Arming Retailers with Proactive Product Sourcing Strategies to Contend with Ever-Changing Market Dynamics

Executive Summary

Should a merchant be a strategic planner or a quick reactor? The glib answer is, yes. It's a reality in retail that, regardless of how much planning a merchant does, there will always be a substantial amount of scrambling during the selling season to convert opportunity into revenue. A great merchant possesses both proactive and reactive skills and understands when and how to apply each. Smart retailers leverage the accelerating global supply chain to establish a position that optimizes flexibility and profitability. They do this by creating an IT infrastructure that supports best sourcing practices and processes that unleash competitive advantage in the key demographics in which they aspire to dominate.

Given that in-season adjustments are a fact of life, there are at least three techniques for which retailers can position themselves to be nimble and respond quickly to their situational assessment:

- **A trial technique,** which enables retailers to capture in-market performance data prior to committing to product orders.
- **A pilot technique,** which brings product into the market very early in the selling season and allows the retailer to measure sales and adjust distribution for the rest of the season.
- **A domestic/import variable sourcing technique,** which combines sourcing options to balance in-stock and margin.

Using these techniques can help retailers serve their customers while managing their inventory investment. This white paper details each of these techniques and presents case studies – both real and hypothetical – to help envision their application.

The Recommended Techniques

Which technique should a retailer follow? That depends on its ability to manage fast turnarounds and decision-making. The recommended techniques below are listed in order of increasing sophistication.

- **Trial:** This technique involves identifying products believed to have strong potential, sourcing a small quantity of the product, determining a trial market and testing product sales. This simple technique hinges on the selection of an accurate trial market(s) that enables the retailer to properly extrapolate sales to the overall market and conduct a proper analysis of results. Because small quantities of product are being purchased, the retailer places less emphasis on cost negotiations during the trial; however, consumer pricing must be consistent with expectations of the overall market in order to get an accurate test. Results are analyzed, and only then does the retailer make product commitments, adjusting product design, specifications, order quantities, distribution, etc., as appropriate. This technique is easy for any

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retailer to pursue, but it requires the longest turnaround time of the three techniques recommended in this paper, since no commitment has been made to product prior to trial. Therefore, the trial is usually conducted in one season, and the product is ordered for a future season.

The primary advantages of this technique are the limited capital needed to implement the pilot and the ability to change any aspect of the product based on the results of the trial. For example, although trial pricing should be set at the expected market level, the retailer can adjust pricing or conduct pricing tests to identify the sweet spot at which they can drive volume. Once potential volume is determined, they can focus on cost negotiations in order to meet financial goals and inventory management through order flow and distribution. The trial's capital investment requirements depend on the speed with which the trial needs to be conducted. For example, with the most fashion-oriented products, time is of the essence, and retailers should expect to ship product by air. From an IT perspective, the key investment is in analytics and tools to select appropriate trial markets and to measure the success of the trial. Retailers should also aim to build a repository of test results to create increasingly pointed trials.

The primary advantage of the pilot is the immediacy with which its results can be applied in-market to the greater distribution.

The biggest disadvantage of the trial technique is the time delay between the trial test and ultimate roll-out, due to the fact that no commitments to materials or factory time have been made in advance. It is possible to combine the significant flexibility of trials with speed by expediting shipments once a commitment is made, but this option may be expensive due to air freight costs.

- **Pilot:** In this technique, retailers ship in early a small quantity of a product to which they have already committed mass quantities to gain intelligence for use during the primary selling season. The pilot enables these retailers to optimize gross margins and flow-through by pinpointing those markets and customers that will support the most sales and, importantly, to validate pricing decisions. Like the trial, this technique depends on accurate pilot market selection for the test to be meaningful. Unlike the trial, this technique involves making an inventory commitment prior to conducting the test and analyzing the results.

  The primary advantage of the pilot is the immediacy with which its results can be applied in-market to the greater distribution. The best way to maximize the program's efficacy is through POS allocation (or store-level distribution at the distribution center) so that unallocated product can ship from offshore simultaneously with the pilot. Since the pilot and the rollout typically occur during the same season, the pilot period is brief and requires a fast turnaround to leverage analytics for decision-making. Pilots are particularly useful for leveraging current market information to optimize existing buying decisions.

  The disadvantage of this technique is that there are limited changes that can be made to the product-pricing and distribution. If product attributes themselves don't resonate well in the pilot, they cannot be altered unless special arrangements are made to rework product that has been manufactured.

- **Domestic/Import Variable Sourcing:** Historically, retailers have defined their sourcing technique at a category level based upon brand positioning, pricing/gross margin targets and other key performance metrics. In recent years, we have seen retailers apply "smart sourcing" parameters, where a product can be sourced in more than one import country to handle localized issues, such as increases in the cost of raw materials and labor wages, political instabilities and weather or other "acts of God." The problem is, this smart sourcing was generally not dynamic enough to handle changes or improved knowledge within the season.

