

# The Retailer's Challenge

Responding Effectively to Seasonal Demand In a Global Sourcing Environment

## Executive Summary

Retailers of seasonal merchandise source and manufacture most of their goods overseas. Reducing cost of goods sold (COGS) is the primary motivation to source globally. However, a key disadvantage of global sourcing is increased lead time and resulting lack of responsiveness to demand.

Many retailers are finding that available savings opportunities from moving to low cost sources are nearing exhaustion. As a result, retailers are examining the demand chain, looking for ways to compress the order-to-delivery cycle and to accelerate goods in transit to protect margins and avoid markdowns.

If the supply chain were responsive enough to allow postponing the order, manufacture, and shipment of some goods until after the start of the selling season, a retailer could use actual market demand data to determine store inventory and thus prevent markdowns.

Some leading retailers are working on a model that breaks the season into two segments, the “initial buy,” based on forecasts, and the “responsive buy,” which is based on actual store sales. Success in this approach is contingent on superior global supply chain intelligence and control, which can be achieved through a series of key building blocks, including:

- Postponement Strategies
- Margin vs. supply chain cost analysis
- Segmentation and initial buy
- POS data analysis
- Vendor visibility
- PO to store delivery monitoring
- World-class partners

To develop the metrics and achieve the goals that drive a highly fluid, seasonal demand-driven global sourcing and logistics operation, an organization must adopt technologies that support a collaborative, “extra-enterprise” solution. This integrated solution must provide visibility and tools for decision-making that can be used by all constituents across the extended supply chain.

This white paper explores the challenges and solutions associated with creating a nimble, demand driven supply chain for retailers who must deal with the challenges of seasonal merchandise.

## The challenge: Betting for margin

Demand for retail products has always been seasonal. For example, the closer you get to inherently seasonal, high-end fashion goods, the more “perishable” those goods become in the context of market timing and ability to sell at maximum margins. This is true for other product categories, such as outdoor goods, sports and recreation, home improvement, and toys. All are subject to season-specific demand.

Over the past two decades, retailers of such merchandise have gradually shifted the sourcing and manufacturing of these goods from domestic to global factories, predominantly in Asia. The prime motivation for this shift is substantially lower labor costs in those regions and resulting reductions in sourcing cost (or, Cost Of Goods Sold — COGS). A well-known, but tolerated, disadvantage of global sourcing is the increased lead-time or length of the supply chain and a resulting lack of responsiveness to market demand.

A few high-end retailers have instituted strategies and business models that explicitly run counter to this trend; for example, Adidas Taylor-Made is making premium golf clubs to customer order in the US, differentiating itself from the market not by price, but by rapid delivery of exclusive, custom-made merchandise. Nevertheless, the broader market is continuing the trend towards sourcing from remote, low wage countries.

For retailers in seasonal segments, this trend has gradually led to the following business practices and challenges:

### Sourcing and Product Development

Selecting vendors, working on materials and product design are activities that take a surprisingly long time. Many retailers work with overseas partners to make these kinds of decisions between six and twelve months before the start of the sales season. Considering that the world’s leading car manufacturers take just over 24 months to design and launch production of a new automobile, it is astounding that typical apparel retailers take almost half of that time to design, source and deliver to stores the latest cashmere sweater.

The lack of reliable demand data this early in the process creates an obvious challenge in production planning. Much effort has been spent on improving demand forecast accuracy; yet, forecasts will inevitably be substantially off this far out before actual market demand materializes.

