THE APPAREL WARS

How apparel retailers can create and sustain value

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INTRODUCTION

Retailers that base all or a significant part of their revenues on apparel are faced with a serious dilemma. They are dealing in a deflationary commodity. If they are public companies, most likely they have tried to satisfy shareholder growth expectations by expanding square footage. The consequence is that America today is vastly "over stored." As is typical when supply exceeds demand, price becomes the sole determinant of value, and the result is today's highly promotional environment.

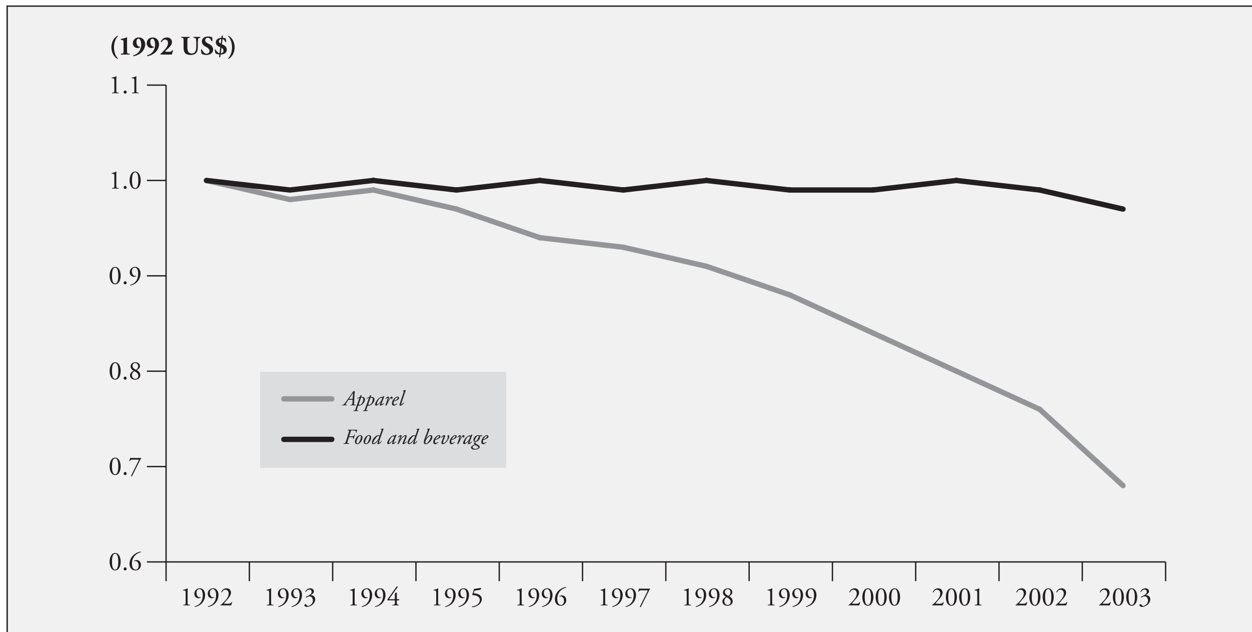
In this paper, we examine the root causes of this deflationary "death spiral" and explore how the apparel industry must change its business models if it wants to thrive in retailing.

THE DEATH SPIRAL OF DEFLATION

Apparel pricing rose dramatically as a result of runaway inflation of the mid-1970s, driven by oil shocks and high commodity costs, which were caused by steep dollar devaluation. Since that time, prices at first stabilized and then declined. In fact, if apparel prices were denominated in 1992 dollars, costs would actually be lower today than they were then: A jacket you paid US$100 for in 1992 would cost US$68 today *(see figure 1)*.

There are many reasons for this. The apparel industry, which is labor-intensive but not capital-intensive, has been used to bootstrap economies of emerging nations. As these nations ratcheted up production capacity, the U.S. government would

Figure 1: The apparel versus food dollar



Sources: U.S. Department of Labor – Urban Consumers; A.T. Kearney analysis

regulate the flow of so-called "sensitive categories" by entering into multi-fiber agreements (MFAs), which imposed export quotas on annual shipments within these categories to control growth.

