

Disruptive Innovations in Sourcing

Critical Game Changers Apparel Sourcing Needs to Prepare for

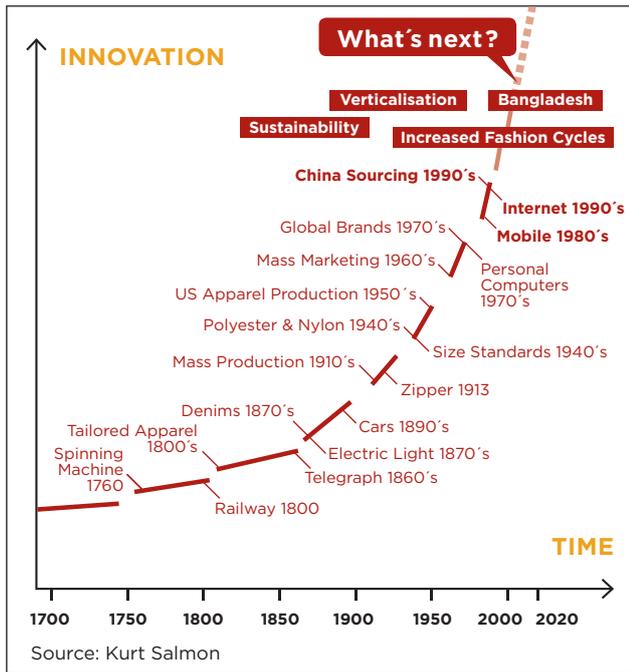


Why Disruptive Innovations Matter. Where we are today in apparel sourcing is less the result of small incremental steps of change, but more the result of large scale shifts the whole industry has experienced. Some of these changes have thrown their shadows early on; others came fast and hit large parts of the fashion industry rather unexpectedly.

Who in the US would have expected in 1990 that the share of domestically produced apparel would drop in the coming 12 years from about 50% to only 3% and likewise in Europe? Who could have been able to anticipate the rise of China's textile exports from 53bn USD in 2000 to over 260bn USD in 2013? And who would have dared to expect Bangladesh to rise from almost nothing to ranking number two in the sourcing market for Europe? Also the remarkable extension of variety and ranges, verticalisation, increase in fashion innovation cycles and sustainability requirements could have hardly been predicted by anybody working on the sourcing front (see fig. 1).

Sourcing executives have never been so busy optimising the existing sourcing portfolios and solving day to day challenges from exchange rate fluctuations, to raw material volatility, erratic freight rates, and production cost increases to keep COGS and margin on track whilst consumer prices are under pressure. Of course always ensuring on-time delivery, quality, and sustainability standards as base conditions is taken for granted. While focusing attention on keeping

Fig. 1: Increased Innovation Cycles



the sourcing machine running we are likely to miss the first signs of the big wave that will change everything, but which is currently only visible as a thin shadow on the horizon.

What if oil prices exceed the thresholds of 2009? What if cotton prices again exceed where we were in 2011? What if production costs in China get less and less competitive? What if rising stars of the sourcing landscape fall away due to political turmoil? What if consumers expect full transparency from sheep to store? What if we have to serve all global demand markets with the same attention? What if new technologies completely change the way we are developing garments? And what if we have to be even faster than we have already been?

A plethora of questions arises when thinking of what we might have to face as the sourcing leaders of the future, but lastly it all boils down to four rather simple directions from which disruptive sourcing innovations come from. We have to expect the sourcing environment to change e.g. regarding raw material and production prices and we will see tremendous change coming from innovations on the demand side, supply side, and technological advancements which will reshape the way the industry is working (see fig. 2).

Disruptive Sourcing Environment

When Kurt Salmon recently asked global leaders in sourcing about their biggest concerns, the following top three topics emerged: 1. Increasing labour cost

and wages, 2. Increasing transportation cost, and 3. Shortage of raw materials and increasing prices. This is not a surprise considering the background of the cotton crisis in 2011 and the general increase in labour cost in almost all sourcing markets globally. While the situation has eased with regards to cotton prices and freight rates in the course of the last two years, indicators are now showing upward movement again and production costs have never stopped increasing (see fig. 3). At least exchange rates currently play in favour of sourcing (e.g. looking at Turkey), but nobody knows for how long.

