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Keeping Inventory—and Profits— Off the Discount Rack

Merchandise Strategies to Improve Apparel Margins

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Despite overall growth, the apparel industry remains fiercely competitive, and sustained success is elusive to many. Over the last five to 10 years, the market has become increasingly saturated—particularly in the mid- to low-priced fashion segments, where retailers are struggling to win space in consumers' closets.

In response, retailers have honed their supply chain capabilities: Many are taking advantage of garment production centers, particularly in Asia, to offshore production to low-cost countries and they have developed rigorous competitive bidding processes for suppliers. However, in focusing their attention on saving a few cents per unit, they may be missing an opportunity to significantly increase profits through better design of their merchandise value chain.

Too many retailers have resigned themselves to long lead times, forcing them to push styles onto consumers with little trend insight, simply hoping that they get the trend right. The frequent result: a few hit items that sell at full price and a mountain of slow-moving inventory that has to be marked down, sometimes significantly. This also results in volatile quarter-to-quarter performance, with revenue numbers depending on whether the majority of items caught the key trends or missed them. So common are sales at markdown that some companies now devote considerable management time and effort to sophisticated markdown strategies. Worse, they have

trained their customers to wait for the sale rather than buy at full price. This approach is inefficient and brings retailers mediocre results.

To generate superior returns, specialty apparel retailers need to keep inventory off the clearance rack in the first place. To do this, retailers must develop new capabilities that more explicitly link product development with supply chain management. The integration and coordination of these activities and decisions will go a long way toward delivering the clothes customers really want, season after season; selling more at full price; and structurally eliminating markdowns.

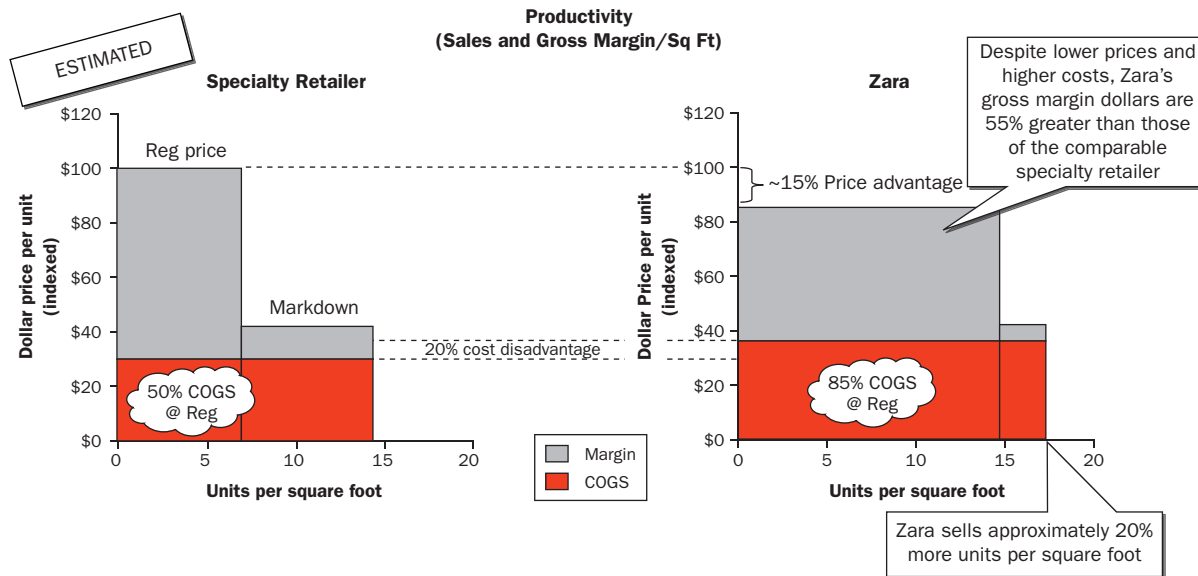
I. Together Again: Aligning Design and Production

The alignment of product development, sourcing, and distribution is the key to delivering winning product ranges. Before today's global garment-production system evolved, design and manufacturing teams worked closely together, rather than in separate silos. That coordination allowed them to solve problems as products were still being designed or were on the factory floor. Today, however, many value chains focus on negotiating the best price with vendors rather than on getting the product right. Although costs will always remain critical, retailers must develop more effective strategies than cost cutting to reach customers with products they really want.