The MFAs, perhaps more than tariffs, stabilized prices of cotton, wool and synthetic apparel as quotas became a freely traded commodity. Quota prices soared, often exceeding labor costs in hot categories. As production capacity grew at a faster rate than quota allotments, competition increased, driving prices to dizzying heights. Then the rules changed. The Reagan administration announced liberalization of quotas, which would lead to their elimination by 2005. This action was followed by a series of initiatives including NAFTA and the Centre for the Promotion of Imports from Developing Countries (which assists companies in developing countries to import to the West European market), reducing or eliminating tariffs altogether. Thus, the two forces that for years had supported price stabilization had essentially disappeared.

Driven by these incentives and local government support, production capacity grew first to accommodate and then to far exceed demand. Following tradition, a market shift took place, giving buyers superiority over sellers. To remain competitive, manufacturers in more highly evolved markets sought to capture added value by simplifying their sourcing processes, thereby reducing buyers' risk. By providing merchandising and product development services, manufacturers were able to persuade retailers that lacked these skills to buy directly from them at higher prices. This turn of events forced unbranded importers out of the supply chain and into newer, less reliable markets, further exacerbating global overcapacity.

Apparel that was becoming largely commoditized further contributed to declining prices. Here again, the dynamics are relatively transparent. When retailers began their own direct import programs, manufacturers' minimums, combined with limited internal capabilities to develop product, obliged them to stick to developing proven, basic merchandise. The idea that a private label would differentiate this merchandise from that of every other retailer proved fallacious as basic merchandise tended to be similar from one retailer to the next. Nowhere is this more evident than the men's sportswear business. Items such as khaki pants, five-pocket denim jeans and polo shirts have been copied so many times that price is the only driver of sales. Prices in these categories have become so deflationary that price promoting has leached most of the cost advantages won by direct sourcing.

Moreover, lack of innovation has created a cycle in which the consumer's sole motivation to buy is replacement. In such a case, deflation is compounded as consumers compare the new purchase price against the last price paid. If we assume a useful garment life of three years and a 2.5 percent annual rate of inflation, the compounded effect is a deflation factor of 9.3 percent if the consumer buys the product at the same price as the last purchase. Assuming the same amount of square footage per store, sales of such merchandise must increase the same 9.3 percent over the period to achieve parity.

Comparing sales growth adjusted for inflation and square footage growth over the past 10 years, it soon becomes clear that productivity in apparel retailing has not been increasing nor has it even been stable. Instead, productivity has given way to the law of diminishing returns. This is even worse for retailers that are reporting negative comparable sales in stores open more than one year *(see figure 2).*

