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# FROM COST FOCUS TO TRUE VALUE CREATION –

ON THE ROAD TO  
ANALYTICAL SOURCING  
& SUPPLY CHAIN



**GLOBAL SOURCING REFERENCE**

13TH EDITION 2017

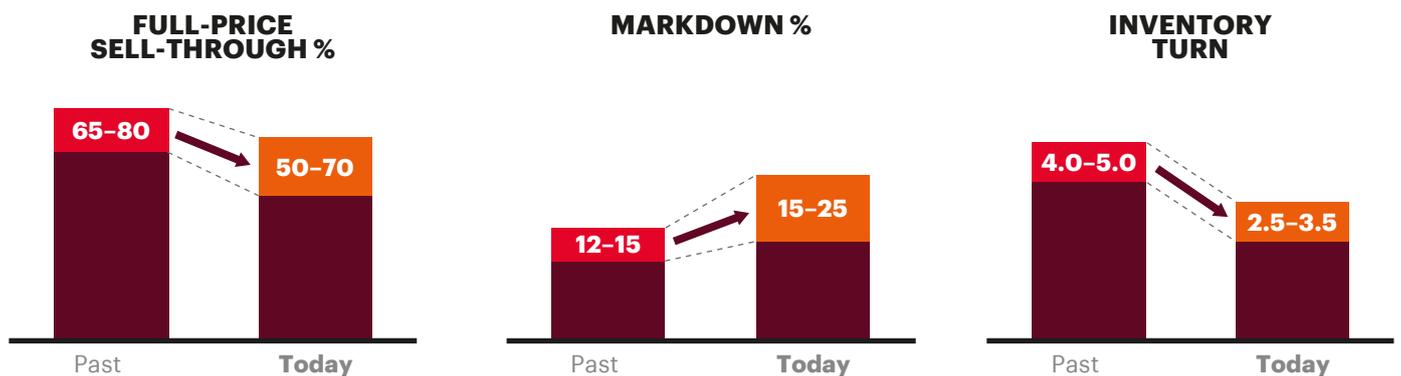
# From Cost Focus to true Value Creation – On the Road to Analytical Sourcing & Supply Chain

## Cost Increases hit Fashion Industry in Transformation

It is no secret that fashion retailers and brands currently find themselves in a tremendously challenging environment. An abundance of apparel and footwear products coming in fast cycles of innovation is offered across a broad spectrum of retail and online channels available to customers almost anywhere and anytime. Consumers have more transparency and choice than ever resulting in an extremely competitive environment for brands and retailers who cannot afford any shortfalls with regard to latest trends, at most competitive prices, technical innovation, quality, and most appealing overall assortment structures.

The development of central performance indicators for fashion retail in the recent years is well documenting the current challenges (see exhibit 1). Many fashion brands suffer from high inventories and suboptimal sell-through, which cause strong markdowns and diminishing margins. Full-price sell-throughs between 65% and 80% and stock turns above 4.0 to 5.0 have been more a rule than an exception in the past. Today both commercial fashion brands and premium/luxury brands struggle to maintain comparable levels. Often, even total sell-through falls to levels below 70%, causing inevitable margin losses from skyrocketing markdowns far beyond benchmark levels of 12% to 15%.

EXHIBIT 1: Pressure on KPIs driving gross margin



Source: Kurt Salmon, part of Accenture Strategy

In parallel to these challenges from market and demand side the apparel industry is faced with a continuous increase of cost in the classical sourcing markets resulting in even stronger pressure on overall gross margin performance of the business. In line with these developments this year's Global Sourcing Leadership Survey shows the combination of Demand Market Price Pressure, increasing Labor Cost and increasing market requirements on reactivity and speed as top three concerns. The results of the cost analysis of this latest issue of the Global Sourcing Reference study again shows Production Cost Index (PCI) values sharply on the rise across all main sourcing regions (see exhibit 2).