Zara, owned by Inditex Group of Spain, is often cited as a retailer that consistently gets its product right. At every step, the company's focus is on getting the right product into stores at the right time. Instead of the

Exhibit 1

Gross Margin Productivity: Zara versus Specialty Retailer



Source: Company financials and Booz Allen Hamilton

industry standard yearlong design and manufacturing process, Zara works on a lead time of just six weeks (sometimes less) for its fashion-forward items. Designers, merchants, manufacturers, and even store managers work closely together to speed the entire process, allowing Zara to pounce on the latest trends.

As a result, Zara is confident that it will not have to discount its garments as often as other retailers, allowing the company to price competitively from the start and drive sales volume. The result is superior store-level economics and strong returns to the bottom line.

For example, our analysis suggests that a competing specialty chain may sell a black dress for \$100, with a \$30 cost of goods sold and an initial margin of \$70. Zara can offer a comparable dress at \$85 with a higher cost of goods sold, \$35, and a lower initial margin of \$50. On a hit-for-hit basis, the traditional specialty retailer earns more. However, because its store is full of on-trend products, Zara sells 85 percent of its inventory at the regular price, compared to the 50 percent that its competitor sells. In addition, Zara's fast-moving products allow the company to turn over its inventory more often. The combined result is that Zara stores generate 50 to 60 percent higher gross margin dollars

per square foot per season (see Exhibit 1). Given the fixed store costs in apparel retailing, this lift in gross margin can drive massive value to the bottom line. In essence, Zara has innovated its operating model to systematically eliminate the cost of markdowns.

II. Winning Strategies

How can retailers get the right clothes into their stores at the right times to achieve impressive returns? They need to develop three distinct strategies that can work in combination: optimized product lead times¹, staged manufacturing, and strategic partnerships with vendors.

Strategies that bring speed and flexibility to the business allow retailers to shape their inventory at points where profits can be maximized. Waiting to manage inventory until clothing arrives in retail outlets, then using markdowns to bolster revenue, is a flawed strategy. Once products are on the shelves, it is impossible to raise prices on the most popular items and difficult to get new shipments of top sellers in time to increase volume. Meanwhile, markdowns on less popular clothes may cannibalize profits from new full-price merchandise.

¹ In this context, "lead time" is defined as the time from which a product is conceived to its arrival in stores. This is also sometimes also referred to as "cycle time."

Optimizing Product Lead Times

The first strategy is to optimize product lead times for different types of clothing, basing them on the predictability of consumer demand. This helps to balance the costs of getting the product to market faster against the potential upside of generating more full-price sales. One element of this is shipping—for example, sometimes it might pay to ship a super-hot item by air to get it into stores quickly; for a timeless style, however, it would probably make more sense to lock in a low price with vendors many months in advance and ship by sea. For success, lead time must be optimized across the entire length of the value chain.

To optimize lead times, retailers need to rip apart the traditional, prolonged product-development calendar that still rules apparel design and production. The calendar should be redesigned to balance the value of time-sensitive items against the cost required to deliver those items more quickly. For many retailers, a