Looking at the main drivers for potentially disruptive risks from the sourcing environment, it is evident that raw material prices expose all sourcing geographies to the same extent and leave only very limited options for mitigation from alternative materials like synthetic fibres or new natural fibres from banana leaf to bamboo. Exposure to all other risk factors is dependent on the respective sourcing region with particularly high vulnerability to potential risks in South East Asia including the rising stars of Bangladesh and Cambodia (see fig. 4).

This includes potential risks from the rising cost of long distance transportation, exchange rate volatility, risks to duty preferences, social and environmental risks, and also political risks which became specifically evident in the protests in Bangladesh and Cambodia during the last year. This similarly applies to the long established sourcing markets in Northern Africa which have been severely affected by the insecurities of the Arab Spring uprisings. It might turn out, that none of these risks will materialise, but we might also arrive at a situation with specific sourcing markets falling away due to one or even several risk factors hitting at the same time and requiring urgent need of alternatives for respective sourcing volumes. With currently 38% of total sourcing volume for Europe coming from China, another 11% from Bangladesh,

Fig 2: Sources of Disruptive Innovations in Sourcing

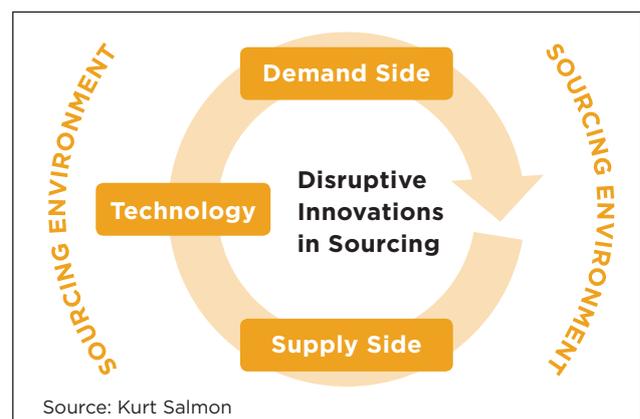
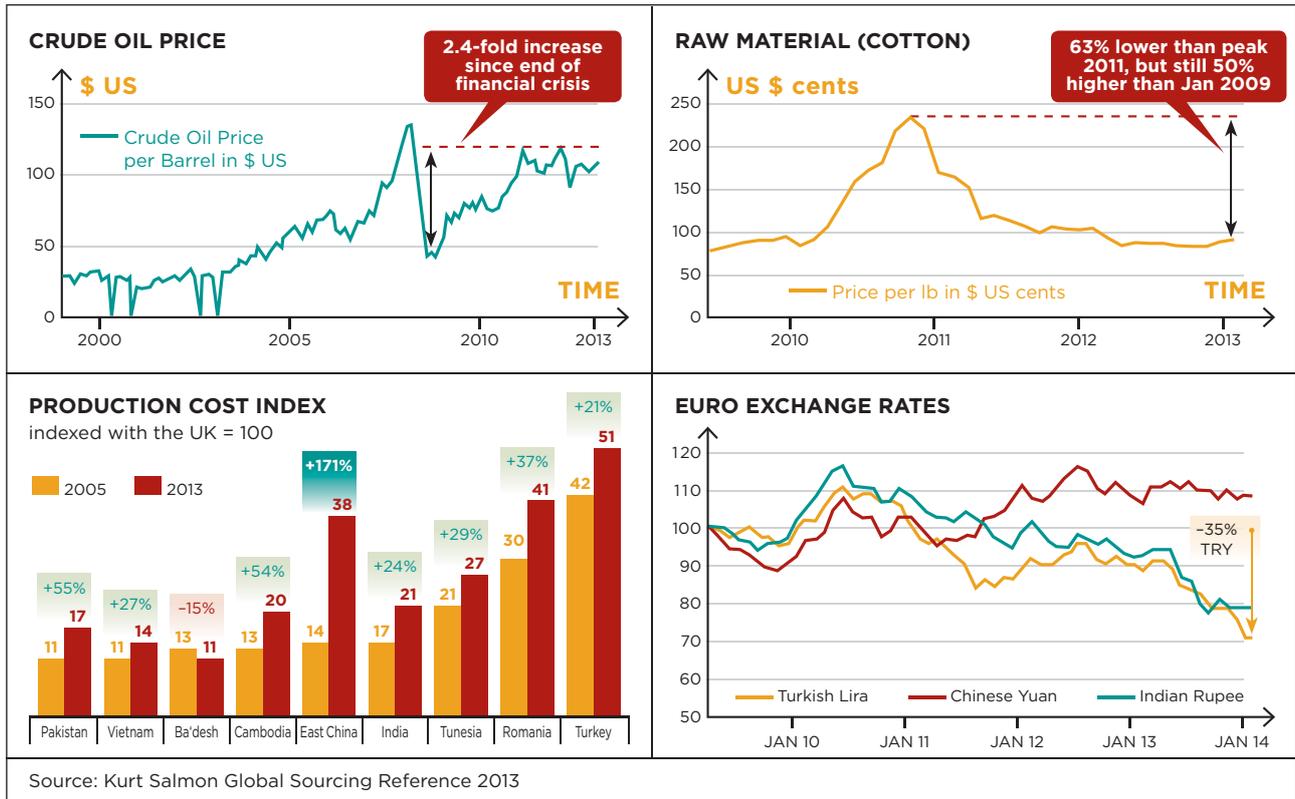


