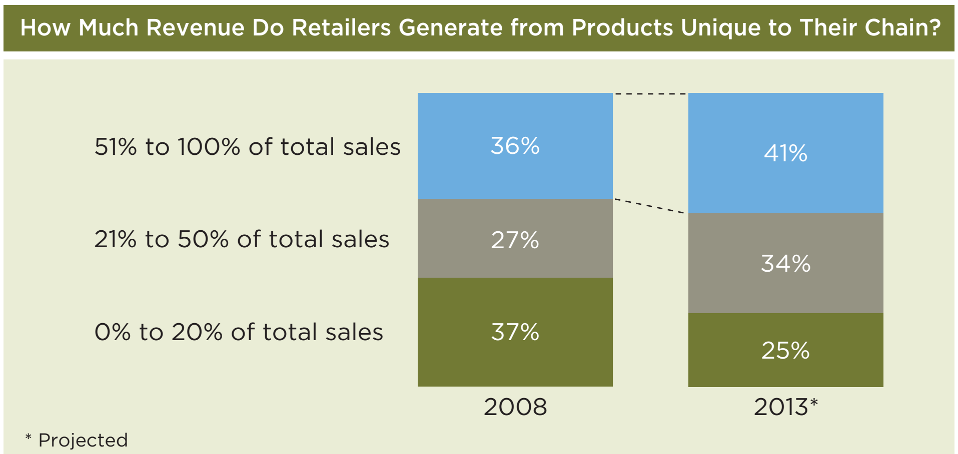
EXHIBIT 1: Retailers foresee unique products capturing an increasing portion of their overall sales



Source: KSA Act Vertical survey and analysis

in 2008, and more than a third of Kroger's sales (35%) are now from private-label products.

What's behind the push for proprietary offerings? Our research found that it largely comes from retailers who don't want to compete on the price of national brands against mass merchants, warehouse clubs, off-price retailers and online merchants such as Amazon. Retailers competing on the basis of price do so by having huge buying clout over national brands and by having seamless supply chains, as well as highly efficient customer experiences that take labor out of the store. If product and customer experience are the two fundamentals of every retailer, the price competitors can be thought of as providing low prices on ubiquitous products (i.e., national brands that can be purchased from other retailers) and transactional customer experiences (i.e., streamlined and with little customer hand-holding). (See Exhibit 2.)

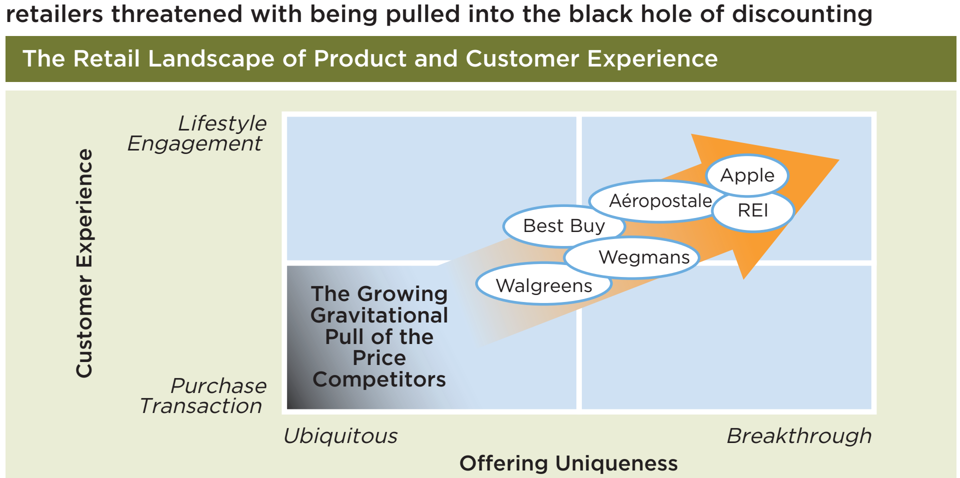
Over the last 30 years, with the disappearance of dozens of regional mass merchants and department store chains, only retailers with huge scale, efficient operations or highly convenient stores can survive or grow profitably in the lower-left quadrant of Exhibit 2, as Wal-Mart, TJX, Costco, CVS, Walgreens and others have demonstrated.

