Kurt Salmon

INDUSTRY INSIGHTS

Private Equity Readies Portfolios for Margin Squeeze

Portfolio company managers face a new threat to performance: supply chain inflation. Kurt Salmon estimates apparel wholesalers and retailers can expect a 15% to 20% increase in total landed costs for 2011. With only a modest recovery to date in consumer spending, new inflationary concerns mean intensified margin pressure for management.

Having benefited from two decades of deflation in key input costs, most apparel business managers are not accustomed to dealing with rapid cost increases, and higher prices for consumers are almost inevitable. Kurt Salmon estimates that prices could rise as much as 10% to 15% on average across the industry before this year's holiday shopping season. But the concern, of course, is national consumer sticker shock.

To defend against this and margin pressures, private equity managers need an objective and rigorous assessment of how supply chain inflation will affect their portfolio businesses' bottom lines over the next year, as well as a comprehensive brand assessment and pricing strategy that reflects the competitive dynamics of the segments in which the companies compete.

Supply Chain Inflation

In recent months, there has been a considerable amount of media coverage on the skyrocketing costs for U.S. soft goods manufacturers. Indeed, the industry faces product cost pressures not seen in decades. Shifts in cotton and oil prices, Asian labor rates and China's currency are driving up key components of supply chain costs.

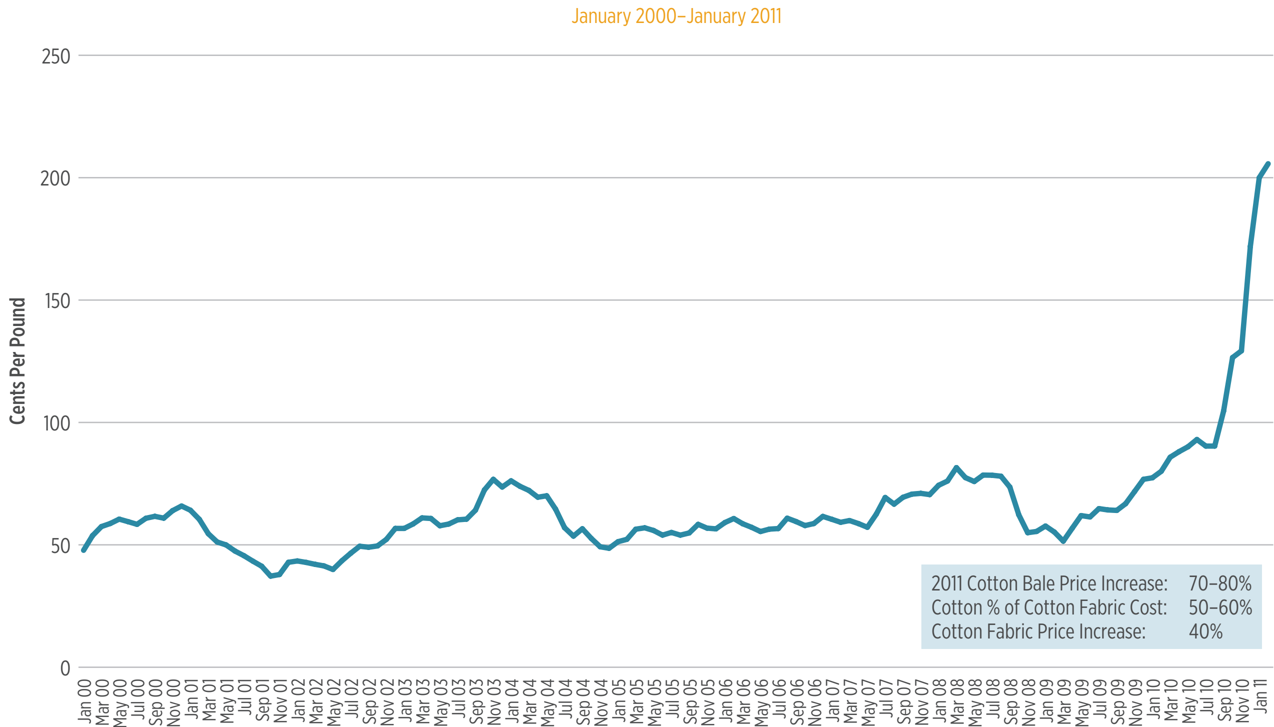
Cotton

Cotton prices have more than tripled since 2000, including a 122% jump in 2010. (See Exhibit 1.) Rising global demand, especially in China, coupled with a shortage in supply, led to demand outpacing production by 14% in 2010. The supply-demand dynamic is expected to normalize by summer 2012, but until then, cotton bale prices are expected to increase 70% to 80% over the next 12 to 18 months, translating to a 40% increase in the price of cotton fabric.

Synthetics

The price of synthetic materials is also rising as more manufacturers substitute synthetic fabrics for cotton in their clothing and as the cost of petroleum increases. Over the next year, apparel and soft goods manufacturers can expect a 10% increase in synthetics prices.

EXHIBIT 1: Cotton Prices



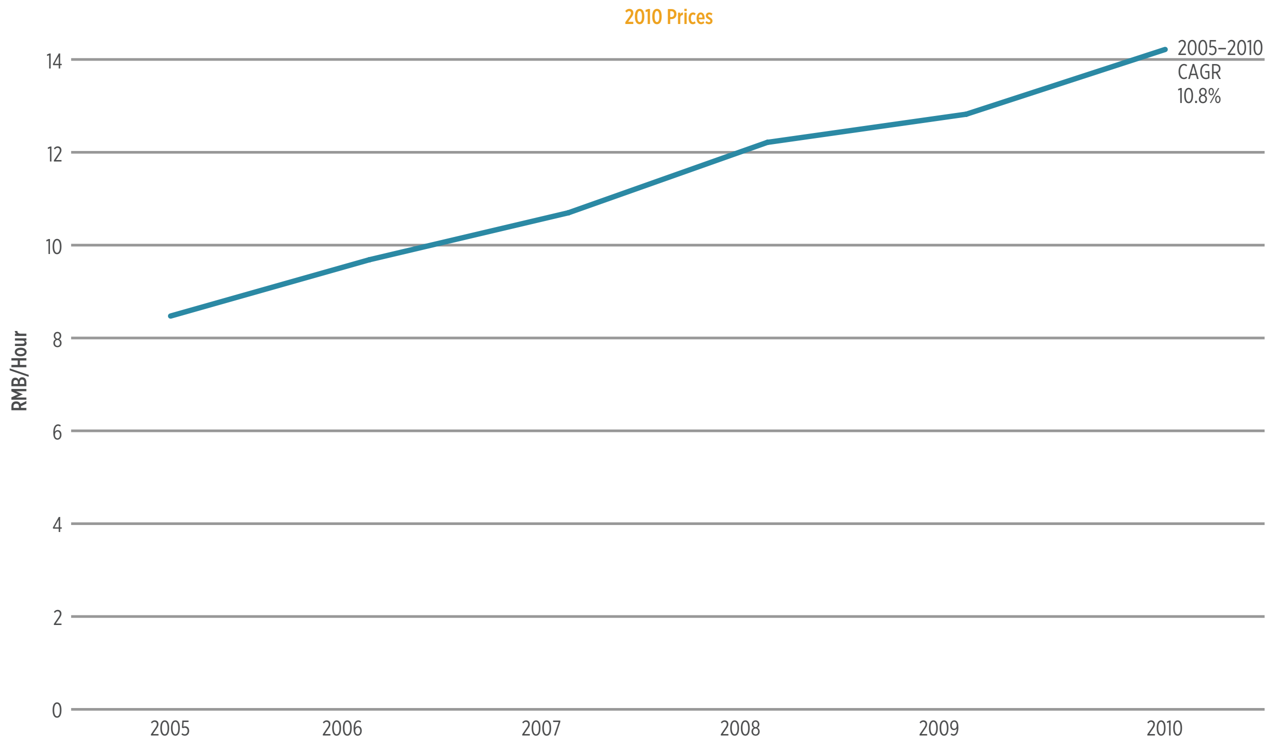
Source: Emergingtextiles.com, Data.tradingcharts.com; Kurt Salmon Research

Asian labor rates

Growing domestic and export demand, especially the increased capacity necessary to support fast-fashion retailers, has created labor shortages in China. These labor shortages, plus a new Chinese government mandate, mean wage increases for Chinese workers. Further, the heightened development of China's interior provinces is exacerbating labor shortages in Southeast Asia.