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### 100% Make-to-Forecast

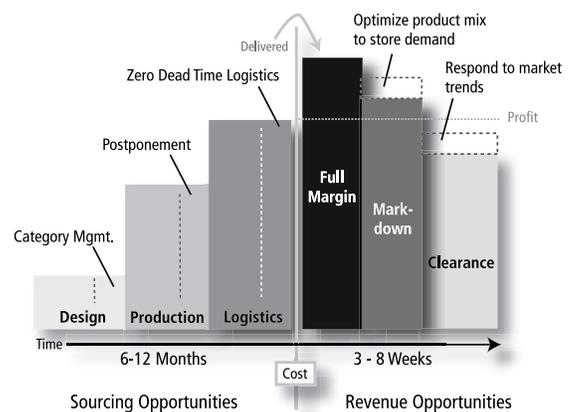
The selling “window” for seasonal items is very short. The US holidays of Halloween, Thanksgiving and Christmas are good examples, with peak selling periods of as little as three to at most eight weeks. The regular spring and summer apparel seasons also are measured in weeks, typically 12-15 weeks per season, with 50-80% of the merchandise being season-specific. At the same time, lead times to order, manufacture, ship, and distribute that same merchandise to stores can range from six to twelve weeks for the key supplier regions of China, the Philippines, Singapore, and South America.

The common business practice resulting from supplier lead times that meet or exceed the length of the sales window is that retailers order and ship close to, if not all, of an entire season’s merchandise well before the beginning of the selling period. For instance, a retailer like The Gap receives 100% of its seasonal wares into its US distribution centers at least two to three weeks before start of the season.

The challenge here is that all of this buying, down to the specific configuration of the merchandise, is based on forecasted demand. If the buyers do not have the right instincts or short-term fashion waves change the demand profile, there is nothing for the entire season that can be done to respond to new market signals. The retailer is stuck with the product on hand.

### Margin vs. Markdown

As consumers we are all familiar with — and actually quite like — the result of this inflexibility: Sales, mark-downs, and clearances. From the retailer’s point of view, however, these events are quite costly. Since the supply side of the equation is fixed, the only option the retailer has is to give up margin on slow-selling merchandise by cutting prices. The high margin on hot selling items becomes the source of income that subsidizes losing items. It is not unusual to see as little as 20-30% of merchandise sold at full margin. The remaining goods are “pushed” into the market in three phases: First, sales, with prices discounted to a lower margin, then markdowns priced at cost, and finally clearances at a loss, simply to recover some of the COGS investment and to make room for the new season’s goods. This scenario is repeated every season, every 12-15 weeks, four to five times a year.

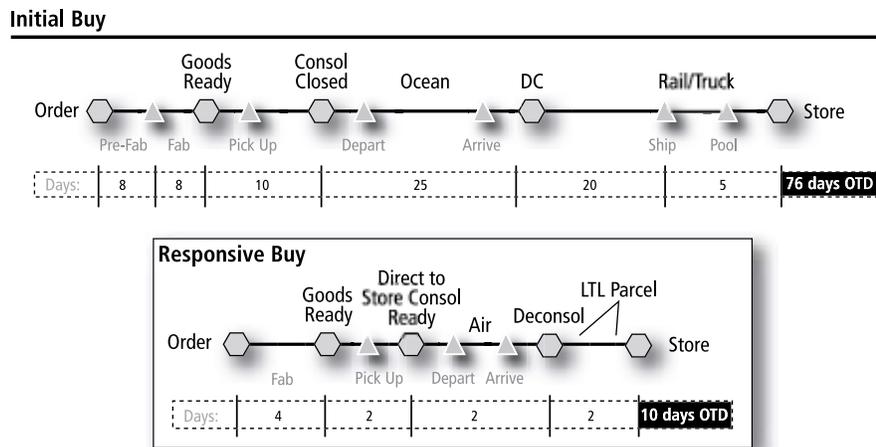


The demand chain presents opportunities to compress the order to delivery cycle to protect margins and avoid markdowns.

Today, many retailers are finding further improvements in COGS increasingly hard to realize. Price optimization, category management and other improvements in corporate sourcing activities may hold further potential. Yet, the available savings opportunities from moving to low cost sources are nearing exhaustion. As a result, retailers are examining the demand chain, looking for ways to compress the order to delivery cycle and to accelerate goods in transit to protect margins and avoid markdowns.