Fig. 3: Key Indicators affecting Global Sourcing Costs



and roughly 20% from Turkey and Northern Africa, a hit on any of the three main regions will confront sourcing with great challenges. This once again highlights the strong need for a balanced portfolio to both provide alternatives within each product category and also ensure safe havens in case of serious disturbances in key sourcing markets. This will in many cases mean having alternatives at a higher cost, but lower risk near sourcing locations.

Demand Side Innovations

A major driver of how sourcing in future will look is what the demand side will require in terms of products, reactivity, flexibility, innovation, quality, and transparency. The Kurt Salmon expert network has identified five key drivers which will foster demand side innovation with major impacts on sourcing:

1. Geographical Expansion and Differentiation: It is already obvious today. Traditional fashion markets in Europe and the US are largely saturated; space growth has reached its limit, and with over 800 denim brands and abundant choice of variants, there is not much more to be expected in terms of growth. Research institutes forecast annual growth rates between -2% and +1% for the coming years. Relevant growth will only come from emerging markets like China, Brazil, the Middle East, and India. Sooner or later this will cause a clear shift of

focus. At that stage it is no longer about sourcing for Europe and “somehow taking care Asia is fine”, it will rather be about sourcing for Asia, for South America, and for the Middle East with the same focus and attention as for Europe and the US as market sizes will be at least as relevant. This will require completely new ways of thinking about globally optimised product development and sourcing structures, bundling of capabilities and synergies, double sourcing needs and opportunities, and product commonality as a key driver of supply chain efficiency while catering for specific market needs to leverage their full potential.

2. End-to-End Transparency “from Sheep to Store”:

It is a constant in the recent issues of the Kurt Salmon Global Sourcing Reference survey, that respondents rank the importance of tier 2 supplier management higher and higher. Public pressure on apparel brands and retailers to ensure social and environmental standards is steadily increasing and undoubtedly the point in time will come when consumers will demand fashion brands and retailers to provide full transparency and assume full responsibility along the complete value chain; something which is already taken for granted in other industries, e.g. in the grocery sector today.

