



The Due Diligence That Retailers Should Do Before Turning Sourcing Operations Over to an Agent

This January, the world's largest retailer, Wal-Mart Stores, agreed to turn over purchasing operations for certain apparel lines and other goods to Li & Fung, the world's largest sourcing agent. The deal could generate \$2 billion in revenue for Li & Fung this year alone, helping the Hong Kong-based firm reach its 2010 revenue target of \$20 billion, more than triple its sales of 2004 (Bloomberg, Jan. 2010).

But the landmark deal marks more than a boon for Li & Fung. It also foments the popularity of a growing trend: Retailers of all types are shifting product sourcing to agents. The benefits for such a shift can be compelling: a quick boost to cash flows, reduced overhead and minimized operational complexity.

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But despite the many reasons retailers may choose to outsource some, most or all of their sourcing activities, there are also several potential pitfalls to doing so. (We stress the word "potential" here because they are not inevitable and they can be avoided through striking the right contract with an agent and managing the relationship carefully.) The two major types of possible pitfalls are product cost increases and being one step removed from manufacturing.

Product cost increases

Sourcing agents make money through the commissions they charge retailers. For most retailers, such commissions will be higher than the cost of a well-run internal sourcing office. In addition, those commissions can increase if a retailer misses the revenue target it sets with an agent. Furthermore, a retailer who aggregates purchases of fabric, trim and other product components and negotiates big price concessions with suppliers can face higher component costs by going through an agent who doesn't negotiate the piece goods directly with the mills and suppliers.

Being one step removed from manufacturing

This can lead to time-to-market, quality and compliance problems. Even within their four walls, many retailers are familiar with delays and dropped handoffs in design, development and sourcing operations. Putting sourcing into someone else's hands runs the risk of additional delays and dropped handoffs, especially if both organizations lack the technology to link their systems and product development processes. In addition, a retailer has to be sure that a sourcing agent maintains the retailer's product quality standards. Furthermore, many retailers have adopted corporate social responsibility (CSR) standards that determine labor, environmental and other practices. Certain manufacturers used by a sourcing agent may not comply with those standards. All told, inserting another party between a retailer and its product suppliers can increase the risk that its goods arrive late, are of inferior quality or are manufactured through undesirable practices.

Unfortunately, these pitfalls and many others are often overlooked during the due diligence phase of this major financial decision. A retailer's fixation on the cash it will receive for its sourcing operations can lead to inadequate upfront attention to product cost, quality and cycle time setbacks that will offset some of the deal's benefits.

We are not suggesting retailers should shy away from exploring outsourced sourcing to agents. However, because products bring customers in the door (physical or virtual), a sourcing relationship that goes sour can have a devastating impact on a business. In light of the magnitude of what's at stake, we argue that turning over sourcing to agents is a board-level decision, one to be scrutinized with the same rigor as an acquisition or divestiture. From the due diligence phase to contract negotiations and sourcing agent management, successful deals are those that optimize the potential financial and strategic benefits without putting the product offering at risk.

In the last few years, we have helped many retailers strengthen their sourcing operations. About a quarter of these firms worked with agents for some or all of their programs. To learn more about how these retailers and others are successfully using sourcing agents, request the second part of this series on outsourced sourcing.

LEARN MORE

You will find the second part of this article on optimizing your outsourced sourcing strategy at www.kurtsalmon.com/outsourcingsourcing2.

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