## Can global supply chains be made nimble enough for more profitable seasonal merchandising responses?

The concept is simple. If the supply chain were responsive enough to allow postponing the order, manufacture, and shipment of some goods, a retailer could use actual market demand data to determine store inventory and thus prevent markdowns. A handful of retailers have successfully accomplished this feat, including Adidas Taylor-Made, mentioned above. Another example is the European fashion retailer ZARA. However, both of these companies market higher-end products, at higher prices. Thus, they have big enough margins to be able to locate production close to demand. Large retailers with narrow margins, who compete for mainstream demand and are compelled to source globally, face the greater challenge: Can they find ways to make their supply chains nimble enough both to achieve low COGS and to preserve their margins?



The "responsive buy" allows retailers to rapidly adjust supplies based on actual demand.

Some of the leading retailers believe that they can master this art. The model they are working on breaks the season into two segments. The first four to six weeks, the "initial buy," will be forecast driven as is the case today. The second segment, the rest of the 12-15 week season, is the "responsive buy" period, which will be informed by actual store sales, i.e. market demand. In this period, retailers adjust the supply of merchandise to the extent possible and sensible, considering the profit margin. This model requires the following capabilities:

### Postponement

Fundamentally, overseas vendors must be able to support retailer needs to postpone the ordering of merchandise until the latest possible moment. Sourcing decisions, design, and material selection should be mostly unaffected, although exploring ideas popular in other industries, such as modular design, may positively support postponement. Similarly, contracts may have to be adjusted to reflect the additional flexibility demanded by the capability, for instance by committing buyers and vendors to volumes at the product family, rather than the style/size/color, level. The largest challenges lie in developing the vendor's ability to offer short manufacturing lead times, possibly by pre-fabricating semi-finished products that can be produced in large volumes within hours, once replenishment orders with exact specifications come in.

### **Market demand assessment**

Forecast accuracy increases closer to the start of the season. Two weeks prior to season-start, forecasts will be more accurate than they were six or even two months before. However, even two weeks out, retailers can only forecast general levels of demand. For apparel, predicting demand at the level of color, size, and style is error-prone even then. The ultimate postponement strategy, however, will allow the retailer to delay re-ordering merchandise for the second segment until the season has begun and actual store sales data is available for analysis. That data, aggregated across hundreds of stores, will allow vastly more accurate demand prediction at the detailed specification level.

### **Expedited transportation**

Major retailers predominantly use containerized ocean freight to import merchandise from overseas. The much more expedient air cargo transportation mode is, on average, seven to eight times more expensive. In effect, the retailer finds itself in a “loss-loss” situation: Using slower ocean transport saves freight dollars, but results in margin loss due to supply-demand mismatches (product late to stores). Using fast air transport allows postponement and thus improves the supply-demand match and preserves margin, yet consumes higher freight charges and reduces the overall profitability of the goods. The challenge for retailers is to optimize the mix between air and ocean freight; they must know which method is costliest, depending on season, product, and region. If retailers can compare the margin upside of reduced lead-time with the freight cost downside, they can make globally profitable postponement decisions. Clearly, these decisions will vary by product, source and season.

### **Zero dead-time logistics**

Once the retailer makes a calculated investment in expedited transportation, it becomes imperative also to shrink the overall vendor-to-store lead-time. Consolidated transportation practices are optimized for low freight cost, but not for minimal lead-time. Typically, over half of the total time goods spend en route globally from vendor to store is spent waiting: Waiting for pickup at the vendor, waiting for consolidation into containers, waiting for loading into airplanes or onto ships, waiting at the destination airport or port, waiting for customs clearance, waiting for pickup for inland drayage to the DC, waiting in the DC yard for receiving, waiting in the DC for allocation to a store order, for pick and pack, and, finally, waiting for pickup by the LTL carrier for shipping to the store. A door-to-door air shipment from a China-based vendor to a US store via DC cross docking may take 25 days, out of which 15-20 days are non-travel time. Retailers aiming to capture extra margin through postponement and expedited transportation must track, measure, and eliminate as much of this dead time as possible.