3. Short-Term Demand Reactivity: The accelerated cadence of product innovation was one of the

Fig. 4: Disruptive Risk Factors for Global Sourcing

		VULNERABILITY TO DISRUPTIONS				
Disruptive Risk Factor	What if....?	Euro Zone	Eastern Europe	Northern Africa/TR	China	South East Asia
1. Raw material prices	Cotton prices return to beyond peak of 2011?	⚡⚡⚡	⚡⚡⚡	⚡⚡⚡	⚡⚡⚡	⚡⚡⚡
2. Oil price and transportation cost	Oil prices and transportation cost exceed peaks of 2009?	⚡	⚡	⚡⚡	⚡⚡⚡	⚡⚡⚡
3. Production cost increases	Production cost in key markets strongly increase?	⚡	⚡⚡	⚡⚡	⚡⚡⚡	⚡⚡
4. Exchange rate volatility	Exchange rates significantly fluctuate/ strengthen vs. Euro?	—	⚡⚡	⚡⚡⚡	⚡⚡⚡	⚡⚡⚡
5. Duties and preferences	Duty preferences expire or new duties are introduced?	—	⚡	⚡⚡	⚡⚡	⚡⚡⚡
6. Social and environmental risk	Markets disqualify due to social/ environmental standards?	⚡	⚡	⚡⚡	⚡⚡	⚡⚡⚡
7. Political risk	Markets fall away due to political turmoil or sanctions?	⚡	⚡⚡	⚡⚡⚡	⚡⚡	⚡⚡⚡

Source: Kurt Salmon

⚡⚡⚡ High ⚡⚡ Medium ⚡ Low

major forces behind the increase of collection cycles we have seen over the last years. This has already led to an average shortening of collection calendars of about 40% across the industry. What we currently see is an even further accelerated flow of information and innovation largely triggered by digital and social media.

At the same time markets became less and less predictable. Overall consumer confidence has been going up and down about 40 percentage points within just one year according to Eurostat and specific products' success is even less foreseeable considering speed of trends and competitive dynamics nowadays. This will lead to a further reduction of overall collection calendars from concept to in-store. It will also put pressure on those who already achieved calendar shortenings to now really leverage the benefits from being closer to the market by also having the right techniques in place to interpret newly available short-term market information and translate them into targeted actions.

4. Crowd Product Development: With the market requiring brands to be even closer to consumer needs the importance of consumer input into product development is further increasing. This does not necessarily mean letting consumers design products, but it definitely means involving consumer input into the product development process. This will include the use of selective social media communities for sketch and prototype feedback and utilising the means of digital media

for gathering immediate consumer innovation input early in the process.

5. Mass Customisation: The career of “mass customisation” as a long-term marketing buzz word cast more and more doubts on real life relevance the longer no real traction was visible in the market. With new technologies now being available to support customers in customising products and brands in providing tailored products suited for mass markets, the topic is now for the first time going live (as, for example, the extensive Adidas mi collection shows). Starting with sportswear, mass customisation has not yet arrived at classical fashion apparel brands, but no doubt sooner or later it will be a requirement to think about how to restructure sourcing operations in relevant product groups to be able to deliver customised products on a 1-3 week consumer lead time.

Supply Side Innovations

Looking at the production cost index values (PCI) of China over the last 15 years, we can see that when the big shift to China started we had a PCI of 36 (compared to UK 100) which made it sufficiently attractive to move production over there. In the following years productivity gains and abundant labour supply further drove down production cost in China resulting in a PCI of 14 in 2005. Since then production costs have been steadily increasing again as salaries grew and capacities got scarce. Now in 2013 we are back at a PCI of 38 for the

coastal sourcing regions of China and further increases are to be expected for the coming years. So what next on the supply side?

1. Total Cost Optimisation and Near Sourcing:

Growing production cost in today’s key sourcing markets and the increasing need for fast reactivity on market impulses will require apparel companies to change the focus from a pure optimisation of FOB to an optimisation of total cost of product development and sourcing. While a pure production cost perspective leads us to Bangladesh, Cambodia, Vietnam and China; a total cost perspective will balance the potential cost disadvantage of near sourcing markets against gains from faster product development interactions with better hit rates, better buy plans resulting in less markdowns, and better estimates of required volumes leading to better availability and lower inventory levels (see fig. 5). As a consequence, future sourcing portfolios will still contain low cost markets for products on low price points with good predictability, but also contain near sourcing locations for everything that strongly profits from being able to react fast to consumer demand. With markets like Romania, Tunisia, and Morocco not being far away from the production cost in China, the gap to close is, in many cases, not too big.

