Looking for *Cost Savings* in *All the Right Places*

Sixth Annual **Apparel** Research Study & Analysis

Against a backdrop of skyrocketing labor costs, a depreciation of the U.S. dollar in foreign markets and uncertain stability levels in some regions, sourcing executives are narrowing in on specific cost-savings measures, while staying mindful of quality needs and risk levels.

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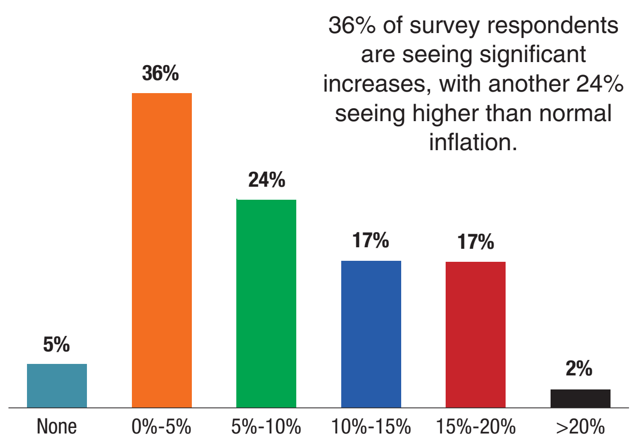
Apparel companies have spent the past few years searching every corner of the supply chain to identify any area where they can cut costs, yet this year's "Excellence in Global Sourcing" survey highlighted three areas in particular where firms are focusing their cost reduction efforts:

- Vendor portfolio optimization
- Raw materials management
- Streamlining internal sourcing organizations

The challenge for brands and retailers is developing a sourcing strategy which captures these cost savings without sacrificing quality or introducing unnecessary risk to the supply chain.

As apparel companies redefine their sourcing strategies, they do so against the backdrop of rising FOB$. More than 60 percent of survey respondents have experienced FOB$ increases of 5 percent or more over the past year, compared to the U.S. Consumer Price Index inflation rate of 3 percent over the same period. ***See Figure 1.***

FIGURE 1: Percent FOB Increase Over the Past Year



This study is based on a survey of key sourcing topics affecting the industry today, presented in aggregate. A more detailed analysis will be presented by Kurt Salmon on August 21, 2012, at *Apparel's* Sourcing Summit at MAGIC in Las Vegas. To register, visit apparelmag.com.

Survey Methodology and Respondents' Profiles

The sourcing survey was comprised of approximately 40 questions covering sourcing activities from the post-product development stage to delivery at the final destination. Survey respondents' profiles are as follows:

- 48% are retailers and 52% are manufacturers
- 85% of respondents work in corporate operations, product development or sourcing/procurement
- 16% of respondents have greater than $1 billion in annual sales volume
- 40% of respondents have less than $100 million in annual sales volume
- 7% of respondents have more than 500 stores
- 58% of respondents are sourcing through a centralized sourcing group in their home country or headquarters office
- 42% of respondents have an FOB$ per sourcing FTE of less than $2 million

