

Private Label Sourcing
Strategies to differentiate
and defend



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Introduction

Retail has entered a period of rapid change—Omnichannel forces are reshaping consumer behavior and the competitive landscape, the pace of international expansion continues to grow, and supply markets face more volatility and regulation. In this new environment, retailers are looking to Private Label sourcing to drive more differentiation on the shelf and to defend market share, margin and brand reputation.

As a \$1 trillion global market, the Private Label industry accounts for nearly 1 of every \$6 of consumer spend.¹ In the United States, Private Label made up 18% of consumer goods dollar sales in 2011.²

Key 'mega-trends' are driving the importance of Private Label for retailers. Rapid **population growth**—disproportionately located in developing regions—is opening up low-cost country sources of supply, creating new markets for retail expansion, driving commodity volatility, and fueling supply chain complexity. The rise of the **Omnichannel retail environment** is driving demand for innovative and exclusive Private Label products since national branded merchandise is easily sold by online competitors. Finally, **consumer interconnectedness**, enabled by social media, has led to greater transparency to Private Label supply chains.

Whether looking to create or grow innovative Private Label offerings, retailers face the imperative to enhance their sourcing capabilities. Deloitte's 2012-13 Private Label Sourcing Survey highlights shifts in market trends and uncovers leading Private Label sourcing practices. With 266 respondents from Apparel, General Merchandise and Grocery retailers, the survey is one of the largest and most comprehensive studies of the market to date.

Key findings from the 2012-13 Private Label Survey include:

- Retailers' **top market pressures** are those driven by a higher and increasingly volatile cost structure:
 - Raw material cost increases and/or volatility
 - Rising production labor wages
 - Fuel price volatility
- Top **emerging strategic responses** to market pressures appear to be responsive to these cost pressures:
 - Country source of supply footprint diversification
 - Re-shoring production to domestic vendors
 - Vendor consolidation
- Although China remains the dominant **source of supply** for Apparel and General Merchandise, other South East Asian countries like Vietnam, Cambodia, and the Philippines are an increasingly attractive option for sourcing—particularly for Apparel and softlines
- Cost, quality and customer service prevailed as **top vendor selection criteria** over factors such as ability to scale production and exclusivity of production
- Retailers are employing a mix of **operating models** to manage the Sourcing function
 - While in-house operating models are prevalent, outsourcing plays a significant role across activities like Raw Materials Sourcing, Quality Assurance and Import/Export Compliance
 - Though Sourcing and Merchants often both own decision rights, formal governance tools are not in wide use related to selecting methods for sourcing products

¹ Lincoln, K. & Thomassen, L., "Private Label: Turning the Retail Brand Thread into Your Biggest Opportunity", 2008.

² Private Label Manufacturers Association, 2012 Private Label Yearbook, June 2012.

The rise in strategic importance of Private Label sourcing

Three ‘mega-trends’ are radically changing the retail landscape, and in turn, Private Label sourcing strategies.

Figure 1. Mega-trends driving the strategic importance of Private Label

Mega-trends	Implications for retailers
<p>Population Growth 7 billion people on the planet,³ rapidly growing in cities</p> 	<ul style="list-style-type: none"> • Disproportionate population growth in developing regions, creating new low-cost supply markets • New growth opportunities in emerging markets, leading to supply chain complexity • Increased pressure on raw materials contributing to commodity input and cost volatility
<p>Omnichannel Retailing Pressure from online retailers accelerated by mobile technology</p> 	<ul style="list-style-type: none"> • With nationally branded merchandise easily sold by online competitors, retailers are turning to more exclusive Private Label offerings to maintain loyalty • As consumers are faced with a proliferation of online options, product design and innovation are becoming increasingly important for Private Label • The demand for new innovations or customized product is leading to shorter product lifecycles and smaller, more frequent order quantities
<p>Consumer Interconnectedness A new, faster lens into retailer supply chains via social networking</p> 	<ul style="list-style-type: none"> • Greater reputational risk via social media can expose supply chain practices faster • Some retailers are using ethical sourcing and sustainability practices to drive more brand loyalty through social networking and Private Label marketing

Population growth

Around October 31, 2011 the world welcomed its 7 billionth inhabitant. Of this population, about half was born in the last 40 years, and more than ever are living in cities: in 1950, 29% lived in urban areas; by 2050, it's expected to reach 67%.⁴ China alone is attempting to move 250 million people from the rural countryside to cities and towns by 2025.⁵ There are numerous implications of a growing, urbanized population to Private Label sourcing, but three are particularly relevant.

First, increased population can provide new low-cost supply markets for labor-intensive products like Apparel and footwear. The last several years, for example, have witnessed a shift of less-complex softlines production out of China and in to markets such as Vietnam and Laos in the face of rising wages. Second, urban dwellers require more sophisticated products to consume and have provided organized retail with new markets to sell their

products. Given the softening of consumer spending in the US, some American retailers are looking overseas for growth, presenting new opportunities and complexities with regard to sourcing for multiple international retail markets.