These factors are expected to drive a 10% annual increase in Chinese labor costs for the foreseeable future, with similar increases in other Southeast Asian manufacturing hubs (e.g., Vietnam, Malaysia, etc.). (See Exhibit 2.)

EXHIBIT 2: Chinese Labor Rates For Manufacturing Jobs

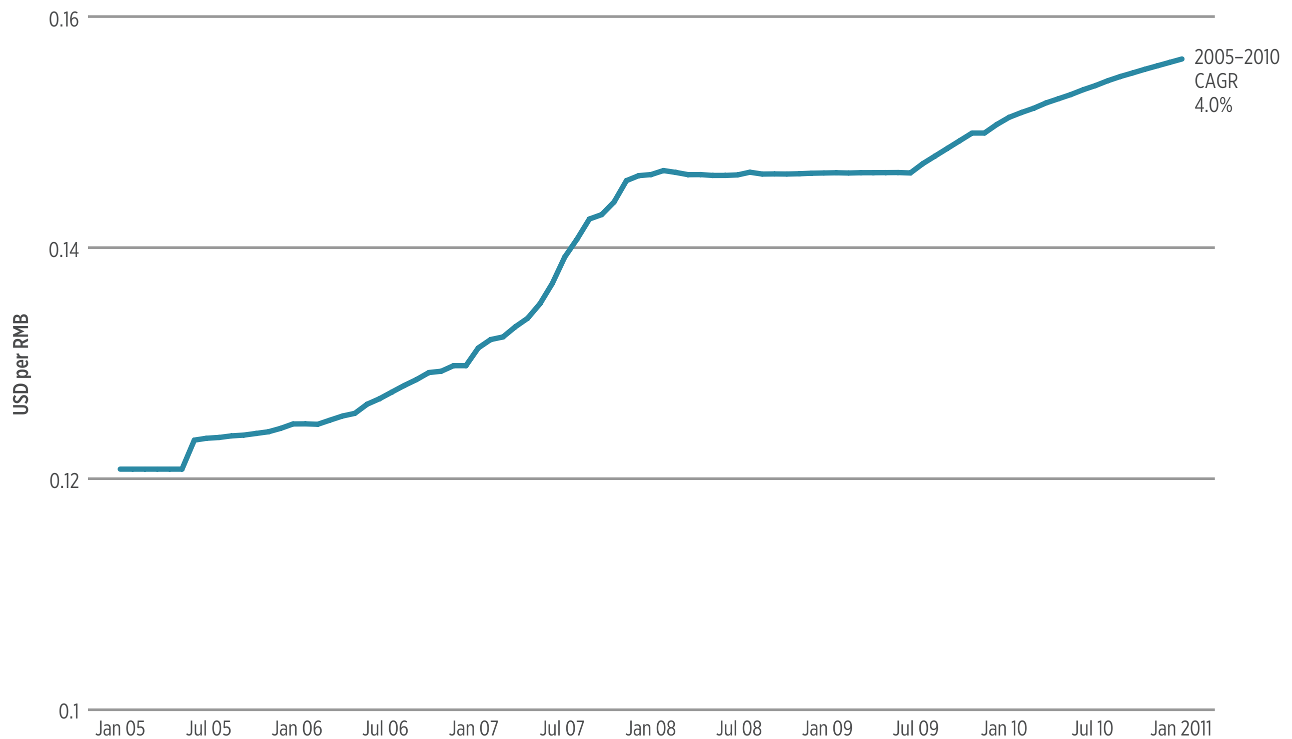


Source: State Administration of Foreign Exchange of the People's Republic of China; People's Bank of China, Kurt Salmon interviews.