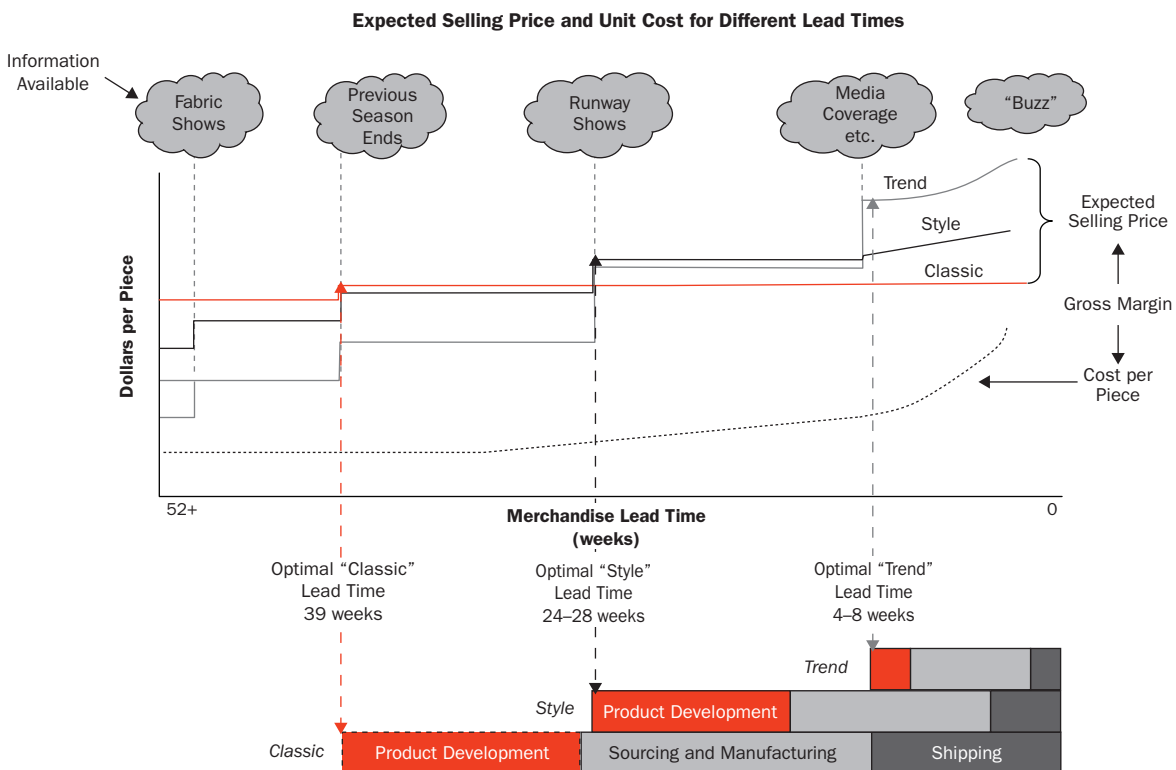
pair of basic men's blue jeans and a trendy women's knit top follow the same product-development and manufacturing timetable—despite the fact that the two garments have very different sensitivity to fashion trends. The top is highly dependent on the latest trends, whereas tastes in men's basic jeans remain much the same from year to year.

Retailers need to segment their products into different models on the basis of the speed–cost trade-off. We have found that a maximum of three models is the ideal balance of flexibility and complexity. For each of the three models described below, there is a unique value chain that maximizes gross margin by addressing the most important needs of the garment (see Exhibit 2):

1. Trend: White-hot items that have a short shelf life, sometimes only weeks. Women's tops typically fall into this category.

Exhibit 2

Economic Trade-offs: Apparel Items



2. **Style:** Fashion-oriented collections that can last through several seasons, often with more original design. Examples include form-fitting trendy denim jeans.
3. **Classic:** Garments that endure over time and can potentially live over many years, like the tried-and-true white button-down shirt.

To develop a design and production schedule that suits each category, retailers must factor in the times at which important sources of fashion information become available during the course of the apparel industry's annual schedule.

At the start, about a year before garments arrive in stores, fabric mills unveil their new ideas in texture, color, and patterns: One year, new bouclé fabrics may emerge and capture the imagination of designers, and the following year, plaid may be the rage.

After the new materials are introduced, high-fashion designers begin to form consensus on the fabrics they will use and start to create new styles and shapes for their collections. For the key fall and spring seasons, leading design ideas begin to appear at runway shows in New York, London, Milan, and Paris about 24 to 28 weeks before garments arrive in stores. Soon after the runway shows, magazines begin to highlight their top picks, and trend-setting celebrities are seen wearing the latest looks on the red carpet.

Locking in a design six to nine months in advance may guarantee favorable production terms with vendors, but retailers have little information at that point about what will be trendy. Such an early commitment to inventory levels increases the risk that a garment will be out of fashion when it hits the shelves and will have to be discounted. The results can be significant: Early production commitments might save \$2 per unit on a shirt that costs \$10 to source and that sells for \$35 at full price. However, if the shirt is not what customers want and does not sell quickly, the \$2 savings is more than offset by a typical markdown of \$10 to \$15.

- **Trend Model:** For the trendiest clothing, companies should be able to design, manufacture, and ship goods to stores in just four to eight weeks. Some of

that speed depends on manufacturing capabilities, but most of it lies in the retailers' own internal processes. Retailers with best-in-class lead times have design and selection processes that take as little as one week, compared to 30 to 40 weeks for traditional retailers.