2. New Sourcing Markets on the Rise: With cost indicators of almost all sourcing markets showing upwards, the search for the next China or new Bangladesh is in full flow especially for the lower priced segments. While infrastructure, capabilities, quality, and CSR requirements are still major obstacles for the currently discussed hot candidates including more evolved ones like Cambodia and Vietnam, and less evolved ones like Myanmar and Ethiopia, the coming years will show which of these aspirants have the true potential to

provide a stable and efficient environment, are able to reliably handle significant volumes, and thus can establish themselves as major players on the global sourcing landscape.

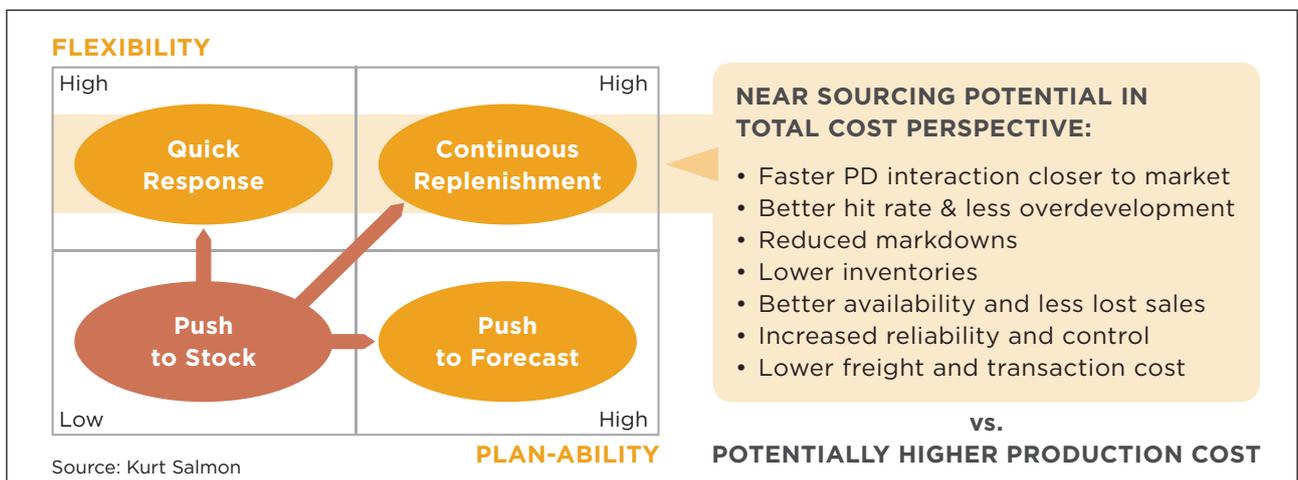
3. Cross-Value Chain Collaboration and Optimisation:

Providing transparency, being faster, and mitigating risks effectively all require a much stronger involvement of apparel brands and retailers along the textile value chain. This will include close interactions and collaborative optimisations with regards to nomination of fabric suppliers, certification and auditing, material research and development, capacity planning, fabric planning and blocking, sampling, and quality assurance. A much broader utilisation of benefit and risk sharing models with strategic suppliers will build the foundation for mutual optimisations. Already today continuous forecast exchange and material blocking are able to cut down lead times by 30 days.

4. Leveraging Off-Shore Capabilities:

With increasing complexity of global sourcing portfolios considering multiple demand regions and an intensifying need for closer collaboration along the value chain product development, sourcing capabilities are key to ensure control and optimisation. But how to manage operations along the complete value chain involving a multitude of partners without building up excess resources? And where to find corresponding capabilities which have long since vanished in Western Europe? The key lies, depending on the type of business model, either in leveraging agents or building up own off-shore product development and sourcing capabilities which can cater for the new requirements. Especially with regards to product development there is a clear tendency to use shared PD-staff in the Far East, this is already visible today.