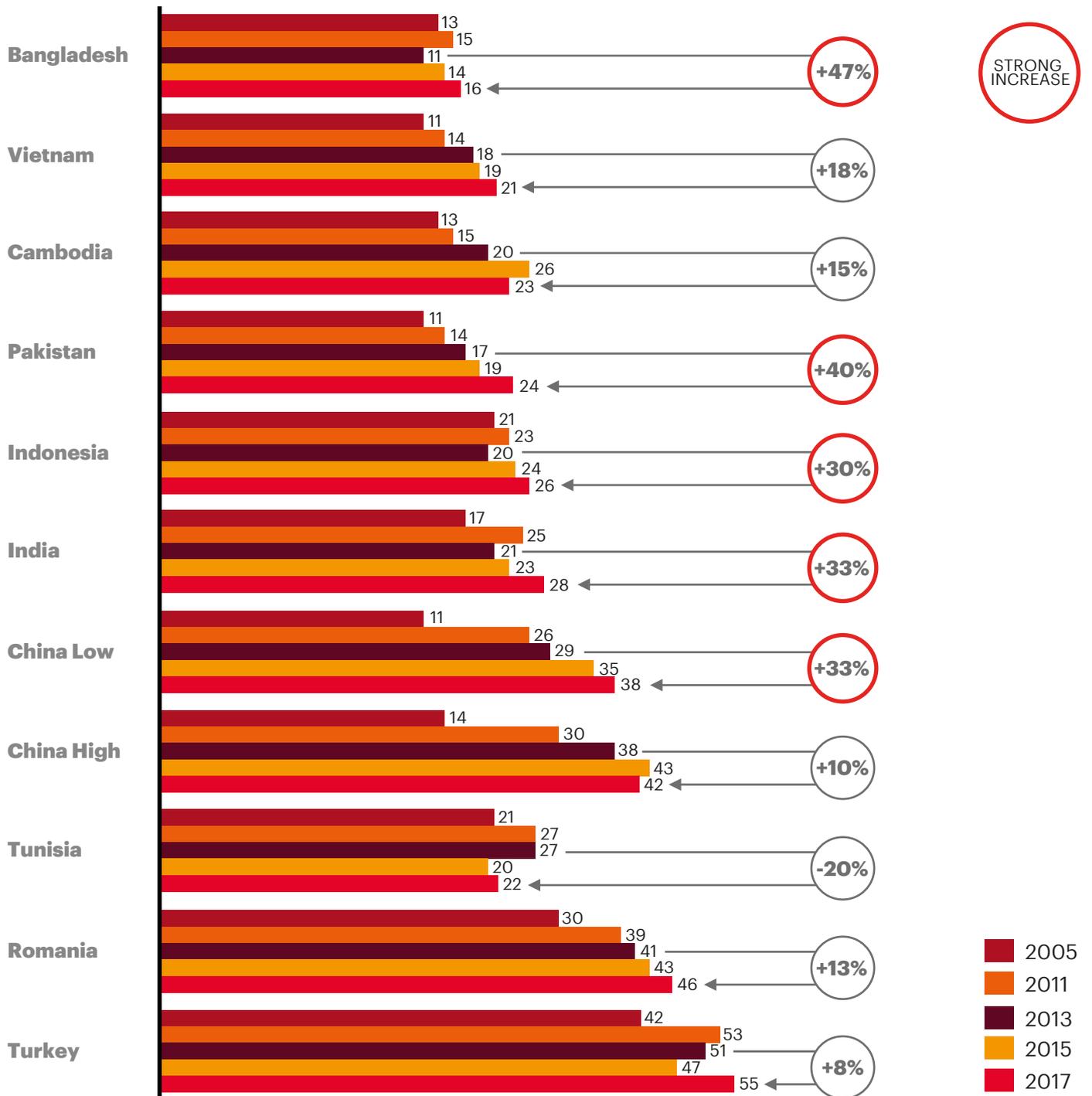
Global increases of cost for apparel and footwear production have steadily continued during the last two years. Sourcing markets with stable costs are rare while the vast majority showed strong to very strong increases of production costs. This does not only affect China which has already been on a strong upward trend for many years, but also many of the typical low-cost sourcing destinations in South East Asia like Bangladesh, Pakistan, and Indonesia. Recent cost increases have been driven by both rising labor costs and strengthening local currencies in the sourcing markets versus US Dollar and Euro.

The higher labor costs are not only rooted in rising minimum wages in developing markets, but also in strengthening competition for skilled factory workers and growing alternative work offers especially in China.