  We have started to see a unique fixture in the U.S. manufacturing landscape: the import manufacturer. All parties are starting to recognize that domestic sourcing does have a place in today's retail environment, since shorter lead times can be exploited for mid-season replenishment. The scenarios typically work as follows: pre-season or early-season shipments are sourced from offshore to maximize profit, and mid- and late-season shipments are sourced domestically to shorten lead times to stores. This more sophisticated approach looks at the entire season and factors in opportunity costs, such as out-of-stocks and inventory carrying costs.

Making the Sourcing Decision

The factors that need to be considered when it comes to the domestic/import variable sourcing technique include the length of the selling season, the extent to which the product is fashion-oriented, the flexibility of manufacturing capabilities and the financial tradeoffs between onshore and offshore production.

- **Length of selling season:** At first glance, this factor is self-explanatory and refers to the number of weeks or months during which product will sell. We break products into two groups: short (one- to three- month selling seasons) and long (four- to six- month selling seasons), since one might argue that items that sell for more than six months are not, in fact, seasonal.
- **Level of fashion:** This refers to how trend-driven an item is. A low-fashion item might be a basic product with an element of seasonality, such as T-shirts that change color palettes from season to season, pants, shorts, sleepwear, etc. Please note that bagged underwear and similar year-round goods do not fall into this definition of low fashion. High fashion refers to trend-driven items that are not likely to continue from one season to the next. Ponchos, which experienced a revival in the mid-2000s, are such an example. Level of fashion can also be related to demand predictability from year to year. Low-fashion items tend to have less volatility in sales compared with high-fashion items.
- **Flexibility:** This relates to the ability to access manufacturing capacity and move production from one location to another. Low flexibility might apply to products with valuable raw materials that may be hard to hold in multiple locations or heavy materials that would be difficult to move. It would also include situations where initiating a run of product in a new facility would be difficult due to start-up costs and processes. High flexibility would include easy access to required raw materials and relatively low costs for starting up new production vs. continuing to produce in the same location.
- **Tradeoffs:** This factor refers to quantitative measures of financial line item impacts. One point to consider is sales forecast accuracy, since more predictable demand enables planning further out in time, which is key for offshore production. Also, differences in the cost of goods and shipping between onshore and offshore will make one option more attractive than the other.

All these factors, taken together, create a framework (see Figure 1) for determining how a combination of offshore and onshore/nearshore can be effective for a retailer, looking at product-level situations.