Figure 2: Drivers for Making Vendor Reallocation Decisions Over the Past 2 Years

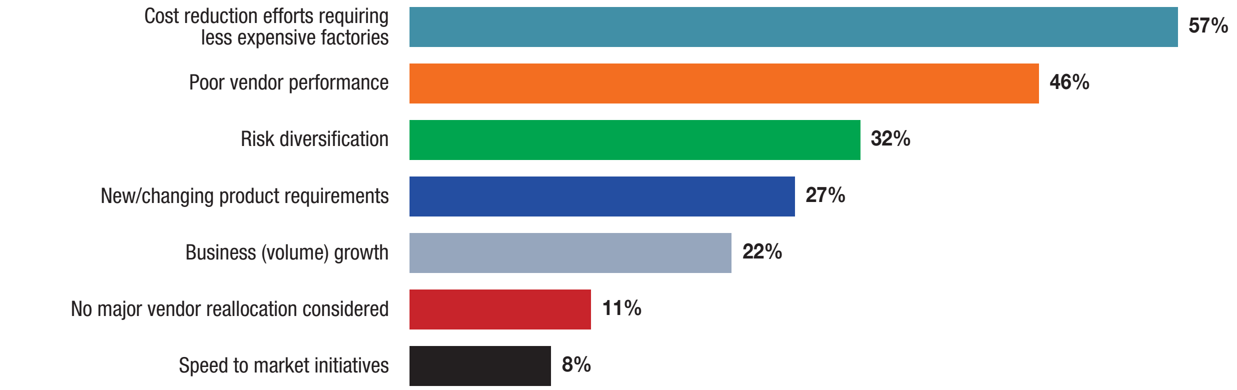
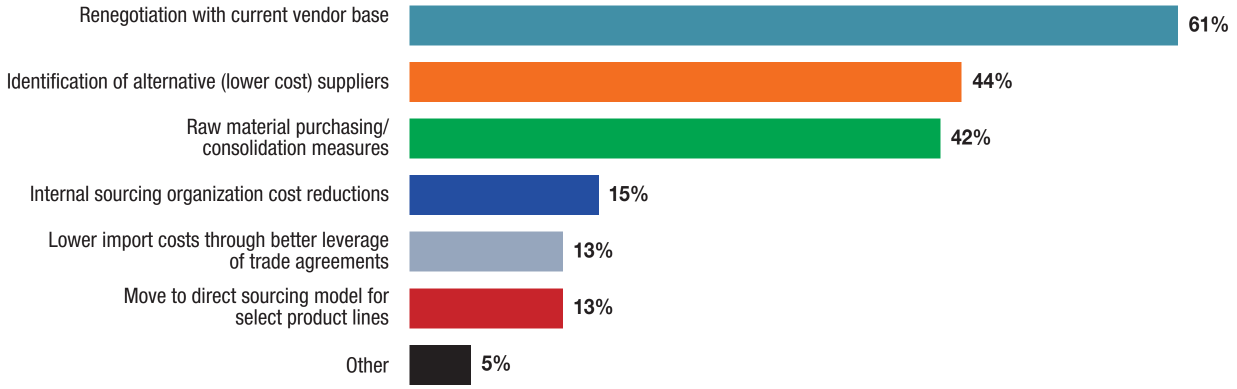


Figure 3: Sourcing Strategies Driving Cost Reduction Results



KEY TRENDS

Companies are looking to new regions and tools to optimize their vendor portfolios

Many apparel companies view vendor cost negotiation and reallocation as their primary lever for achieving cost reductions. In fact, almost 60 percent of survey respondents said their primary driver for vendor reallocation is cost reduction. This does not come as a surprise, as Kurt Salmon projects have shown that strategic reallocation and vendor rationalization can save 2 percent to 5 percent of FOB$.

Vendor negotiation can help cut costs significantly and is increasingly important as labor rates skyrocket, more complicated product requirements fuel demand for new sourcing partners and poor vendor performance continues to increase the cost of delivering high-quality product to the consumer.

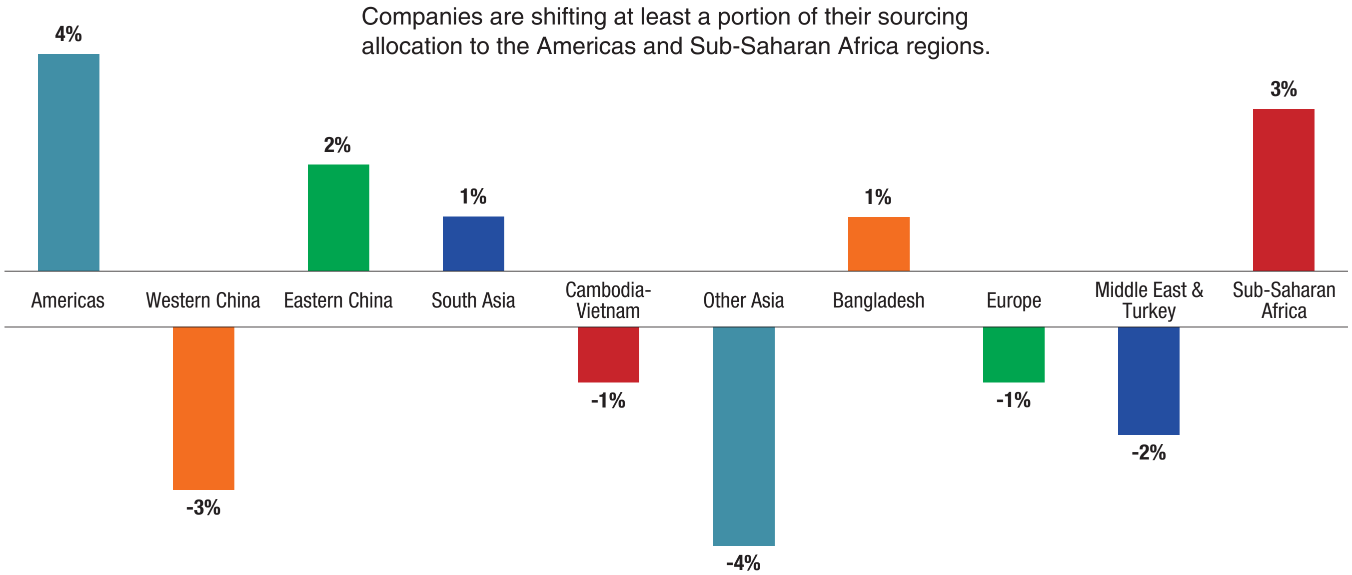
Driving the trend toward vendor reallocation are several macroeconomic factors that sourcing executives view as potential risks to their overall sourcing strategy. This year, the depreciation of the U.S. dollar in foreign markets, the stability of the sourcing regions and the cost of labor in those regions were mentioned as top concerns. Depreciation and regional stability both took a leap to the top this year, while cost of labor in various sourcing regions has been seen as a concern for several years now, especially to companies sourcing in China and the Asia-Pacific region.