Facing these strong cost increases in key sourcing markets, brands and retailers continue to search for alternatives in their global sourcing portfolios, shifting their production from more established yet increasingly costly regions (e.g. South-East China)

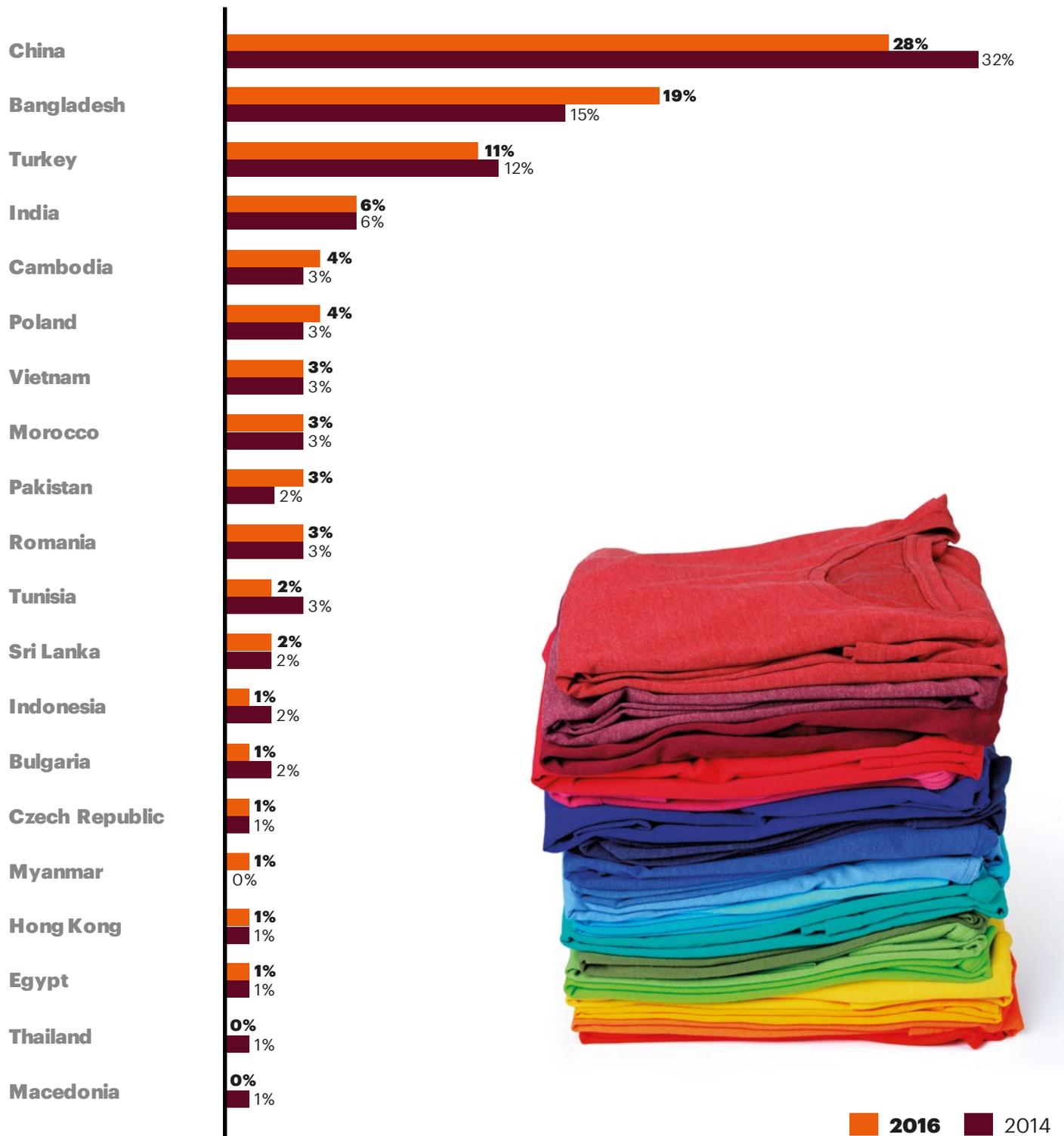
to less developed but cost-wise promising regions (e.g. Western China, Myanmar, Cambodia). While this is easing the pressure on the cost side in the short term, it is adding clear risk on flexibility and operational performance as well as product quality and corporate social responsibility. In addition capabilities and capacities for selected product groups are not available in the same breadth and quality, limiting the opportunity for larger shifts of volume especially of products on higher price points and with more sophisticated technical requirements.