Currency

The RMB has appreciated 4% annually against the dollar since 2005 and is expected to continue appreciating gradually. (See Exhibit 3.) The U.S. Congress is applying political pressure on China to raise the value of the RMB and claims the RMB is up to 40% undervalued. However, China has stated its desire to make the Yuan an international currency, which would require stable exchange rates and make rapid appreciation unlikely. We expect 4% annual inflation in the cost of Chinese goods to continue for the foreseeable future.

EXHIBIT 3: RMB Appreciation

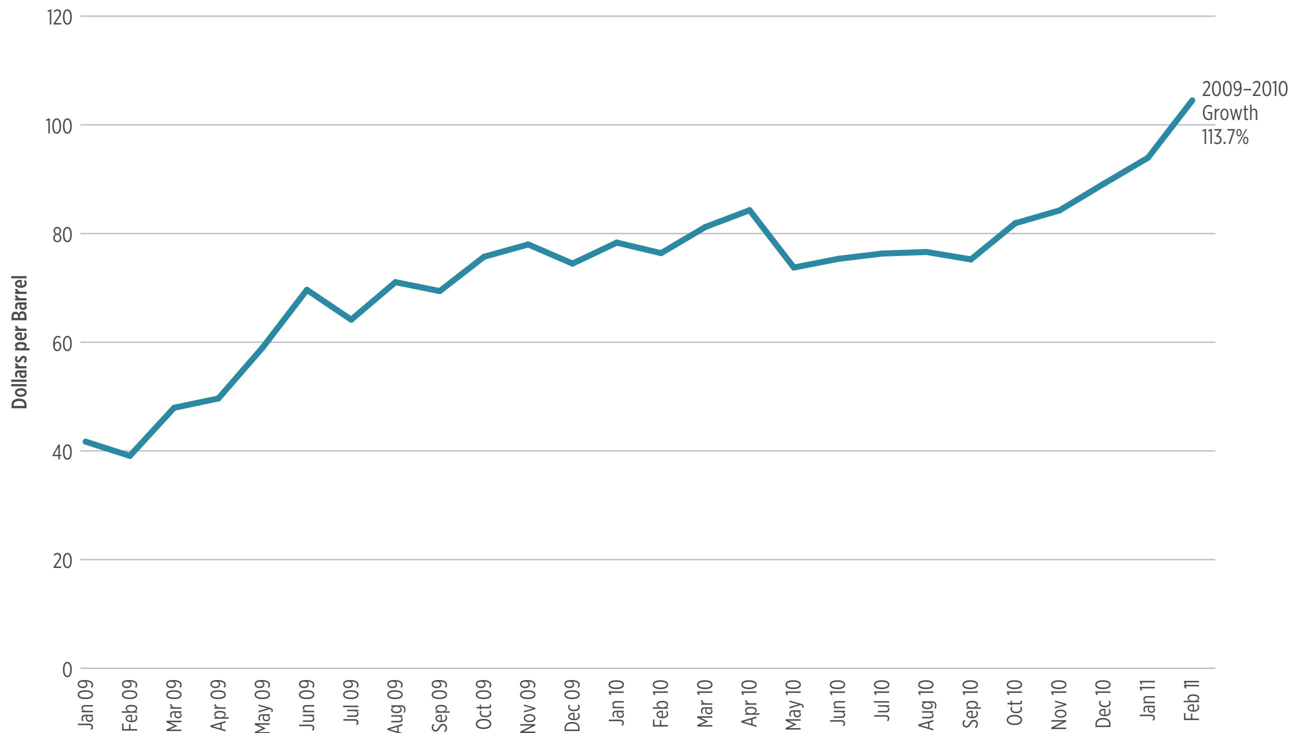


Source: State Administration of Foreign Exchange of the People's Republic of China; People's Bank of China. Chicago Mercantile Exchange

Transportation

A typical apparel company has already experienced a 5% to 20% increase in transportation costs in 2010, as oil prices have increased 30% in the last 12 months and 17% since year-end 2010. (See Exhibit 4.) We expect this trend will continue through 2011, with an estimated 10% increase in transportation costs over the next 12 to 18 months.