As retailers look to reallocate FOB$ to optimize their vendor portfolios, vendor performance is a major concern. Poor vendor performance was listed as the second-most common reason for reallocating FOB$ over the past two years, which coincides with the trend of increasingly complicated product requirements. This has led to a focus on more structured vendor management through the use of scorecarding and other vendor performance measures. These measures allow them to better track performance and reallocate sourcing dollars more effectively. ***See Figure 2.***

With these tools in place, apparel companies indicated that their top strategies for reducing costs are renegotiating with current vendors (61 percent) and identifying new, lower-cost vendors (44 percent). This is a shift in strategy from 2010, when survey respondents were overwhelmingly trying to identify new, lower-cost vendors as their primary strategy for reducing costs. ***See Figure 3.***

A few words of caution, however, for those companies looking to engage new, lower-cost vendors: Be mindful of the costs of on-boarding a new vendor. For example, a current vendor may have intimate knowledge of a retailer's business and well-established relationships with its product development staff. The cost of developing that knowledge and forming those

Figure 4: 2011-2012 Change in Current Sourcing Regions by Companies Sourcing Over $2 Million per FTE



relationships with a new vendor can be significant and time-consuming.

One area leading apparel companies are focusing on, for both renegotiation with current vendors and negotiation with new vendors, is payment term standardization. Consolidating payment terms to a handful of options based on vendor tier can result in tangible bottom-line savings.

Ultimately, maintaining an appropriate balance of strategic and new vendor relationships, with beneficial contract terms, is the cornerstone of a vendor portfolio strategy which keeps supply chain costs down without sacrificing speed or adding excessive risk.

With that in mind, how are companies optimizing their vendor portfolio?

First, many apparel companies have recently introduced more formal scorecarding systems to record vendor performance and identify poor performers. Twenty-nine percent of respondents said they use formal vendor scorecards and additional quantitative metrics to measure lead time and quality, while 26 percent of respondents said they also use metrics to measure lead time variability and product cost. Both groups represent significant increases in the number of companies that are using formal vendor scorecards and measuring costs, variability and quality. In the previous two years, the majority of respondents said they were measuring performance informally based on major delivery issues, and only 19 percent of respondents chose that answer this year. Kurt Salmon is increasingly seeing clients leverage advanced PLM capabilities to gain visibility to the metrics needed to support a robust vendor scorecard system.

These scorecards and metrics are a main input into sourcing vendor allocation decisions. More than a third of retailers make these decisions on a quarterly basis, while 80 percent make them annually, which illustrates how important these metrics are for most apparel companies.

And as sourcing organizations reexamine their portfolios, they are also investigating several new sourcing hotspots, as identified in this year's survey.

China, of course, remains the largest apparel sourcing hub by far, but its popularity fell this year. The trend was similar in Cambodia and Vietnam, as rapidly increasing domestic demand hampered their export capacity and rising labor costs made them less attractive from a cost perspective. For example, compensation costs for Chinese manufacturing workers increased at a CAGR of 18.9 percent between 2006 and 2011, according to the IMF. ***See Figure 4.***

Rising labor costs in China, Cambodia and Vietnam had companies looking for other options, and India and Bangladesh shot up in popularity, with 12 percent of respondents saying those countries were one of their top three of interest, up from 5 percent last year. Cheaper labor, infrastructure developments and improved work force skill sets made India and Bangladesh look increasingly attractive.