Fig. 5: Supply Chain Mode Selection based on Supply Chain Risks



Technology Innovations

Technology will prove to be the critical enabler for staying on top of change dynamics. This will both include tools for providing transparency to allow targeted optimisations and specialised systems for design and development which will reshape the way products are being created. Lastly products themselves will experience a stepwise 'technologisation'.

1. Advanced Product Lifecycle Management (PLM): The increasing need for cross-value chain transparency, control, and optimisation will give a further push for the proliferation of PLM solutions which cover the entire product development and sourcing workflow. Already in our most recent survey 58% of respondents planned corresponding investments. PLM will prove to be the key enabler for analytical optimisations from material and trim standards down to technical development, costing, prototyping, and quality assurance. On top of this the next wave of 3D technology requires to be embedded in a comprehensive PLM concept. Thus PLM is not just the basis for today's optimisation of cycle time, COGS, margin, and SG&A but also the prerequisite for a lot more that is still to come.

2. 3D Design, Prototyping, and Printing: 3D is a technology which inherits true revolutionary potential for the apparel industry. While today only a few players have started to make use of 3D in the fashion industry, their experience shows tremendous future potential. The main focus of 3D usage is at present the design and product development process which is significantly accelerated at reduced cost (e.g. for proto samples) and enhanced quality and product innovation. In addition, 3D samples are powerful and efficient sales tools replacing physical salesman samples

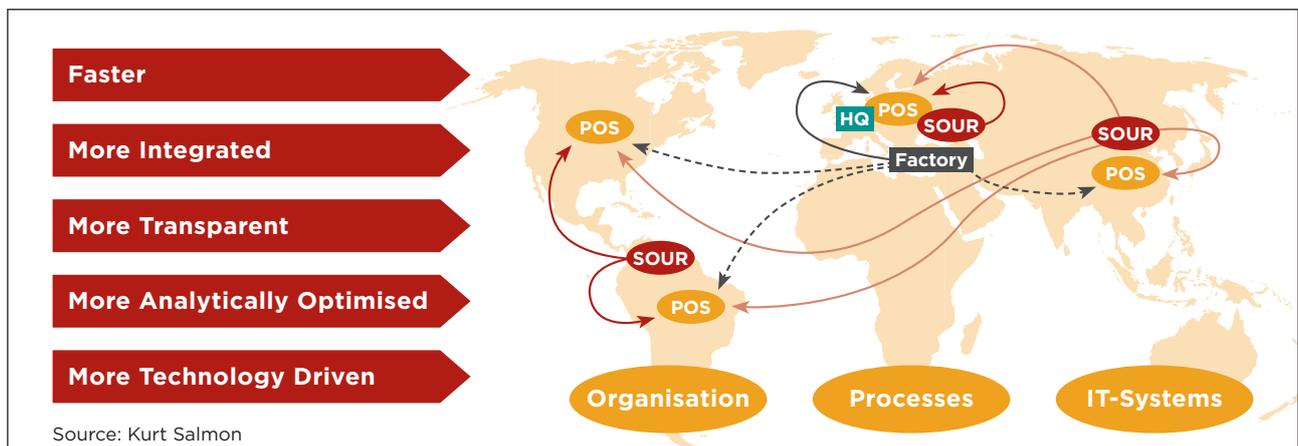
and complementing graphical visualisation in B2C and B2B interactions. Whilst first steps are being made in 3D design and development, the application of 3D printing is still far from being mature. Leading edge retailers already experiment with 3D printing for footwear prototyping and achieved reductions of proto turnaround times from several weeks down to 1-2 days. At the same time 3D printing has been adopted initially in mass customisation for tailoring components to individual consumer needs. In summary: The potential is tremendous and we will see a lot of movement in 3D design and development in the short- and midterm, 3D printing will remain a niche while technology evolves further.