Other merchants must play a different game. On the product spectrum, they need a healthy percentage of their offering that they can call their own—unique offerings they design and develop. (Some of the products can be fee-generating services, such as the type that Best Buy, PetSmart, Home Depot and others have made into big business.) And they need to invest in the customer experience in their stores—especially to ensure that their salespeople, signage, promotions and marketing all highlight the part of their product offering that is special. In other words, these retailers need not only distinctive products and services, they need to provide distinctive customer experiences.

Why Unique Offerings and Compelling Experiences Are Not Enough

Retailers such as PetSmart in the pet segment, Aéropostale in apparel, Best Buy in consumer electronics, REI in outdoor equipment and clothing, Target in mass merchandising and Coach in

EXHIBIT 2: Product and experience differentiation is especially critical for retailers threatened with being pulled into the black hole of discounting



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accessories have grown rapidly this decade in large part because they recognized the absolute need for unique offerings and more-engaging customer experiences than those found in the mass discounters. By doing so, they escaped the black hole of price competition.

But that isn't nearly enough to avoid death by discounting. Retailers need the infrastructure to support this strategy, specifically, expertise in these core capabilities:

- Product design and development
- Inventory management
- Supply chain optimization

Product design and development
Creating unique offerings means heavy investments in product design and development. Protecting those investments requires accurate demand forecasting for goods that may have little precedent. Because suppliers assume more risk as well, retailers must work much more closely with them (and even their suppliers' suppliers) in demand planning and synchronizing orders and production calendars. Our research found that the most successful act vertical retailers collaborated much more strongly with their suppliers in design and development than the least successful act vertical retailers.

Inventory management
Inventories must be managed tightly as well. It is better to be conservative with orders, e.g., even going so far in some instances as to make stockouts a strategy for very fashionable merchandise. When a retailer has excess inventory of its own product brands, it cannot negotiate a return to a vendor or ask for markdown money. This is to say that if the retailer doesn't manage these and other supply chain issues well, its return on popular products can quickly go from positive to negative. And even if the return is positive, an inefficient supply chain will whittle it down.

Supply chain optimization
To be sure, having the right unique products trumps everything else. A streamlined supply chain cannot rescue product and service offerings that customers find unappetizing. But if its proprietary offerings are on the mark, a retailer must make sure two critical supply chain capabilities are in good working order: assortment lifecycle management and in-season inventory management.

Managing the Assortment Lifecycle

An act vertical retailer is heavily involved in the sourcing of its products. Once it has designed, developed and sourced the production of a product, it must then decide on the quantity and the time period for producing and selling it. This typically isn't covered under product lifecycle management. Thus, we refer to it as assortment lifecycle management. It's about proactively planning the assortment lifecycle from initial set to exit and using this to determine how much inventory to have in the queue.

Stellar assortment lifecycle management doesn't happen by accident, and it begins long before the product is ready for manufacture. Coordination of, and communication between, the different parties involved (design, development, merchandising, planning, marketing, sourcing and the vendor) are key. At defined milestones in the process, design and development managers must confer with merchandisers and planners to review styles and forecast demand. Retailers who have shortened the product design process and pushed key decisions closer to in-store data have greatly increased forecast accuracy, thus they substantially reduce their product development risks.

A foundational element to increasing speed is to have everyone involved marching to the same calendar. In addition, a centralized calendar greatly increases the chances that inventory and promotional materials (store signage, promotional events, direct-mail flyers) arrive in stores when customers are ready to purchase. This is critical because a retailer's unique offerings do not necessarily sell themselves and often lack the large-scale advertising of national brands. Act vertical retailers must make sure their marketing and internal communications are educating employees and customers about the fine points of a new offering. If they don't, great new products can languish on store shelves.