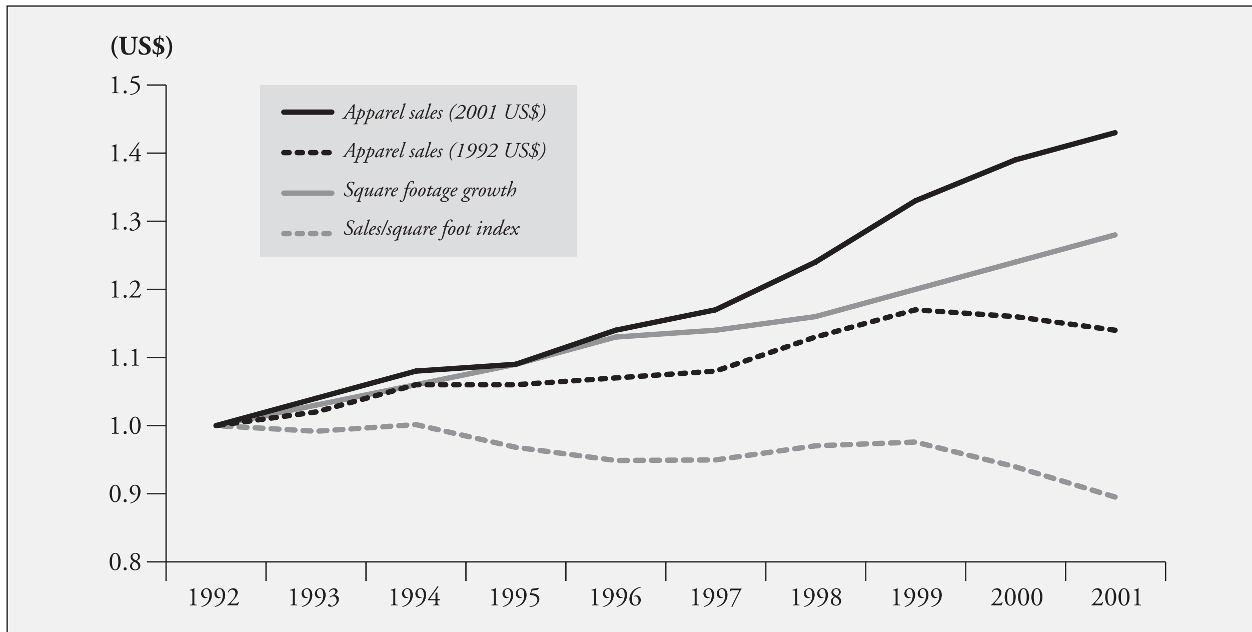
How to command a premium price

Since the sole determinant of value for private label merchandise is all too often price, leading companies are changing their business models to prevent further erosion of top and bottom line revenues. Central to their remedy is changing the equation that consumers use in making a decision to purchase. Before this can be accomplished, however, it is first necessary to understand the factors that enable a product to command a premium price.

Innovation. Traditionally, the highest price premium is awarded for innovation. If a product is first to market and desirable, the consumer cannot compare its value against prior purchases or a competitor's product. For example, when Ellis Brigham, a popular footwear retailer in the United Kingdom, came up with the innovative idea of self-molding footbeds, the resulting product made its shoes unique in the marketplace. In a sense, the product created its own monopoly. Unfortunately, unless the product is protected by patent or some other restrictive covenant, the window for innovation closes within the product development cycle of market-wise competitors. Minus a patent, Brigham's competitors soon designed their own self-molding footwear and caught up with and then surpassed the originator.

Consistency. The secret to defending product equity to the next rung on the product-premium ladder is consistency. When consumer demand still exceeds supply despite other entrants to the field,

Figure 2: Decline in sales productivity



Sources: U.S. Department of Labor; company reports; A.T. Kearney analysis

the company has to continue to improve on its original idea in order to stay on top. Berne-Welbeck's Airpack, for example, first hit the marketplace with a unique idea in swimwear—laminating fabrics on either side of a compression-resistant foam. The company expanded on its original idea and now knits the three layers together, offering a breathable, moldable, and easy-care material ideally suited to swimwear and undergarments.

Product originators such as Berne-Welbeck build residual equity and consumer trust by continuing to meet or exceed customers' expectations during the innovation cycle. The best defense against competition is product improvement or extension, which essentially supersedes the original product that competitors have copied.

Convenience. As supply rises to meet demand, and competition forces companies to refine their original products, convenience determines whether or not a product retains its premium status. Convenience can be defined either by ease of use of the product itself or convenience in doing business with the company. Ideally, it is a combination of the two.

Finally, when the market is saturated with a product and the consumer has more options than need, the premium has disintegrated and a consumer's decision to purchase is driven by price alone.

DEFENDING PRODUCT POSITIONING

Defending product positioning in a price-driven environment can be problematic, to say the least. Cost-cutting measures usually cannot be recaptured, so any advantages achieved through cost cuts tend to be short-lived. Developing internal manufacturing capability is also not advisable because you must sacrifice product flexibility to generate production efficiency. Besides, global overcapacity and the specter of quota-free exports from countries where labor is cheap will quickly nullify this advantage.

The best answer, therefore, is to monitor the product life cycle—constantly researching and developing potential replacement products that will be awarded premiums for innovation. Zara, the leading Spanish apparel retailer, consistently monitors its marketplace. Its efforts, combined with mastering the product development process, enable the company to bring new designs to market in a few days when other retailers need six to 10 weeks. Zara successfully builds the majority of its assortment on new trends, and frequently renews its collections at the same time it reduces its inventories through markdowns. Ultimately, Zara can generate more profit to fuel its aggressive growth strategy. The disciplines required to do what Zara does are central to the merchandising component of brand building.

CREATING A TRUE BRAND

True brands supported by innovative products are a strong defense against price erosion. Zara, for example, has become more than a retailer with outstanding product innovation processes, it has become a true brand: Store design and services provide a shopping experience that consistently supports the core values and style of Zara, enabling it to withstand price erosion over time.