- **Style Model:** When it comes to product ranges that are less trendy, but are still influenced by current styles, retailers can stretch out lead times to focus more on quality and cost than fashion pressure. In this merchandise segment, design should take place 24 to 28 weeks before the garments arrive in stores. At this lead time, sales information from the same season a year earlier is available, and retailers will be able to react to designer runway shows. Both are key sources of information that will help shape design and planning decisions. It is still difficult to gauge this far in advance exactly what the customer will demand, but broad trends, such as a growing interest in cashmere, will begin to break through.
- **Classic Model:** For classic garments, longer lead times are acceptable as demand is predictable. In this segment, retailers should focus on keeping costs down and ensuring production availability. Still, this process should take place no earlier than 39 weeks before delivery to stores. The sentiment "out of stock is lost revenue forever" holds true for classic merchandise. Consumer demand for these garments is more predictable than for the other two segments, and retailers can monetize this predictability by optimizing inventory and reorder levels. With seamless information flow from the point of sale to the vendor, retailers can effectively pass ownership of manufacturing and shipping to the vendor. Additionally, because these products are the least trend-sensitive, items should not be redesigned every season—only when an update is needed owing to changing customer tastes (which normally becomes clear through sales data).

Retailers that have a range of products incorporating items from the trend, style, and classic categories must segment their development model into multiple streams to accommodate each product segment

Exhibit 3

Supply Chain Trade-Offs for Apparel Items

		“Trend” Model	“Style” Model	“Classic” Model
	Objective	Offer latest-trend, market-relevant product with frequent introductions	Create market-relevant, “collection-based” product assortment on a seasonal basis	Provide lowest total cost products, while maintaining availability
	Total new product lead time	4–8 weeks	24–28 weeks	39 weeks
Product Development	Designer focus	Trend adaptation	Original design, collection coherence	Subtle modernization
	Fabric flexibility	Some	Maximum	None in short term, complete in long term
Sourcing and Manufacturing	Sampling guidelines	Samples avoided to maximize speed	Sample until perfect	Sample until perfect
	Vendor capabilities	Speed, flexibility	Quality, innovation	Low cost, quality
	Indicative product cost (indexed)	1.1	1.0	0.9
Inventory Management	Inventory selection	Broad and shallow	Balanced	Narrow and deep
	Average product life	2–6 weeks	6–26 weeks	26+ weeks
	Product replenishment	None—scarcity creates buzz	Replenish where cost-effective	Replenish to maintain 100% availability of SKUs

Source: Booz Allen Hamilton

(see Exhibit 3). Those that do not do so, relying instead on a one-size-fits-all pipeline, will lose the opportunity to optimize their product portfolio.

Using this approach, we put together a design and production model for an apparel retailer that reduced lead times by one-third. Of the time saved, a significant portion came from changes made in the retailer’s own design process. One key was to restructure the work so that designers who had been working simultaneously on three different seasons could focus instead on one season at a time. Designers had previously lost time as they switched among the different seasons. Restructuring the design and production system did not change the workload, but eliminated the overlap, thereby removing six to eight weeks from the process.

The retailer was able to make another improvement in sampling, which tends to drag on for weeks while designers, vendors, and merchandisers e-mail and ship work orders, revisions, and garments back

and forth. We suggested that the retailer dispatch designers to vendors’ plants to speed the sampling process and, potentially, improve on the retailer’s own designs earlier in the process, when corrections could still be made. This change cut another four weeks from the process.

All of this is possible with existing vendors. Retailers who think it can be done only if they build their own production facilities are believing a myth. Zara is able to achieve these lead times with external vendors comparable to its captive factories.

Staged Manufacturing

The second strategy apparel retailers should develop is staged manufacturing, in which some capacity is held back until the selling season starts and consumer patterns begin to emerge. Even after a company has gathered as much fashion information as possible as early as possible, it can still be difficult to predict the exact items customers will want most: For example, ponchos might be in fashion, but in which colors and sizes?