At the same time, the near-shoring trend continues as apparel companies look to cut costs and reduce cycle times to become more responsive to changes in demand. Colombia has emerged as a particularly attractive option, due to its skilled labor force, developed infrastructure and proximity to U.S. ports, which reduces transit times.

Africa has also been growing in popularity, and we expect this trend to continue, especially if the third-country fabric provision is extended. The provision allows most AGOA countries to ship apparel made from fabric outside the region to the United States duty free.

The exploration of new sourcing hubs and vendors will likely continue to accelerate, as the majority of apparel companies plan to reallocate 10 percent to 25 percent of their FOB$ to new vendors over the next two years.

As materials grow to be a larger share of FOB$ costs, raw materials management is increasingly important

Raw materials costs are already the single largest contributor to FOB$ for most apparel companies, and raw materials inflation remains the top macroeconomic concern of the survey respondents. Despite this, many apparel companies have not developed materials management programs beyond traditional pre-buy negotiation. Companies that are able to implement more advanced material management programs will have a considerable competitive advantage, with Kurt Salmon's experience showing material buy cost reductions of 4 percent to 8 percent.

Many companies recognize the significance of raw materials costs. In fact, raw materials consolidation and purchasing measures are the second-most popular way to drive down costs, right behind vendor renegotiations, with 42 percent of respondents indicating materials management is a part of their strategy. But materials management strategies vary among apparel companies.

Half of respondents currently pre-negotiate fabric prices for 30 percent or more of their total fabric buys. While this typically drives down bottom-line costs, there are still significant FOB$ being left on the table.

A third of respondents indicated they are not currently focusing on consolidating materials buys across divisions or brands. The benefits here are significant — by consolidating purchases, apparel companies can negotiate lower prices with mills and set aside factory capacity in advance, saving money and reducing cycle times. A common limitation to consolidating material buys is often lack of visibility across the product development organization. Not coincidentally, 47 percent of respondents have implemented a PLM system to provide greater visibility into materials usage and can enable a more robust materials consolidation strategy. And an additional 47 percent of respondents said they planned to implement PLM within the next 12 months.

Another materials management strategy is materials platforming. As opposed to pure buy consolidation, materials platforming influences the design process through the standardization of base materials across the core product line. This approach enables companies to further increase negotiating power with mills and lower fabric prices. Sixty-two percent of respondents indicate that they currently leverage materials platforming for only 10 percent or less of their large materials buys. With effective materials platforming reducing total fabric costs by as much as 5 percent, leading apparel companies will prioritize materials platforming within their product development and sourcing organizations. *See Figure 5.*

While all apparel companies will continue to monitor fabric prices, the leading companies will advance their materials management strategies to preserve the bottom line despite the uncontrollable macroeconomic forces at play.

Figure 5: Percent of Fabric Buy Impacted from Material Platforming Approaches

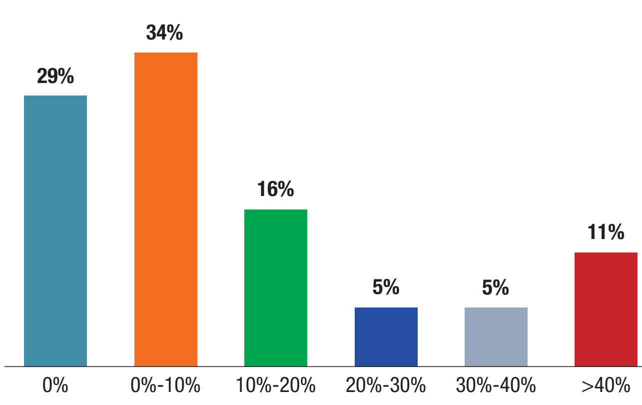
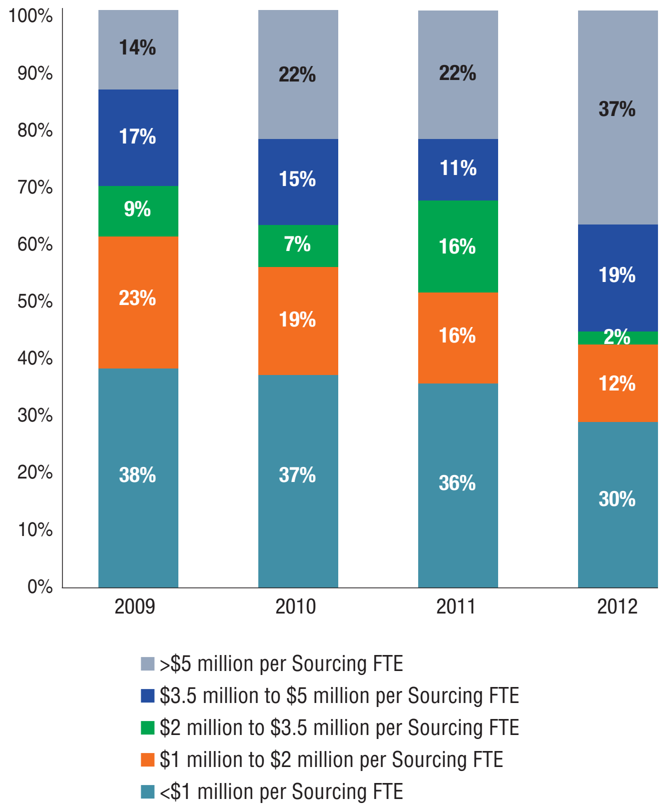