EXHIBIT 4: Daily Crude Oil Spot Price



Source: U.S. Energy Information Administration, Kurt Salmon analysis

The net result, Kurt Salmon estimates, is a 15% to 20% increase in total landed costs for 2011 (mainly in the second half of the year), with a smaller increase likely in 2012. (See Exhibit 5.)

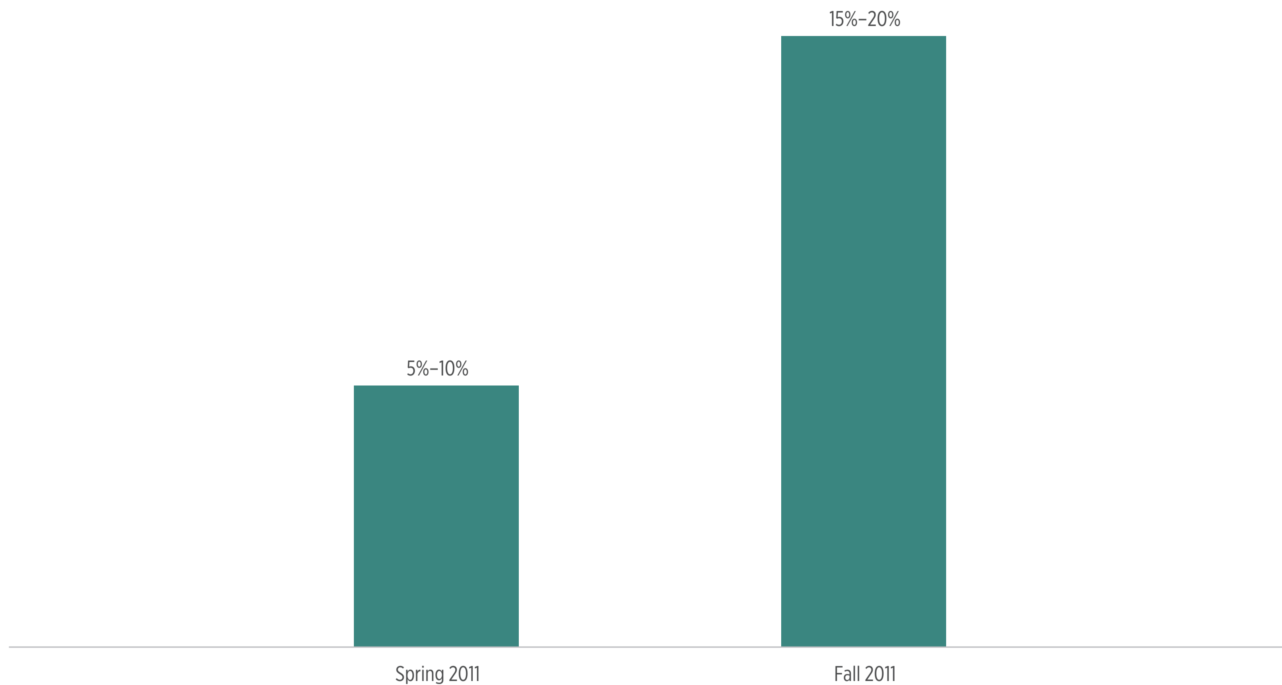
The Bottom Line

We expect that well-run apparel companies will be able to recapture approximately 85% of landed cost increases through higher prices, cost reductions and more efficient operations, meaning 15% of landed cost increases will ultimately impact margins. The most successful companies with strong products and strong brands will likely be able to further raise prices in subsequent years to eventually recapture a portion of this 15%. For companies with neither operational flexibility nor powerful brands, the impact on margins could substantially reduce long-term enterprise value.