Retailers can further reduce the risk of overbuying by having strong supplier relationships. The stronger the relationship, the more likely a merchant will be able to commit to only a portion of its buy upfront and not have to place all its bets at one time. Creating such strong relationships comes down to concentrating one's business with fewer strategic vendors and being good partners. Aéropostale, a hugely successful $1.8 billion apparel chain that has been thriving throughout the 2008–2009 recession with comp-store sales increases, Getting the product to market in the right places and right amounts quickly is crucial. A retailer must have a supply chain that can deliver initial allocation and replenishment shipments to market profitably so that it can make the highest margin on its best-selling proprietary items.

focuses two-thirds of its business on five suppliers. "We stay committed to our vendors because we recognize that our long-term partnerships will give us a competitive advantage," Tom Johnson, the company's chief operating officer, told us.

Having a proactive markdown strategy is also critical. Most markdowns are reactive, i.e., a retailer slashes prices when sales don't meet expectations. A large percentage of those sales can be unprofitable. A proactive markdown strategy is created long before product arrives at stores. It determines in advance, based on projected sales and timeframes, the best times to take markdowns and how much to take so that markdowns can drive revenues and still be profitable. Given a retailer's big investments in development and promotion, effectively marking down its own products is critical to maximizing profit.

Planning markdowns carefully is part of the larger issue of creating entry, continuance and exit strategies for proprietary offerings. When is the best time to bring a novel item into a chain, and which regions and stores should get it first, second, third, etc. (or all at once)? And how do managers know what lines to continue or exit?

Once the numbers are in on a new, proprietary product, a retailer should conduct a post-mortem analysis to understand lessons learned for the next new-product initiative. In many chains, a small percentage of their assortment drives the majority of their profitability. Intimately understanding what product categories, products and product and category attributes (price points, styles, colors, features, etc.) drive profits is critical to designing and developing the next set of winning items.

Inventory Management: Allocating and Replenishing Hot Products

Where among hundreds or thousands of stores a retailer should send its products and how it should replenish those stores bring added complexity to the act vertical game. Getting the product to market in the right places and right amounts quickly is crucial. Aéropostale can get hot-selling apparel from its distribution centers to its 800 North American stores in one to three days.

Managing store-level inventories differently also helps offset the risks of inventory ownership. This includes adjusting display quantities for larger and smaller stores, managing delivery frequency and carefully matching the depth of inventory to the forecasted demand. There are bound to be variations in demand by regions or individual stores—sometimes significant—and making generalized inventory decisions puts margin dollars and working capital at risk.

Finally, a retailer must have a supply chain that can deliver initial allocation and replenishment shipments to market profitably so that it can make the highest margin on its best-selling proprietary items. Chains such as Best Buy and Toys"R"Us have one supply chain for products with predictable sales patterns and another for less-predictable items. These retailers create different supply chains to support products with different selling patterns. Then they flow the goods to the stores in a way that maximizes margins while minimizing the risks of excess inventory.

Overcoming the Barriers

Retailers who are committed to creating their own compelling offerings will face several challenges to improving their supply chains in the way we've described. One is putting discipline into an organization that may be brand- or product-driven. Another is leveraging stockouts. Given the risk of proprietary brands, most retailers are far better off underestimating demand for certain item types (as long as there are backups in the supply chain) and creating a "buy now" mentality in consumers. This will be a struggle for retailers who view stockouts as black marks on their reputations with customers—but this doesn't have to be true. Aligning the calendars of multiple business functions is not easy, and the challenge is less technical and more organizational. The stovepiped functions of retailing are not easy to coordinate. Lastly, without the right information and technology, it is very difficult for a retailer to forecast demand for higher-risk products.

Yet all of these supply chain challenges can be overcome, as the act vertical success stories of Aéropostale, PetSmart, Coach, Trader Joe's and others have shown. The rewards for those who have done so are significant.