**EXHIBIT 2: Selected Production Cost Index Developments 2005 to 2017 (PCI Europe)**



Source: Eurostat; data downloaded on 31 March 2017

### EXHIBIT 3: Import Shares of Top Apparel Exporters to EU15, 2016/14



Source: Eurostat; data downloaded on 31 March 2017

These cost developments on the production side are mirrored in the shifts between sourcing markets (see exhibit 2). Though facing a continuing decrease in market share, China is still by far the biggest exporter of apparel to the EU with 28% ahead of Bangladesh (19%), which continues gaining sourcing share. Turkey and India are the next biggest exporters to the EU. Also near sourcing destinations

for Europe managed to increase their stake in the sourcing landscape with especially Poland and the Czech Republic gaining significantly in relevance. In terms of concentration, the share of the top 5 countries has been roughly stable since 2013, now accounting for 67%. Far East importers represent 72% of the value of Top 20 countries, whereas Greater Europe stands for 22%, and Africa for 6%.

## From Sourcing Cost Focus to True Value Creation

While shifting volumes to “even lower cost countries” might appear as a possible way out of the “gross margin trap” the true effects are limited. An item which is sold for 100 USD retail price and cost of goods sold of 20 USD usually contains labor costs of 6-10 USD (30-50% of COGS) (see exhibit 4). This example shows that a 10% reduction of labor costs has only a limited impact of 0,6-1 USD, accordingly less than 1 percentage point in gross margin improvement.

Nevertheless, sourcing portfolio optimization is a relevant lever which requires continuous observation and enhancement. Especially the long-term development of production cost indices in our studies show that the shift from one sourcing country to another won't be a long-term answer, as almost all current sourcing countries are getting more and more expensive.

However, beyond production cost optimization there are much more powerful levers which are suited to build a truly differentiating answer from the product development and sourcing side for the current market challenges many brands and retailers are facing.

Looking at current markdowns of often 15 to 25 percent of net sales this is obviously a very powerful source of gross margin improvement. Each percentage point of markdown reduction immediately translates into

an equivalent in realized margin. A close alignment between product development and supplier can play a significant role in unlocking this potential by providing true consumer value and brand differentiation with regard to product innovation, time to market, reliability and execution excellence, as well as superior technical capabilities and quality.