Sourcing Framework

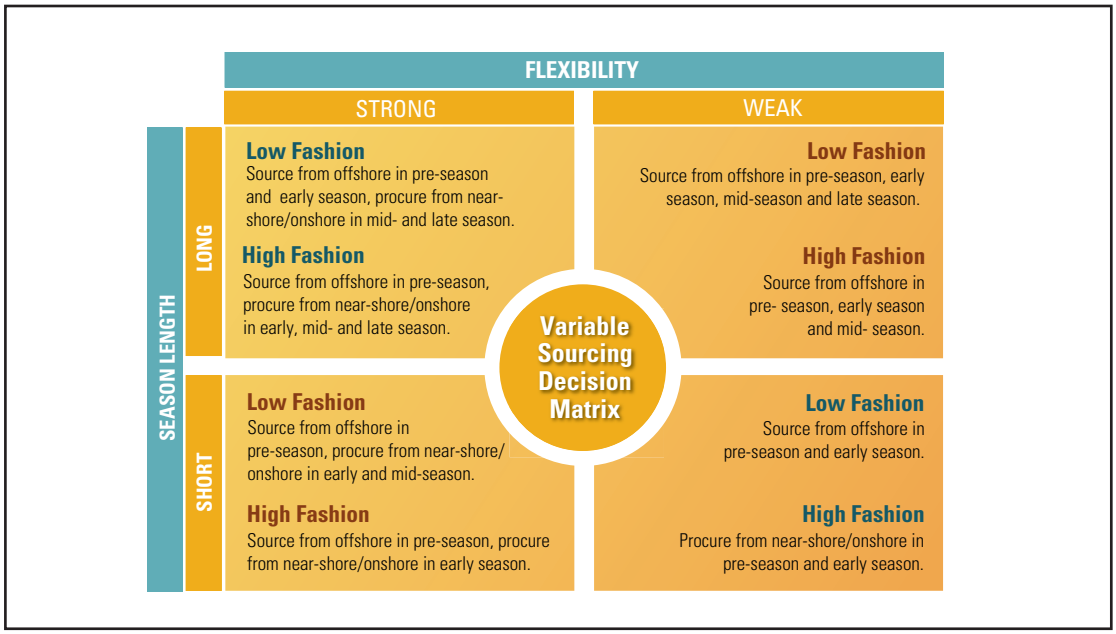

Figure 1

Strong Flexibility and Long Season Length

- **For low-fashion products with strong flexibility in a long season,** merchants can source product from offshore in the pre-season to set stores and fulfill early season demand. They place their orders four to six months before the start of the season to offshore vendors and plan the season inventory according to projected in-season demand. During the early season, they continuously monitor sales data with the help of real-time POS information. If product sales figures are encouraging, they procure from offshore vendors to fulfill mid-season demand; otherwise, they cancel their orders. During the mid-and late-season, after looking at sales and inventory, they procure from the near-shore/onshore vendors for the rest of the season. If they appear to have adequate or excessive inventory, they can cancel future orders and not switch to onshore/nearshore ordering. This technique enables the retailer to keep product in stock for the entire season, with a relatively low inventory risk.
- **For high-fashion product with strong flexibility in a long season,** merchants can source products from offshore in pre-season and fulfill early season demand. High-fashion merchandise items typically sell quickly and are then replaced with the next great styles; as such, the response time is short for these products. Therefore, merchants need suppliers with strong, flexible near-shore/onshore production capabilities for the rest of the season.

Strong Flexibility and Short Season Length

- **For low-fashion products with strong flexibility in a short season,** merchants source products from offshore in the pre-season to fulfill early season demand. During the early season, if sales figures are promising and manufacturing capacity is flexible, then merchants prefer to procure low-fashion items from nearshore/onshore to fulfill early and mid-season demand.
- **For high-fashion products with strong Flexibility in a short season,** merchants source products from offshore in pre-season and then procure products from near-shore/onshore in the early season. This inventory is then allowed to sell down for the rest of the season.

Weak Flexibility and Long Season Length

- **For both low-fashion and high-fashion products with weak flexibility in a long season,** merchants source products from offshore in pre-season to fulfill the early season demand. In the case of low fashion, they source the products from offshore during the early, mid and late season. For high-fashion items, because predictability of demand is less sure, they source from offshore in the early and mid-season, and product is allowed to sell down for the remainder of the season.

Weak Flexibility and Short Season Length

- **For both low-fashion and high-fashion products with weak flexibility in a short season,** merchants source products in the pre-season and the early season. For low-fashion products, products can be sourced from offshore due to more predictable demand, and for high-fashion products, the shorter lead time of near-shore/onshore can provide necessary reaction to sales.

Trade-off Model

- The decision matrix described above is an industry framework for understanding options. However, a retailer must also consider its specific financials and adjust the "variable sourcing decision matrix" accordingly. Figure 2 (next page), for example, illustrates how the sales line item is related to the sales forecast accuracy and why a greater historical strength of sales forecast accuracy can provide better support for an offshore-only sourcing technique.

The domestic/import variable sourcing technique requires a more sophisticated IT approach than traditional sourcing. For example, sourcing a single item from multiple suppliers in multiple countries requires a coordinated item file that enables tracking separate inventories, while monitoring sales jointly. Retailers must capture information at a very granular level, using variable lead times, points of origin, costs, etc., married with forecast accuracy and cost/volume historical data to drive decision-making. Creating the tools to support this analysis requires IT to understand the nuances of the globalized supply chain.

Real-World Examples

Case Study 1: Test, Quick Test and Early Read

A major North American soft-line retailer uses three methods to improve the success of its new item launches: Tests, quick test and early read. The latter two methods are equivalent to our trial and pilot techniques. Although all types of tests

Product Sourcing Management: By the Numbers

Financial Line Item	Factors	Value of Factor	Sourcing Technique
Sales	• The historical strength of forecast accuracy impacts the potential need for in-season adjustments. The better a retailer can predict sales levels and patterns, the more it can rely on offshore production.	+	Offshore only
		–	Decision based on the "variable sourcing decision matrix."
COGS	• The difference in product cost between offshore and onshore/near-shore. • The value of bulk buys from one factory vs. splitting production among facilities. This depends on the total volume a retailer will purchase, negotiating strengths, economies of scale, etc. • Absence or low level of tariffs and duties associated with imports from the producing country.	+	Offshore only
		–	Decision based on the "variable sourcing decision matrix."
Shipping	• The cost of shipping product from offshore. • The risk of shipping from offshore, including labor activity, shipping route safety, etc. • The lead time for shipping the products from offshore.	+	Decision based on the "variable sourcing decision matrix.
		–	Offshore only

Figure 2

enable the retailer to improve the success of their mass market launches, quick test (trial) and early read (pilot) are specifically used to accelerate decision making. All three test methods help the retailer gain market intelligence, but in an ever-changing retail environment, speed can make all the difference. The approach they choose varies based on the item and impacts the logistics of the item introduction.