Staged manufacturing allows for the adjustment of later production runs to reflect trends showing up on the retail floor. Most retailers do not sufficiently stage their commitments: On average, the industry commits 40 to 60 percent of the anticipated sales in a preseason inventory commitment. This can be reduced to as little as 15 percent of anticipated sales, levels achieved by best-practice players like Zara. In these cases, the vendor reserves future capacity—to finish the job after the retailer has digested early feedback on the first run. Staged manufacturing can help reduce dependency on forecasting, which remains hit-or-miss.

For instance, a retailer could order an initial load of knit shirts dyed red, tan, and navy, but reserve additional production of tops that are not yet dyed. Once the first shirts hit stores, the retailer could use point-of-sale data to detect which color was selling best. In addition, conference calls with store managers could give prompt feedback on why consumers were purchasing certain colors. The retailer could then relay this information to the manufacturer, who could then dye more tops in the most popular color for the final production run.

One retailer used this approach with women's denim jeans to get the right color wash and sizes into the stores. The retailer set up a staged production system with the vendor in which 40 percent of the inventory was committed up front, with the rest to come after testing consumer responses. As a result, the company was able to capture a sales increase of 15 to 20 percent that would have been lost under its original merchandise plan because of out-of-stocks on size and wash combinations. This demonstrates that even where size prediction is reasonably accurate (as it was for this retailer), where there are a large number of SKUs (e.g., due to waist and length combinations in jeans), staged manufacturing can yield significant benefits.

An important element in this strategy is to identify which product variables matter most to consumers and which ones manufacturers can change later in the process. When it comes to denim jeans, the wash is typically very important to consumers and is a parameter that vendors can adjust quickly. Another critical piece

of this strategy is to order an initial load large enough to remain in stock until consumers make their preferences known and the vendor can deliver the remaining staged inventory. An alternative is to develop a rapid piloting capability in select markets to collect similar data on a smaller sample (and hence batch) size.

Certain apparel items, fabrics, and finishes are more suitable for staged manufacturing than others. For example, it is much easier to delay the decision on which graphic will appear on the front of a T-shirt than it is to delay the choice of a woven fabric for a button-down blouse. For the T-shirt, the graphic is sensitive to the latest fashion trends and is easy to add at the last minute. Delaying this commitment can have significant margin benefit. However, if the fabric design itself is the element that makes it trendy—for example, for a woman's tweed jacket—retailers have less flexibility: the finishing touches, like buttons and trims, are often the only aspects of the garment that can be delayed. To effectively leverage the benefits of staged manufacturing, retailers must evaluate what aspects of the garment are trend-sensitive—graphics, wash, trim, etc.—and then determine how long they can delay the decision on those aspects.

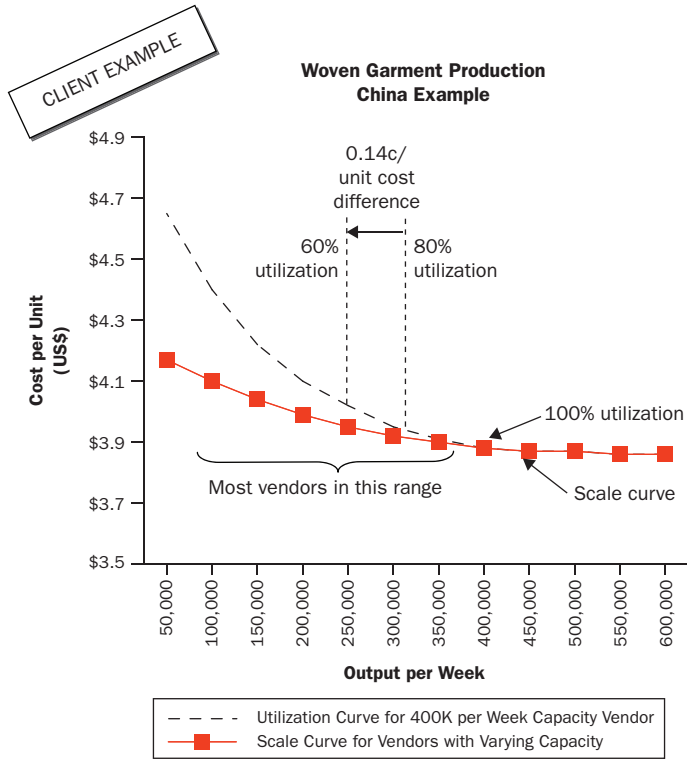
Strategic Vendor Management

Along with optimized product lead times and staged manufacturing, retailers can use a third strategy to achieve impressive returns: building stronger, longer-term partnerships with vendors to create efficient design and manufacturing systems that focus on quality, performance, and flexibility, rather than just price. In the end, these strategic sourcing relationships can help both retailers and vendors improve operations and margins.

