Kurt Salmon

RETAIL INDUSTRY INSIGHTS

Battling Supply Chain Inflation

For most of the last two decades, the U.S. retail industry has benefitted from a thriving American consumer economy and a commitment from China to provide low costs. But in the past year, in nearly unprecedented fashion, costs have risen across all components of the retail supply chain.

In the past, retailers have protected profits by passing along cost increases to suppliers or, in some cases, even consumers. In the current economy, however, suppliers are less and less willing to take up the slack; and consumers, clearly, are already skittish about spending—even at rock-bottom prices. But as costs continue to increase, the pressure to raise prices mounts.

"The world has radically changed," Richard A. Noll, chief executive of Hanesbrands, said in an interview. "There is a clear understanding that prices need to go up in this kind of environment."

Everyone is familiar with the huge hikes in cotton prices, which climbed 122% in 2010. But other key commodity prices are increasing as well. Oil prices are up 30%, raising the cost of synthetic fibers as well as transportation rates. Plus labor rates continue to rise in China and other popular production regions.

Oscar Feldenkreis, president and chief operating officer of Perry Ellis International, points to the challenges shared by all brands. "We are keeping an eye on inflation, and there are issues with rising material costs, sourcing and freight."

Even companies with strong supplier relations are facing pressure. In an optimal supplier matrix, approximately 20% to 30% of suppliers can help share the burden of cost increases, but that still leaves 70% to 80% of the supplier base that may not be as willing—or may simply be unable—to shoulder some of these increases.

In addition to increasing supply chain costs, U.S. retailers continue to face a challenging consumer landscape at home. Saddled with an unemployment rate near 9%, consumers are still reluctant to spend. By contrast, demand is stronger in other global markets. In China, for instance, there is a growing culture of consumerism. The combination of decreased demand in the United States and increased demand in emerging economies means less available production capacity for retailers here at home.

The confluence of changes in the consumer and production landscape is forcing all retailers to develop strategies for displacing inflationary pressures, including:

- **Sourcing and Product Engineering.** Developing an appropriate sourcing strategy to manage product, vendor, supply chain and financial risk is a solid start. This strategy should be coupled with an efficient sourcing process that aligns with company, brand and sourcing strategy; proactively manages vendor performance and designates appropriate cycle times for all sourcing activities. Additionally, product engineering may be able to mitigate some cost increases, but only to a small extent.
- **Distribution and Logistics.** Despite rising oil prices, many retailers can still cut distribution and logistics costs. Strategies such as route and modeoptimization, coupled with aggressive labor management, can produce significant short-term savings.
- **Merchandise Mix and Inventory Management.** Properly managing inventories by holistically aligning them with customer demand can lower markdowns and use warehouse and distribution space more efficiently. In addition to right sizing inventories, proactively managing the merchandise mix can also protect margins.
- **Pricing and Customer Experience.** Consumer confidence is still fluctuating enough to suggest that passing on the entire cost increase to consumers is risky. Even small percentage increases might send a consumer to the competition. Retailers need to assess customer motivations, price elasticities, pricing roles by category and competition to develop new pricing strategies that are not based on what worked last year.

Although cost increases will continue to exert pressure on retailers in the coming year, we believe these strategies will help prevent a severe impact on margins. Focusing on efficiency will help control costs, while continuing to build a strong brand offering and customer experience will minimize the risk of price increases and ensure the retailer is well-positioned for future growth. ❖

Inventories are leaner already | Fabric prices are increasing | Labor costs in China are increasing | Factory capacity has dropped | Oil prices are increasing | Consumers are still focused on value at every price point | Who will foot the bill?

KURT SALMON

Kurt Salmon is the leading global management consulting firm specializing in the retail and consumer products industry. For more information, visit www.kurtsalmon.com.

AUTHOR

John Long has more than 20 years of deep experience in all facets of the retail and consumer products industry. He can be reached at john.long@kurtsalmon.com.