### **Cross-dock direct-to-store**

The classic transportation model of retailers sourcing from overseas is via containerized ocean freight, then by truck or rail to inland DCs. From there, goods are distributed to regional warehouses and finally to individual stores. Again, this model has been optimized for cost efficiency, not for speed.

Retailers looking to improve their responsiveness have to carefully trade off cost efficiency against potential margin gains. One of the more popular network design choices is to avoid inventorying goods for the late-season. Instead, retailers task 3PLs with cross-docking incoming ocean/air freight goods directly at port of entry and redistributing the products as smaller shipments to regional warehouses or even directly to stores. Similarly, retailers are seeking to consolidate at origin according to final destination (not DC), to improve logistics flows and minimize dead time.

## Nimbleness through global supply chain intelligence and control

Retailers working on implementing responsive global supply chains are reinventing many areas of their business. Many processes cry out for adjustments, some minor and some more involved. The most critical changes or new capabilities are the ones listed below. Clearly, hitting every point on this list does not guarantee success, but these are some of the key building blocks:

### Postponement Strategies

The critical prerequisite for an organization to engage in any form of postponement strategy is the ability to produce standardized products and to delay product customization to the optimal point in the supply chain. Once an organization's products accommodate manufacturing standardization and deferred customization, it is essential to modify business processes to encourage adoption of postponement strategies. Such modifications include instituting goals, metrics, and targets that support increasingly necessary and complex product collaboration from order design, raw materials sourcing and manufacturing processing. To this end, executive support is vital to successful postponement implementations.

Additionally, to make effective use of the new goals, metrics, and targets, an organization must adopt technologies that support an extra-enterprise, integrated, web-based solution capable of facilitating collaboration and real-time visibility across the extended supply chain.

"Postponement, especially across a global supply chain, requires high levels of data accuracy, as well as near-real time information sharing. Fundamental to successful implementation of postponement is supply chain visibility, thought of as "an up-to-the-event view" of each node in the continuum bridging orders and delivery. Critical to visibility is the physical logistics network, technology deployed for product identification and tracking, and systems that manage resource allocation and material flow."

Manufacturing Systems Magazine, 4/04

### Margin vs. supply chain cost analysis

Perhaps the most difficult piece of the postponement strategy puzzle is obtaining the reliable information needed to help retailers segment their product portfolio and decide where and when to use demand-driven replenishment. Careful analysis of historical forecast and sales actuals, price points, discounts, and margins will be required in order to determine which products offer sufficient margin upside. Likewise, developing the cost vs. margin-loss trade-off requires an analysis of freight cost, landed cost and delivered-at-store cost by product, depending on mode of transport and routing.

### Segmentation and initial buy

Retailers can select products for demand-driven replenishment based on the segmentation and margin analysis. Sizing the initial buy by product and setting the time windows and lot sizes for demand-driven replenishment are other crucial parts of creating an optimal solution.

### **POS data analysis**

Once the season has begun, retailers require detailed POS (point of sale) data across their various stores and wholesale channels in order to determine actual market demand. Retailers who own their own stores are typically in a better position to gather this data than are those who sell through channels (e.g. department stores). These channel-focused retailers traditionally find it harder to obtain the same data as store owners, at the same level of detail, within a timeframe that allows re-ordering. Having the right tool to analyze the vast quantity of POS data is the other key ingredient needed to determine actual demand. Typically, the sheer volume of this data far exceeds the capacity of the world's most popular planning tool, Microsoft Excel.

### **Vendor visibility**

The vendor plays a very important role in the success of the model; the chance for failure is probably highest at the vendor. Yet this responsibility is new and is complicated by the fact that the vendor is an ocean or a continent, at least one language, and many time zones away. Hence, retailers will have to put in place processes, metrics, and systems to gain visibility into vendor performance and to provide advanced warning of exceptions. For instance, on-line visibility into the inventory of semi-finished products at vendors, into daily production actuals, and into booking and shipment volumes by product are among the many data points retailers must monitor closely in order to guarantee success.