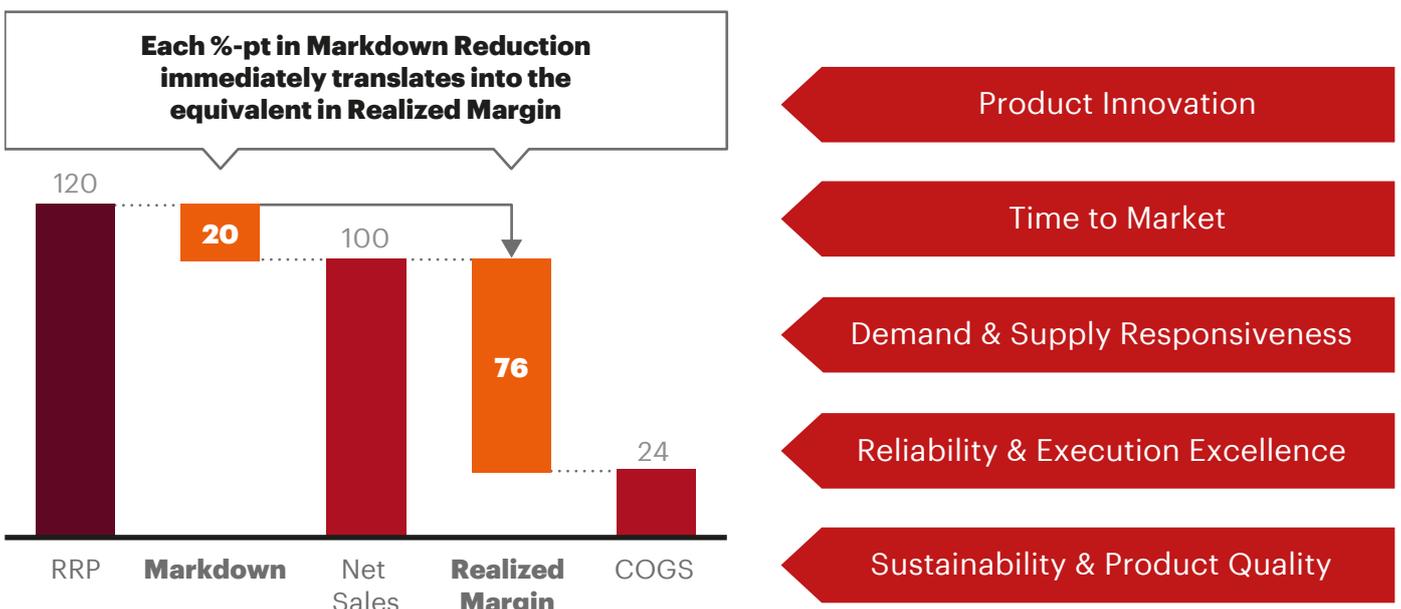
### 1. Product Innovation

In markets with an abundance of brands and less and less differentiating products, product development and sourcing capabilities move back into the strategic focus of fashion retailers. It's the key enabler for differentiation in the competitive environment. Access to deep technical expertise and unique handwriting of product groups that are critical for brand building as well as curated supplier portfolios with the true ability to drive innovation, evolve to an indispensable asset to drive top line as well as markdown and margin performance.

### 2. Time to Market

It is obvious that the speed of trends and innovation has tremendously increased over the recent years and consumers are adopting market impulses from option leaders, celebrities, and bloggers at high pace. This requires being closer to consumer needs with critical seasonal milestones on concept, design, and development for adoption of trend impulses as well as buying decisions to ensure market right products and quantities. Sourcing plays a critical role in enabling differentiated seasonal calendars based on individual product needs and a balanced mix of near shore and far east sourcing destinations.

**EXHIBIT 4: Additional levers and their impact on realized margin**



Source: Kurt Salmon, part of Accenture Strategy

### 3. Demand & Supply Responsiveness

A significant part of end-of-seasons stock and related markdowns stems from buying and production volumes being insufficiently aligned with actual consumer demand on the shop floor and online during full price selling period. Leading retailers and brands currently make significant investments to drive end-to-end planning integration along the value chain across retail, product merchandising, material management, and sourcing/production. Main objective is to act vertical while typically not owning the different stages of the value chain down to production.

### 4. Reliability and Execution Excellence

With shorter in-store product lifecycles, delivery reliability is more critical than ever before. A delivery delay of 1 or 2 weeks will strongly diminish sell-through performance if the overall planned lifecycle is only 8 weeks without any option to extend as following collection drops are already waiting to take the space on the shop floor. In this context, a reliable collaboration on both brand and supplier side will significantly increase importance and clearly dominate compared to short term FOB cost advantages.

### 5. Product Quality & Sustainability

Not many words have to be made about the critical importance of social and environmental responsibility in production – a factor which cannot be deprioritized versus cost anymore without risking the future of any apparel company. At the same time, also product quality compliance and unified standards – e.g. with regards to fit and construction – are gaining significantly in importance with online growth being unbroken. Returns from mismatch of expectations with regard to quality, size, and fit are a significant cost position which is difficult to effectively avoid without aiming for these root causes. While this usually means not choosing the short term minimal cost option, these levers have strong power to drive better sell-through rates, stock turns and a reduction of leftovers hence, positively impacting

markdowns and ultimately improving gross margin. This certainly compensates for higher production cost, and this does not even account for the top line sales potential from brand uniqueness and better differentiation vs. competitive offerings.