Vendors may be willing to reduce their prices significantly when they have long-term business relationships with apparel retailers that would mitigate the risk that their factories might someday stand idle. For instance, Booz Allen Hamilton designed a strategic sourcing plan for a retailer using woven garment production in China. The model shows that a typical vendor that can increase plant utilization from 60 to 80 percent would drop unit prices enough to reduce the

Exhibit 4

Woven Garment Production: China Example



Source: Booz Allen Hamilton

Key Takeaways

- Utilization is a key driver of unit cost in many categories
- Security of long-term strategic contracts enable vendors to improve utilization and price-in a portion of the savings
- Opportunities to drive scale exist in some areas, e.g. wet-wash process
- Additionally, strategic relationships create a vehicle for total quality improvement around critical customer issues such as garment fit, wash durability
- Impact of strategic sourcing was estimated at 9%–12% of COGS for one client

retailer’s cost of goods sold by an estimated 9 to 12 percent (see Exhibit 4).

Manufacturers are not only worried about plants and equipment gathering dust: They need to keep skilled workers busy or risk losing them to competitors. Although there is a vast pool of low-wage workers in most garment-manufacturing centers, skilled workers, particularly sample makers, are critical to ongoing operations and are in high demand.

For retailers, the impact that strategic sourcing can have on quality and, ultimately, retail margins is the most important reason to reexamine their approach to sourcing. For example, shoppers find it frustrating when a store sells size 8 pants that do not all fit the same. The problem can be eliminated if retailers work closely with their vendors to understand and resolve the elements of design or manufacturing that are the source of the inconsistency. The vendor, however,

needs the incentive of more business down the road to put in the effort.

Furthermore, retailers can benefit from strategic sourcing relationships with vendors who can pass along innovations, such as new fabrics or construction methods.

In terms of vendor-relationship management, the apparel industry is well behind other industries. In the automotive industry, Toyota and Honda have successfully used a performance-based approach to sourcing to improve quality, costs, and ultimately price. Rather than bidding out parts contracts from time to time just to keep their suppliers on their toes, the Japanese automakers take a more holistic, long-term approach to their relationship with suppliers. The two sides work together to reduce costs and improve quality throughout operations. A key to the relationship is that both sides agree on specific targets for improvement and work together to reach those goals.

The system is based not on transactions, but on relationships that rely on respect, knowledge of each other's operations, and continuous improvement toward flexible but realistic goals. Transparency is critical. In the automotive industry, some manufacturers and their suppliers openly discuss the supplier's costs and performance—not to squeeze margins but to objectively discuss how to further improve performance.

When retailers and their vendors share information, they gain insight into their partners' operations. That knowledge allows them to identify and capture value that will benefit both companies. In this setting, vendors are more likely to pass along potential improvements in product design, such as elimination of unnecessary stitching, that could cut costs or improve quality overall. In a typical apparel supply contract, in contrast, the vendor would just do the work as ordered.

Conclusion: One Size Does Not Fit All

With an extremely dynamic consumer market and rapidly changing consumer trends, retailers need to

ensure that they have the capabilities to understand evolving customer needs and develop flexible supply chains. Doing so will require a careful balancing act between competing priorities. New technologies and production capacity in low-cost countries have significantly reduced costs; but a quest for the lowest-cost supply chain will result in a longer, less flexible chain that may turn out products that customers no longer want or never wanted to begin with. On the other hand, an ultra-fast, flexible chain is likely to be cost-prohibitive. The key is to achieve a healthy balance between the two and to segment supply chain flows based on the characteristics of demand.

Though the three strategies described here can be implemented individually, retailers will maximize the benefits only by using all three in conjunction. By aligning design and production through optimized product lead times, staged manufacturing, and strategic vendor relationships, specialty retailers will be able to unleash the full potential of their brands.

Also contributing to this article were Michelle Vandebraak, Abbas Hasan, and Michael Pfitzmann.

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