### **P0-to-Store delivery monitoring**

Once goods have left the vendor's factory, the fight against "dead-time" begins. As every day that passes erodes profit margin, retailers cannot afford to rely on their transportation and 3PL partners to deliver minimal dead-time. Visibility from vendor pickup to store delivery — across many carriers, 3PLs, and internal warehouse locations — becomes the single source of truth and metric of success for the retailer and all of its partners. Beyond tracking shipments against anticipated cycle times, the visibility platform also gathers the logistics cost data elements required for the landed cost analysis described earlier in this paper.

### **World-class partners**

Finally, the goal of "zero dead-time" can only be accomplished by involving world-class partners. The retailer must utilize the value-added services provided by both carrier and 3PL partners with this overall goal in mind. Express service by carriers, in-transit customs clearance, cross-docking at port of entry, and multi-stop TL service from cross-dock to store are just a few of the options available. Gaining visibility across the performance of partners and the costs of their service offerings is essential to drive continuous improvement along a set of well-defined, shared metrics.

## Conclusion

Implementing responsive global supply chains that can successfully deliver high-revenue, high-margin performance for time sensitive seasonal products is one of the most difficult management tasks facing retailers today. This hurdle is not insurmountable, but does require that fundamental elements of the organization adapt to new capabilities and new realities. Needed changes include:

**Employee culture management:** Operating as a business that responds rapidly to changing demand and short fulfillment cycles requires that employees learn to work in a highly collaborative, efficient, time-compressed environment. The silo-based mentality (I work for purchasing; I work for merchandising; I work for logistics; I work for finance) that pervades many retail organizations today needs to be re-oriented to team-based performance, where information is shared, decisions are made and executed quickly, and responsibility is placed as close to the work as possible. To incent proper behavior and motivate individual action toward team goals, compensation systems must reward individuals based on achieving stated team goals for supply chain performance, revenue and profit. This is the way to build a culture of collaboration and responsibility for shared goals across the organization.

**Business process change management:** As outlined throughout this paper, there are many opportunities for retailers to adopt strategies to successfully manage seasonal demand while sourcing globally. These business initiatives can be adopted incrementally in the sequence that best fits the retailer's needs. Yet organizations run the risk of failure unless process change is managed aggressively, with commitment. Without strong leadership, the workforce will fall back on past practices that won't rise to meet the new challenges of demand-driven seasonal global sourcing and logistics. New business processes must be founded on an understanding of the new global market in which the company now operates. In order for them to be successfully implemented, employees must be trained to develop an understanding of how these processes influence and guide their everyday jobs.

**Technology change management:** Technology enables an organization to accomplish business goals more effectively and to operate more efficiently. However, the choice of technology, how it is applied, and how pervasively it becomes institutionalized will be the true determinant of success. To support the goals and metrics that drive a highly fluid, seasonal-demand-driven global sourcing and logistics operation, an organization must adopt technologies that support a collaborative, "extra-enterprise" integrated solution capable of providing visibility and decision-making tools across the extended supply chain. On-demand, web-based systems are emerging as the technology of choice to meet these requirements. These systems are integration-centric; by design they receive and send information from a multitude of partner platforms. They provide a central data repository with an "up to the event" view of products as they proceed through the demand chain, from order placement at the factory, to tendering with the carrier, through cross-border transportation, to delivery. This new class of technologies is built first and foremost with the user in mind and is designed for rapid training and ease of use. This visibility system, appearing at first glance to be tactical, is the foundation of a strategic technology platform. This platform becomes the single source of truth and the basis for a common workflow system on which all partners in the demand-driven seasonal supply chain perform their tasks with powerful applications.

With world class partners, an effective Web-based collaborative global visibility and control system, and a workforce motivated and trained for the rigors of the global market, organizations can prosper in this ever-more-competitive world of globally-sourced seasonal products.

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