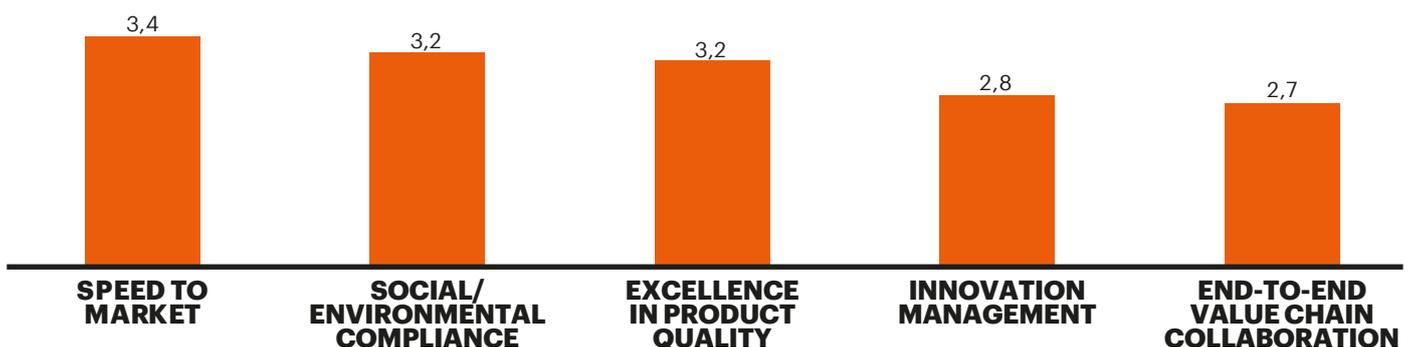
In line with these developments this year's Global Sourcing Leadership Survey clearly shows that cost does not lead the list of future priorities anymore. Instead, speed to market is stated to be the #1 sourcing priority by survey respondents followed by social and environmental compliance, quality, innovation management and end-to-end value chain collaboration (see exhibit 5). Asked about speed models like Rapid Replenishment, Test and Scale, Read and React or Trend Injection, two thirds of respondents have them either in place or are currently planning to introduce them.

## Intensified Collaboration and Range Segmentation According to Consumer Needs

These are priorities which let fashion brands and retailers rethink and reinvent their operating model with regard to collaborating and integrating across all internal stakeholders and tier 1 and 2 suppliers. Survey respondents expect a clear increase of tier 2 supplier management along different dimensions illustrating the return to a deeper value chain involvement of brands. In addition, the importance of oversea buying offices is expected to increase not just with regard to classical functions like supplier search, prototyping, and quality management, but also with regard to material management and technical R&D capabilities.

The definition of a clear Range Segmentation typically builds the foundation for the planning, development and sourcing processes targeted specifically to the consumer needs for each Range

**EXHIBIT 5: Priorities for Future Sourcing of Senior Sourcing Executives**



Source: Kurt Salmon, part of Accenture Strategy Global Sourcing Leadership Survey

Segment. This means setting up the entire value chain from Marketing/Product Merchandising to Design/Development, Costing, Material Management, Sourcing, and Production in a way that ensures an optimal set up and capabilities for innovation where uniqueness counts, time to market where quick reactions are critical, and supply responsiveness where consumer demand is volatile and stock is risky.