Figure 6: FOB$ per Sourcing FTE (Full Time Equivalent employee) (% of respondents)



Companies are placing a renewed emphasis on streamlining their internal sourcing processes

As companies look to cut costs, it's difficult to overlook the significant amount of money spent on internal resources, especially for those companies operating overseas offices. These companies are seeing the value in leveraging their vendors' product development capabilities to reduce internal overhead expenses.

This year's survey shows that companies are becoming more efficient, as the percentage of respondents who say they are sourcing less than $1 million per FTE has declined by 5 percent over the past three years, while the percentage of respondents who are

Figure 7: Factors Considered Most When Choosing a Sourcing Region/Partner (% of respondents)

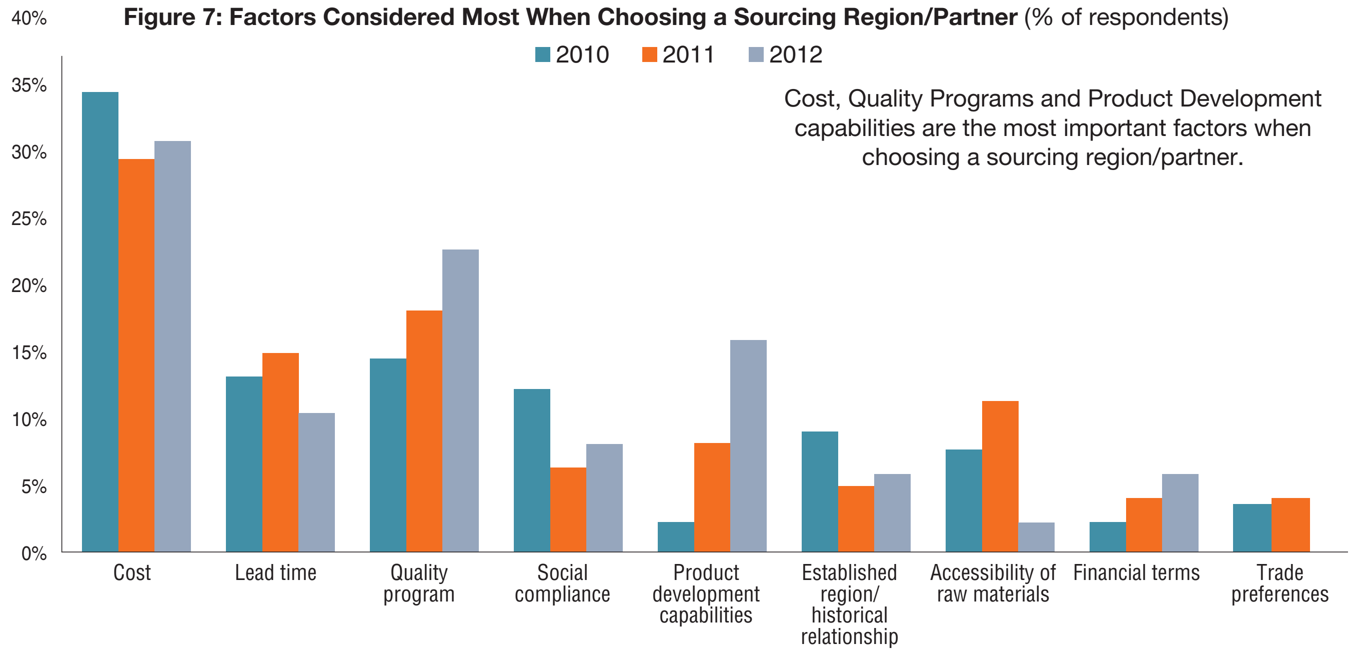
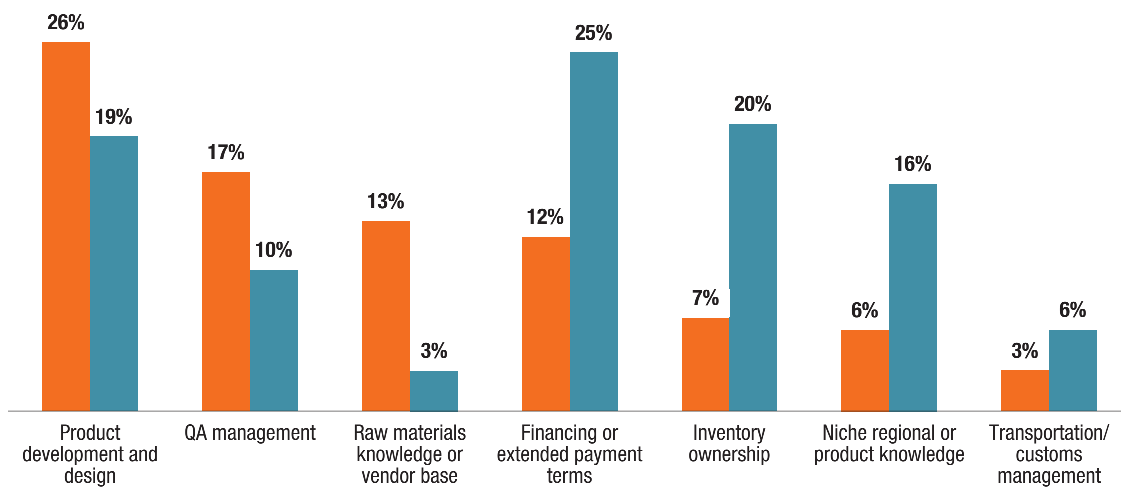


