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LIFT EBITDA WITH A FOCUS ON PRODUCT COSTS

In our business we have the pleasure of experiencing how different companies operate throughout the fashion, retail, apparel, footwear, and accessories industry. We are involved directly with many of them, and others we see and hear about through vendors, agents, and other third parties. While it is foolish to apply sweeping generalizations to the industry as a whole, there are certainly common observations and themes that emerge. One such observation is that while all retailers and brands recognize the major impact product costs have on their bottom lines, it is increasingly rare to find one who has a sustained focus on reducing and optimizing these costs.

Obviously, companies do attempt to reduce product costs - the benefits are too big to ignore. Our analysis of public specialty apparel retailers shows that for every one percent of product cost reduction there is up to a three percent increase in EBITDA, assuming all else stays constant. However, the efforts we see companies take to reduce costs are often short-term in focus, transactional in nature, and fail to achieve a sustained impact on the direct cost of the product itself. These efforts tend to fall into one of three buckets:

- Internal costs – increasing efficiencies through process and organizational change, with corresponding reductions in headcount, sampling, and shipping/expediting costs. While important, these costs generally total less than 5% of COGS, and can only be reduced so much before resulting in significant deficiencies in capabilities. In addition, these efforts do little to impact actual product costs, but rather only affect the cost of procuring the goods.

> *"For every one percent of product cost reduction, there is up to a 3% increase in EBITDA"*

- Other Supply Chain costs – increasing freight consolidation, changing ports of lading, strategic use of 3PLs, renegotiating ocean, air & freight contracts, and implementing duty optimization programs. These initiatives need to be, and generally are, a part of every company's toolkit. However, they are focused on reducing costs associated with delivering the product, not the cost of the product itself.
- One time efforts – renegotiating agent commissions and factory rates, rationalizing the vendor base, and optimizing material costs. Typically, companies will go through a project every few years to reset agent commissions or factory labor/profit – through either discount requests or new negotiated rates moving forward. With commissions ranging from 4-7% and factory labor/profit reaching as high as 30% of product costs, these can be significant opportunities.

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Unfortunately, as there is rarely a continued focus on them, they tend to creep back up, either explicitly or through small increases in trim costs or less favorable yields. Similar efforts to optimize material costs through better product engineering and supplier consolidation are common but rarely sustained. We also frequently see companies shifting to less expensive materials and/or vendors. However, these changes are likely to be noticed by consumers and negatively impact the value they perceive in the product.

It was not always like this. When most brands were manufacturing their own goods, there was a deep understanding of what drove costs in raw materials, labor, and overhead, as well as the methods to optimize them. This is still evident today in footwear, where tooling costs, along with their associated amortization, are well known and efforts are constantly made to optimize their usage. However, when much of the manufacturing shifted overseas, there was an understandable shift away from this level of detail. Now well into the second generation of "full package sourcing", much of the knowledge and approach from that time have been lost.

To drive real, sustainable bottom-line gains, retailers and brands need to bring many of those concepts back and reinstate product cost management as a core competency. It is important to understand that cost optimization is not the same as cost reduction. Cost reduction is often singular in focus ("Where can I cut costs?"). Cost optimization is multi-dimensional and focuses on weighing cost against other factors ("How can we get more value out of what we're paying for, and where do my consumers perceive value in the product?", "When is it justified to adjust retail prices or margin intake?") and sustaining it over seasons and years. For many companies, finding the right balance between all of these questions is the key to truly optimizing cost.

With a variety of goals, price points, consumer expectations, and product types, it would be easy to assume that the approach to product cost optimization will be very specific and custom to each company or even brand and classification. While there is some truth to that, the real divergence is in the details, and we believe that the entire industry will benefit from four operating principles.

1. START WITH RAW MATERIALS

Going back to our earlier analysis of product cost reduction impact on EBITDA, let's now assume that raw materials make up around 70% of total product cost (while actual numbers vary, this is a good rule of thumb across apparel and footwear). This suggests that a 1% reduction in raw materials cost results in roughly a 2.3% increase in EBITDA. There simply is no other place in COGS where such a significant impact can be made. This sizable contribution to COGS is not the only reason to focus on materials first. Materials differentiate products, and many times they are critical to the expected function of the goods. In addition, consumers see quality, or lack thereof, in materials – from the initial hand feel to how they wear over time. Therefore, focusing on materials and finding the right balance between cost and quality is paramount.

As an industry we rightfully treat materials as the driver for product cost, but there needs to be a greater focus on what they should cost - What are the commodities that are used? What manufacturing techniques are required? Where are there potential quality risks? How can we find greater efficiencies in their production?