3. The Next Edge: Apparel with Technique: In sports and outdoor wear, value added ingredients reducing perspiration, drying more quickly, or filtering ultraviolet rays are already available in the market and will without doubt further proliferate into other segments of the apparel industry with additional new applications. At the same time digital technologies are slowly starting to sneak into the apparel sector. First pilots include weaving of electronic fabric into clothes allowing storage of energy from the body, shirts which can charge electronic devices (e.g. a mobile phone), and clothes which can warm the wearer with electronically conducting materials. Even prototypes of colour switching fabrics and skirts displaying uploaded and even moving pictures have been developed. All these applications are still far from being suitable for the mass market, but when looking for the real avant-garde these are developments pointing farther in the future of fashion.

What Does it Mean for us Today?

While some of the discussed innovations are currently not more than a thin shadow on the

Fig. 6: Key Drivers of Future Fashion Sourcing Models



horizon, others are already closer than we might expect. This especially applies to the potentially disruptive risk factors in the sourcing environment. Sourcing executives need to be conscious of the vulnerability of each of today's key sourcing regions and need to actively ensure a balanced sourcing portfolio including alternatives in case disruptions hit. This will also require having a closer look at the newly emerging sourcing markets in Asia and Africa, and potentially reactivating near sourcing regions in Eastern Europe.

Similarly, demand side, supply side, and technology innovations are currently in different states of maturity and of varying relevance depending on the business model of individual fashion companies. However, overall there are five key directions all these trends point to. Future fashion sourcing will be faster, more integrated, more transparent, more analytically optimised, and more technology-driven

to be able to effectively address the expected innovations (see fig. 6). Apparel retailers and brands already need to work on improving these dimensions to ensure that the basic building blocks are in place to be able to profit from the innovations to come. This encompasses significant changes in organisations, processes, and supporting systems.

Proven Success

Kurt Salmon has more than 75 years of experience in fashion product development and sourcing. Kurt Salmon has successfully supported apparel brands and retailers globally in building the foundation for the future of sourcing. This included both the build-up of comprehensive end-to-end sourcing models to serve all global markets and the operational optimisation of sourcing processes and portfolios to operationally enhance margins and cost of sourcing.

CASE STUDY 1: BUILD UP OF A GLOBAL SOURCING MODEL

A leading global fashion player with a strong portfolio of apparel and footwear brands distributed in all world regions possessed historically grown sourcing structures owned by different brands which stepwise joined the portfolio. This included direct sourcing, use of different agents, and own sourcing offices serving US, European, and Asian markets. Kurt Salmon supported the client with setting up a comprehensive product development and sourcing model to serve brands according to their specific needs while leveraging synergies and efficiencies at global scale. The programme encompassed:

- Assessment of sourcing frameworks, requirements, and potentials of the different brands of the portfolio and definition of future sourcing service offering of the new shared sourcing organisation
- Definition of common global sourcing processes and organisation with capabilities in Asia, Europe, and South America to cover product development and sourcing services according to individual brand needs
- Operationalisation of new sourcing model and support of change management and implementation planning and execution across four continents

The project resulted in shorter product development calendars and production lead times, FOB improvements of 3-5% pts and optimised efficiency of global sourcing structures.

CASE STUDY 2: SOURCING STRATEGY AND OPERATIONS

A strong European fashion brand came under increased cost pressure causing diminishing overall gross margin and EBITDA. Kurt Salmon supported the client with identifying key levers for short-term enhancements of cost of goods sold and building the foundation for optimised sourcing efficiency. The project included:

- End-to-end analysis of product development and sourcing processes and identification of improvement levers for short-term quick wins and sustainable enhancements
- Development of an optimised sourcing strategy including an improved global country portfolio, strategic suppliers, and targeted capabilities for different product groups and price points
- Enhanced target costing, cost management, supplier relationship and negotiation processes to leverage cost potentials

The project resulted in short-term improvements of cost of goods sold of 5% pts during the project based on developed quick wins and further midterm potentials of additional 5% pts in COGS.

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