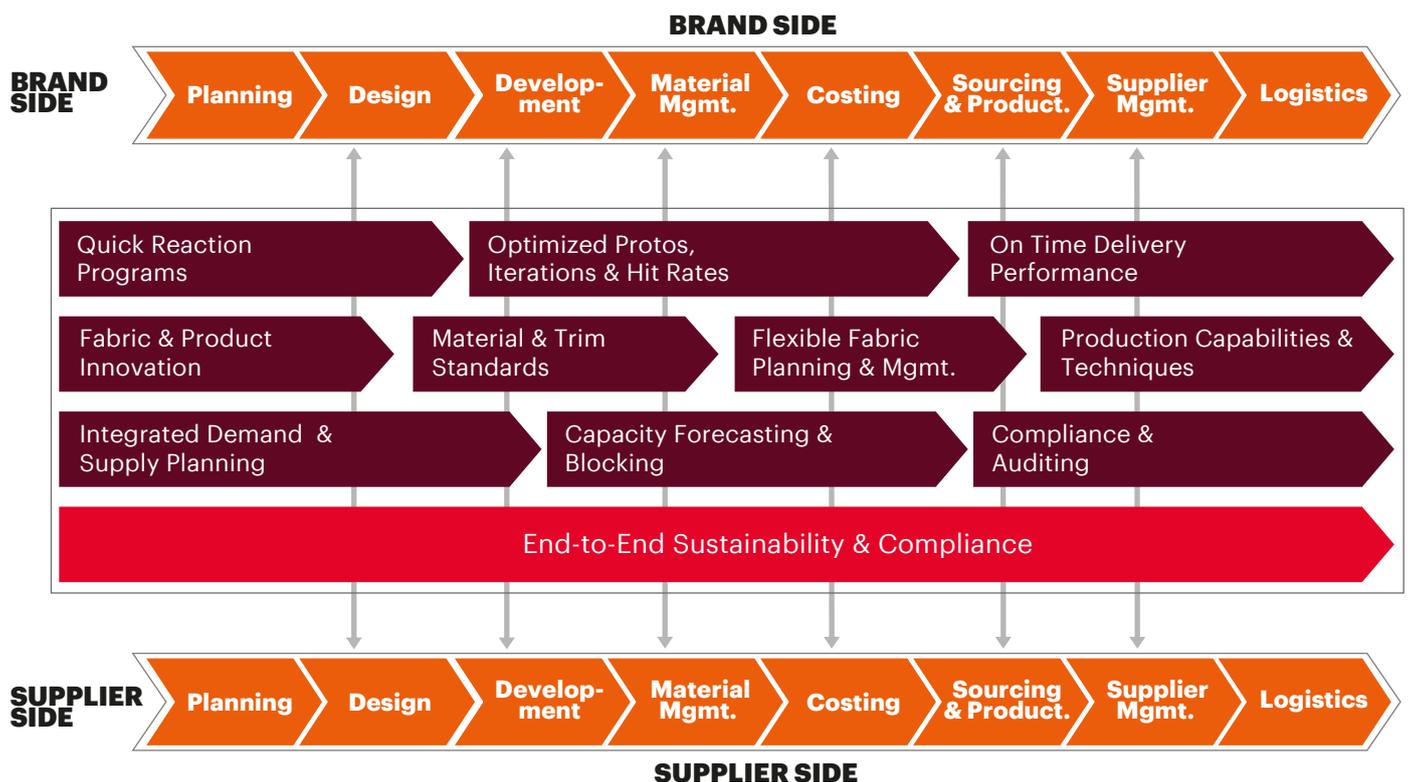
Differentiated supplier capabilities must be leveraged and developed in close collaboration along the entire value chain, from planning, through design & development, material management, costing, down to logistics (see exhibit 6). Intensified collaboration will also mean more common standards, definitions and KPIs. An integrated cloud-based database provides end-to-end transparency and control, internally as well as with third party suppliers. Furthermore, it allows a dynamic access to big data across the entire value chain and enhances predictive analytics for an improved merchandise planning, production capacity planning etc. In re-shaping the fashion value chain, technology will prove to be the key enabler to provide the tools for analytical optimization. Data transparency and the smart application of Artificial Intelligence will give retailers and brands the power to drive true value.

## On the Road to Analytical Sourcing and Supply Chains

Managing these consumer-driven differentiated supply chains requires a massive change compared to the classical model of the rather execution oriented sourcing function. It will only be achieved with a significant extension of today's analytical capabilities. This includes defining and tracking KPI targets along all stages of the complete process, differentiated based on product and market needs per range segment. Orchestrating the respective sourcing and supply chain capabilities will increasingly leverage digital interactions across all value chain partners, advanced predictive models, and emerging artificial intelligence capabilities to enable optimized decision making in volatile environments and on short timelines.

In summary taking such a consequent value driven product development and sourcing approach is a powerful lever to drive consumer benefit and at the same time realize significant improvements with regard to sell-through performance, stock turns, markdown, and gross margin. The benefits are by far outperforming potential short term gains from moving to the „even cheaper“ place in the global sourcing landscape. And most importantly this does not just apply to premium/ luxury brands, but also to mid-market and even value players.

**EXHIBIT 6: Intensified collaboration between brands and suppliers**



Source: Kurt Salmon, part of Accenture Strategy

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