Response Strategies

Management teams can respond to supply chain inflation by raising prices, managing inventory more efficiently, reducing markdowns and promotions, and lowering sourcing and non-product costs. Management teams are struggling most with raising prices, as there is still a great deal of uncertainty around

EXHIBIT 5: Anticipated Increase In Landed Costs for U.S. Apparel Companies



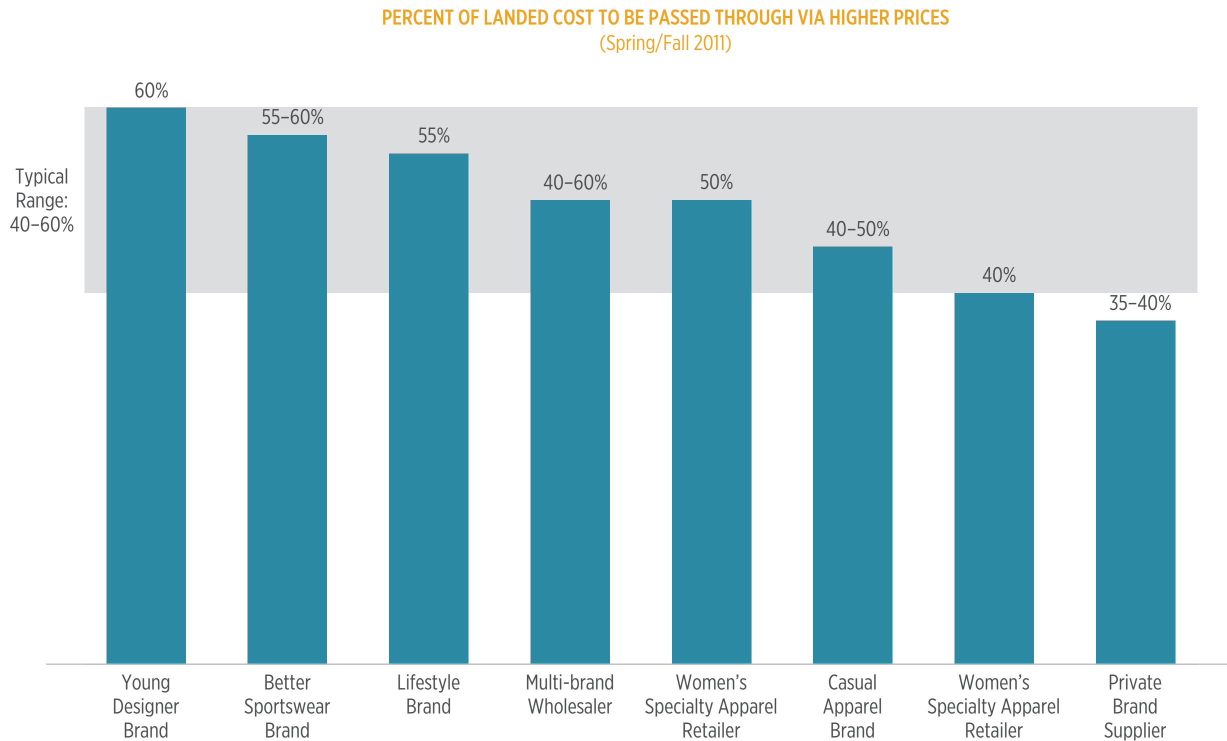
Source: Industry interviews; Kurt Salmon analysis

consumers' willingness—and ability—to absorb price increases given the slow economic recovery, high unemployment rate, depressed housing market, and increased food and fuel costs. But, ultimately, raising prices is almost inevitable for many brands.

Just how much brand managers can raise prices is driven by brand and product strength and the ability of core customers to pay more. In apparel, for example, many Kurt Salmon clients say they are planning to pass on 40% to 60% of landed cost increases through higher prices. (See Exhibit 6.) These are not unilateral price increases. Instead, the critical component is analyzing the entire SKU portfolio to understand which product prices should increase and by how much based on the existing assortment, brand strength and competitive landscape.

Finally, in the short term at least, deal-makers should scrutinize cost mitigation and pricing plans more closely during due diligence. Many apparel companies, for example, have likely locked in purchases for the first half of this year, but efforts should be made to ensure that cost increases later in the year are adequately reflected in management's margin projections.

EXHIBIT 6: U.S. Apparel Industry Pricing Plans



Source: Industry interviews; Kurt Salmon analysis

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