The transition from labels to true brands calls for merchandising and marketing skills that do not typically exist in a retail environment. Yet the build-out to these competencies can be managed in stages—beginning with education and developing processes for private label goods that will eventually lead to full-blown brand building.

A brand goes through three phases in its lifetime: development, penetration and management

at maturity. At every phase, a coordinated approach must be orchestrated to maintain brand integrity. Over time, having met or exceeded consumer expectations, a brand can gain enough residual goodwill to become a franchise. For purposes of definition, a label is generically used to define product or merchandise lifestyle and has little or no inherent recognition factor. A brand is recognized by name. A franchise is a brand that consumers request by name.

Brand development

In the first or development stage, two ways to create branded discipline should be practiced simultaneously. One way is to develop manufacturers' brands into franchises. In a sense, retailers outsource brand equity by co-opting manufacturer expertise. By engaging the manufacturer in this process, the retailer can align its organization with protocols essential to brand development. For example, department stores often learn how to develop their own brands through relationships with their vendors. The relationship between Saks and Laura Ashley drove exclusive licenses and value for both brand owner and retailer.

Retailers that leverage the manufacturer's supply chain, merchandising and marketing expertise, can then engage in late-stage brand development activities. These activities include, but are not limited to, testing prior to launch, modular assortments, and just-in-time in-season replenishment. By involving merchants early in the product development process, manufacturers can create items that are unique to their stores.

To execute this successfully, both manufacturer and retailer must jointly formulate time and action calendars for product development, production, marketing and promotion. Both parties win, as the manufacturer optimizes business and enhances brand equity, and the retailer gains an operating template, analytical mind-set, and operating proficiencies critical to brand development. Obviously, trust has to be built between the parties for the implementation to be successful.

At the same time, the retailer should be doing preliminary research vital to successful development of proprietary brands. At the core of this research are the standard questions that sculpt brand mission: Who is the customer? What influences his or her decision to purchase? When are purchases likely to be made? Where should merchandise be placed in the store? Once these questions have been thoroughly researched and answered, the retailer can evaluate its organization for home-grown skills and supplement missing elements with its own brands. Also during this phase, the retailer will want to evaluate traffic management functions, capacity of distribution centers, and throughput and cash flow requirements.

Brand penetration

The penetration stage is the most critical period in the life of a brand. This is the inflection point at which consumer recognition is driven by three key factors: products that meet or exceed consumer expectations, product penetration in total assortments and a compelling marketing message. Although complacency is dangerous at any phase, it can be particularly treacherous at this point. Improper forecasting, inconsistent products or failure to develop updated products can have disastrous financial implications.

Forecasting of both trends and logistical management are core competencies that are indispensable to brand penetration. At this phase, the supply chain is fine-tuned to compress lead times, and is supported

by the timely transfer of information and the flawless execution of the product development calendar. Transparency must be built into the supply chain to allow for assortment changes in response to business upturns, downturns or late-developing trends—this calls for continuous sharing of information regarding sales, inventory and forecasting data. Analyzing sales trends and early product testing will help to reduce risk prior to major delivery drops, while constant "reality" checks and product improvements will ensure that the intrinsic value of a product meets or exceeds that of the competition. Finally, retailers that negotiate payment terms with suppliers (based on quantity) will minimize the need for short-term borrowing.

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Brand management at maturity

When a brand reaches maturity, there are several measures that retailers can take to prevent a loss of sales. This is the point at which proper brand management can propel the brand to franchise status. By now, we must assume that the product meets or exceeds consumer expectations, logistical support is firmly established and there is significant brand recognition. *It is now time to re-stage the brand.*

The key determinants of a successful brand management strategy are product leadership, modular assortments, enhanced store environments and brand extensions.

Product leadership. The first step is obvious. Listen to the customer. Sales associates must be trained to listen with a "third ear" while on the sales floor, and the best companies will conduct focus group studies to enhance their understanding of customer expectations. After digesting this information, it may be necessary to perform raw material research, concentrating on consumers' expectations. In fact, top retailers work closely with fiber companies to apply technical capabilities and influence spinners to develop improved yarns. They explore new weaving, knitting, dyeing and finishing techniques, all with an eye toward bringing products to market that tell the consumer, "We listened to your concerns and we are addressing them."