Figure 8: Value Adding Services Considered the Most Important Expectation from Agents/Importers/Vendors (% of respondents)



sourcing more than $5 million per FTE has increased 17 percent in the same time period. ***See Figure 6.***

Apparel companies are exploring several tactics to remove costs from their internal sourcing organizations. First, when choosing a vendor partner, they are increasingly considering what types of product development services that vendor offers, with the goal of moving select internally-owned activities to the vendors. This moved up two spots on the list from last year and is now the third-most important consideration when choosing a vendor, right behind cost and quality. The percentage of respondents seeking product development services from their vendors has doubled over the last year, from 8 percent to 16 percent of respondents. ***See Figure 7.***

More than 60 percent of respondents indicated that strategic vendors provide materials research services, while more than 40 percent said their vendors provide product design input and technical specification development services. This high level of collaboration indicates that companies are clearly seeing the value of outsourcing select activities to minimize costs.

Cultivating closer relationships with vendors can also save time. An increasingly popular trend is for agents and overseas offices to approve the first round of samples, which cuts time from the product development cycle. That being said, as apparel companies look to renegotiate with vendors to cut costs, keeping these services in mind as part of the cost equation is essential. ***See Figure 8.***

The fact that 94 percent of respondents have either implemented or plan to implement a PLM system is also a strong indicator that many companies are looking to streamline their internal sourcing processes. PLM can enable more efficient communication between sourcing, merchandising and design, and, if vendor portal functionality is enabled, PLM also significantly improves communication channels with top vendors.

There are significant benefits to creating leaner product development and sourcing operations. Not only will a leaner product development process save time and money, it will cut out unnecessary work and free up product development staff to focus on where they can add the most value: creating high-quality, innovative products.

The Tug of War Continues

With survey results indicating that cost is the primary concern on sourcing executives' minds, and that negotiation with production partners is many companies' first target for cutting those costs, it looks like the margin tug of war between retailers, wholesalers and vendors is likely to continue for the next few years.

As the margin battle wages on, the main question is what retailers will do to reduce costs through the effective deployment of their own resources. The three trends outlined — vendor optimization, material management and internal sourcing organization streamlining — must be carefully coordinated at the executive level to ensure the organization's goals are aligned. The apparel leaders will develop a corporate sourcing strategy which effectively balances cost-cutting measures with quality, speed and risk tolerance. ■

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