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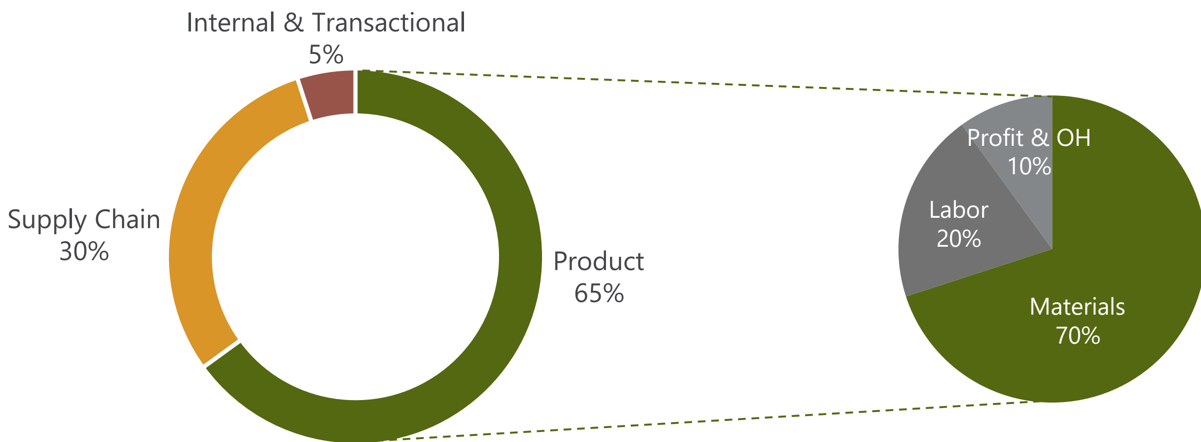
2. UNDERSTAND TOTAL COST, NOT JUST TRANSACTIONAL

Frequently we are asked to benchmark product transactional costs – What percent of FOB does the overseas office represent? How much commission is an agent charging? What is the cost of opening a new LC? These are certainly important numbers, but even at the high end they represent significantly less than 10%, and cannot be reduced to less than 3-5% (without significantly degrading capabilities), of product cost.

3. LEVERAGE DATA TO THE FULLEST

Cost sheets and BOMs contain some of the most granular, and valuable, data that companies in our industry gather. Even basic approaches in using it - comparing like products within a season & year over year changes on stable components or extending blocks to "model" cost breakdowns can identify opportunities that otherwise were not known. That said, those approaches quickly reach their limits – they are manual and still require significant knowledge to apply.



Understanding the total cost is critical, which not only means knowing what goes into making the product, but also identifying and recognizing the "hidden" costs that arise when decisions made in the name of reducing product cost negatively impact the revenue side of margin calculations - when development and production decisions drive outsized markdowns or lost sales; where chasing the lowest labor costs will result in losing the intent of the designers and merchants; how a constant churn of vendors results in a focus on compliance and onboarding instead of consistency and innovation.

Given the wealth of detailed data, costing is a prime target for the next generation of tools – predictive analytics, machine learning, and AI driving sourcing teams to the products that require attention, prioritizing those products that will provide the greatest margin opportunities, and ultimately guiding development decisions to optimize cost while there are still options available to meet the designer's vision. Some of these tools are available today, and some are emerging, but the common thread through them is that the more accurate and complete the data set, the better answers they can provide.

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4. TREAT COSTING AS A CONTINUOUS AND INTEGRATED ACTIVITY

The approaches above will drive value, but if they are not treated as constant – ongoing ways of working in an organization – the benefits realized will be small, or in some cases completely offset in later seasons. Integrating these practices into an organization starts with the development calendar.

"Every decision during design and development has an impact on cost, and needs to be treated as such."

Calendars should be built to incorporate the upfront time needed to develop robust material sourcing and finished goods production strategies, and have clearly defined check points throughout the season for costing, forecasting and aggregation decisions.

Costing must be made inherent to the development process, which should be built to allow for pre-costing to occur early while design and development are on-going and before ideas are locked in. Every decision during design and development has an impact on cost, and needs to be treated as such.

Organizational structures must also be set up to allow for Development, Sourcing and Production teams to have equal seats at the table with Design, Merchandising and Planning. This means ensuring roles and levels are aligned across each functional area, and empowering each area to serve as checks and balances against one another to effectively weigh cost decisions.

Finally, to truly bring back this cost management competency, organizations must focus on building knowledge and skills. With Development, Sourcing and Production, this includes understanding yields and labor, how various fabrications react in manufacturing, how product should be engineered to see the greatest efficiencies, and what quality risks may exist and how they can be mitigated. However, a core costing competency must also be developed on the Merchandising and Design side, where Merchandising sets price and margin targets upfront as they build the assortment, and Design is able to interpret and design into those targets.

In summary, product cost optimization needs to be a strategic organizational capability, as deserving as merchandise or supply chain planning. Too often, companies only turn their focus to product cost in reaction to negative financial results, and in a way where the long term impact is negligible at best. Successful approaches will start with raw materials, ensure that the focus is on total cost, and create organizational structures that sustain the change.

Whether the outcome is increased margins, exceeding consumers' expectation of value, or maintaining positioning in an ever increasingly competitive environment, the benefits of sustained product cost optimization are too great to continue to ignore.

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