The product life cycle can be extended through trademarks or patents, a strategy that has proven to be particularly successful in the area of active wear. Footwear manufacturers, Nike for one, constantly apply new technology to products and employ marketing efforts that train the consumer to want the newest and best. In doing so, manufacturers keep their newest items promotion-resistant and continuously extract premiums from their consumers.

Modular assortments. There are two main elements to building a successful brand: local demographics and customer transference. Both are by-products of retail overexpansion. As stores are built in secondary markets ("b" or "c" locations) within the same trading area, manufacturers must give these new stores their own identity. This is accomplished by tailoring product assortments to

meet the needs of local consumers while still preventing duplication with nearby locations.

Product assortments will be determined both by price protocols in the immediate trading area, and by introducing new products to "stretch" consumers' imagination when appropriate. Leading companies will apply their testing and analysis skills, and design their allotment capabilities to develop modular assortments.

Store environments. The store environment plays a leading role in the transition from brand to franchise. In addition to the traditional tactics—plan-o-grams, adjacencies, signage, shops within shops and swing areas—companies must always be on the lookout for new technologies and ideas. For example, interactive displays and new self-service product delivery modules will help improve consumers' in-store experience. Cosmetics companies are leaders in this area. Vittorio Radice, former CEO of Selfridges, a popular department store in London, transformed his stores with a simple change of expression—describing them as a "place." From there, store designers went to work rethinking, revamping and renovating all existing locations with the overriding criterion to create customer excitement by making stores a "fun place to be." Today, a handful of department store chains are experimenting with new ideas—from smaller formats, centralized dressing rooms with computer stations and coffee bars, to areas where kids can play video games. The goal is to change the shopping experience to be more in line with consumers' lifestyles.

Brand extensions. Finally, turning a brand into a franchise is often accomplished through the use of brand extensions. The athletic shoe industry provides a good illustration of this point as it develops products tailored to specific activities. Not only is there a specific product for a specific sport but shoes are also differentiated depending on how the customer practices the sport, for example, a weekend jogger versus a marathon runner. By thoroughly evaluating consumer lifestyles, brand reach can be extended through activity-oriented products. Some other areas to consider: performance-oriented (wrinkle-free) travel wear, day-into-evening career apparel, and soil-release, easy-care products.

A RETAILER'S DIAGNOSTIC

In an era of commoditization, how is your organization positioned to create a differentiated apparel offering? Your position will depend on how you answer the following questions:

1. Over the past five years, has the real (inflation-adjusted) price of your core categories remained flat or declined?
2. How well does your organization know its customers' expectations? Which customers are loyal and which are not? Do you know why some customers who used to be loyal do not come any more or tend to buy less in your stores?
3. Would you consider your organization as being poor, average or really good at product innovation?
4. How much lead time do you require from design to market on proprietary products? Is it in the range of eight to 10 weeks or three to five days?
5. Does your merchant and product development organization have a strategic framework for working with key partners in apparel manufacturing?
6. When was the last time your organization

looked at the store environment with a fresh eye? Do your customers consider your stores a “fun place to be”?

7. What portion of sales is in categories or product segments that your stores did not carry two years ago? In your organization, who thinks of extending your brand to better fit with your customers’ lifestyles?
8. Do your customers request your proprietary products by brand name? What brands do they request by name?
9. Do you measure the profitability of fashion versus staple items?
10. Do you have 10 years worth of records that show the relationship between your initial and sustained mark-ups?

There is no set number of yes or no answers that will deem your apparel offerings satisfactorily differentiated. Rather, the quiz is merely designed as a way to encourage more critical, and strategic, thinking about apparel and how it is offered to consumers.

CONCLUSION

If value—real or perceived—is evident to the consumer, he or she will pay a premium price for it. This is particularly true in the apparel industry. The key to success depends on building a brand franchise that is properly supported by excellent products and an urgent and consistent marketing message. Value is built by companies that place a strong emphasis on innovation, consistency and convenience. Those companies that master the skills and processes necessary to meet, and surpass, each phase in the lifetime of a brand, will be the first to earn the rewards of a lasting brand and a premium price.

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