Three Ways to Succeed with New Product Launches

	Test	Quick Test (Trial Technique)	Early Read (Pilot Technique)
Item Type	• Lower fashion element	• Strong fashion element	• Lower fashion element. • Medium to long lifecycle items.
Timing	• Test market in Season 1. • Mass market in Season 2	• Test and mass market in the same season or in subsequent seasons.	• Test and mass market in the same season.
Item Design	• Trend identified in Europe. • Product designed in the U.S.	• Trend identified in Europe. • Trend examples hand-carried to China immediately. • Product designed in China.	• Trend identified in Europe. • Product designed in the U.S.
Production	• Standard product process.	• Targeted factories that can expedite production.	• Standard production process.
Shipping	• Product shipped through regular shipping process of sea freight.	• Product shipped via air freight to distribution centers and then through regular channels.	• Product shipped through regular shipping process of sea freight.
Test Store Selection	—	• A group of stores that is representative of the chain in terms of volume, climate, etc. is identified and updated seasonally. This same group is used for all quick tests. • Group represents XXX% of chain.	• Stores are randomly selected for each test. • Group represents XXX% of chain.
Lead time	• Product reaches test stores within nine months of trend identification.	• Product reaches stores within two months of trend identification.	• Product reaches test stores within seven months of trend identification.
Merchandising	• Product worked into basic assortment without special marketing.	• Product worked into basic assortment without special marketing.	• Product worked into basic assortment without special marketing.
Strategy Result	• Impacts product selection, quantity, distribution.	• Impacts product selection, quantity, distribution.	• Impacts product distribution, speeds up reorder of product.

Figure 3

Case Study 2: Domestic/Import Variable Sourcing

The case studies below (see Figure 4) highlight how the "domestic/import variable sourcing" technique helped major apparel retailers position themselves to react quickly to the most current marketplace data. The first example is from a North American apparel client; the second includes insights gleaned from a major European retailer. In both cases, the retailers utilize a combination of methods to react to marketplace conditions. In particular, they use a combination of domestic and import sourcing to react to insufficient inventory in their pipelines.

A Hybrid Approach to Product Sourcing

Business Challenges	North American Retail Client	European Retail Client
Forecast Inaccuracy	1. Merchants track planned and actual sales and either buy more products from existing vendors/find more vendors or slow down/shut down orders. 2. If the sale of a particular brand is not performing in season, the retailer adjusts its brand fee.	1. Merchants track planned and actual sales and either buy more products from existing vendors/find more vendors or slow down/shut down orders.
Excessive Inventory in Chain	1. Retailer updates the forecast and stops future orders. 2. If it is early/mid-season, then retailer negotiates with vendor to return the product. 3. If it is late season, then retailer runs heavy markdowns to move the inventory. 4. Retailer runs national promotion for the product and creates promotional displays.	1. Retailer updates the forecast and stops future orders. 2. If it is early/mid-season, retailer negotiates with vendor to return product. 3. If it is late season, then the retailer transfers inventory to stores where product sales are encouraging. 4. Retailer runs national promotions for the product and creates proper promotional displays.
Insufficient Inventory in Chain	1. Retailer updates the forecast and orders more product. In the early season, retailer orders from offshore (Asia Pacific), and in mid-season, retailer orders from near-shore (Mexico) and local vendors (U.S.).	1. Retailer updates the forecast and orders more product. In early season, the retailer orders from offshore (Asia-Pacific). In mid- season, the retailer orders from nearshore (Eastern Europe) and local vendors (England).
Specific Brand Underperforming	1. If during the season a particular brand is not performing well, then the retailer finds an alternative brand from a nearshore/local vendor and replaces the non-performing brand.	—
Inventory Misallocated Across Stores	1. Retailer updates the forecast at item/store level. 2. Retailer runs market-level promotions on the products and creates promotional displays. 3. If the item is not performing, then retailer negotiates markdowns with suppliers.	1. Retailer updates the forecast at item/store level. Retailer mobilizes the inventory from one store to another, as distance between two stores is small.

Figure 4

Product Sourcing to Build Stronger Business

Although adapting to sales patterns in-season is a fact of life for retailers, there are ways in which they can position themselves to gain the data necessary to react and reduce the time between decision-making and impact. Taking advantage of a globalized supply chain can create opportunities for forward-thinking retailers. They should consider the trial method to gain information prior to making commitments, pilots to both collect data and react quickly, and employ a domestic/import variable sourcing model to optimize both profit and in-stock. Model choice should be based on relative needs to accelerate decision making, improve business agility and increase management focus on optimizing the product sourcing process.

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