Finally, a growing population places more demands on natural resource inputs and can contribute to raw material cost volatility, among other factors. Greater demand can lead to more protectionist behavior and higher prices. In March 2011, for example, the Indian government announced export controls on cotton to protect local consumption in the face of increased demand from countries like China.⁶

The Bottom Line: Sourcing can help open up new supply markets, serve new international retail markets with varying tastes, and manage raw material cost volatility.

³ U.S. Census Bureau, International Data Base.

⁴ United Nations, Department of Economic and Social Affairs, Population Division: World Urbanization Prospects, the 2011 Revision: Highlights. New York, April 2012.

⁵ Johnson, I. "China's Great Uprooting: Moving 250 Million Into Cities." The New York Times, June 15, 2013.

⁶ International Cotton Advisory Committee, "Production and Trade Policies Affecting the Cotton Industry", October 2012.

Omnichannel Retailing

The world's growing, urban population is more connected than ever before. In the US, nearly 80% of residents have access to the internet and 46% of adults are Smart Phone owners.⁷ Connected consumers influence each other's tastes and buying preferences. They are also more empowered in what was once an asymmetrical environment where retailers knew more about their price competitiveness than the consumers. Consider, for example, how easy Smart Phones and the Internet have made comparison shopping.

Omnichannel refers to the coordination of eCommerce, mobile, social, and evolving digital technologies into one seamless customer experience. Retailers are responding to Omnichannel forces with multiple strategies, some of which are highly dependent on deep sourcing capabilities. Many are developing sophisticated, unique Private Label offerings that cannot be offered by a lower-cost online competitor.

Retailers are also keeping the assortment fresh with new, innovative offerings. With highly connected consumers, trends seem to move more quickly and pressure is high to offer the next 'big idea.' This of course puts pressure on the sourcing function to be more flexible and adaptable as retailers grapple with shorter product cycles (including increased uptake of 'fast fashion' for Apparel), resulting frequency and smaller order sizes.

The Bottom Line: Sourcing can enable the development of more sophisticated and unique Private Label offerings to combat online competition.

Consumer Interconnectedness

With the rise of social media, the activities of retailers' supply partners are more easily documented and disseminated than ever before. Offering Private Label merchandise has many benefits, but it can also expose a retailer to significant reputational risk as it's clearly the retailer's label on the product and not that of a national brand. The ease with which one can find examples of consumer product manufacturers involved in environmental degradation or worker safety issues speaks to the transparency to which supply chains are now exposed.

The Internet and social networking has made the world a smaller place, and has awakened societal consensus greater than ever before. Consumers are more aware of the impact of their purchases on both the environment and society at large, and they are choosing to 'change the world' with their wallets.

Some retailers use their supply chain practices to build an even closer emotional bond to their shoppers and to communicate the impact they are making on society and the environment through their web sites and social networking channels. Consider the 'one-for-one' policy of TOMS, where for every shoe purchased, one pair is donated to a child in need. TOMS uses social networking—specifically online videos—to tell the story of the impact they are making. These videos help TOMS build an emotional bond with their customers, which fuels sales and their ability to help more children in need.

The Bottom Line: Sourcing can be critically important to protecting a retailer's brand, building a closer emotional bond with shoppers and fulfilling a retailer's aim to make a positive impact on the environment and societies around the globe.

⁷ Smith, A., "46% of all American adults are smartphone owners", Pew Research Center, March, 2012.

Private Label sourcing pressures and strategic responses

In the face of these game-changing shifts, Deloitte launched its 2012-13 Private Label Sourcing Survey. The survey provides an assessment of Private Label sourcing trends, including:

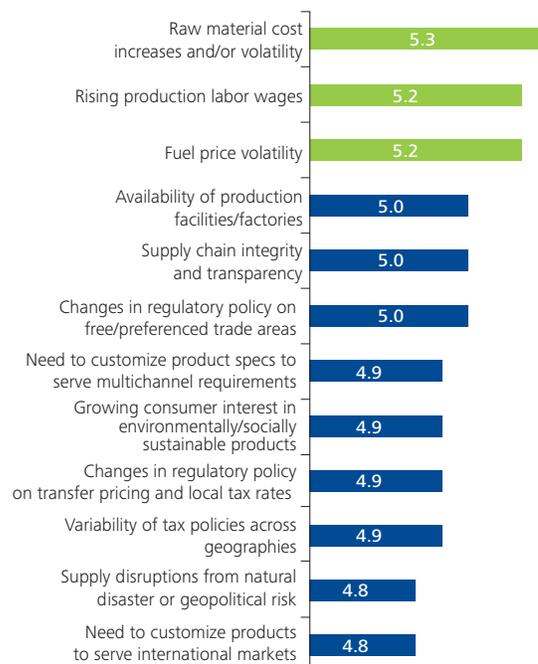
- Top market pressures retailers face with respect to Private Label sourcing
- Current and evolving strategic responses to market pressures
- Shifts in retailers' sourcing footprints, including source of supply and vendor selection criteria
- Associated operating model, governance, technology and tax trends

Retailers offering goods in three categories—Apparel, General Merchandise and Grocery—participated in the survey. Although the results included in this report generally show cross-category trends, category and company size-specific cuts of the data have been compiled. Please contact the survey authors for additional results.

Private Label Sourcing Pressures

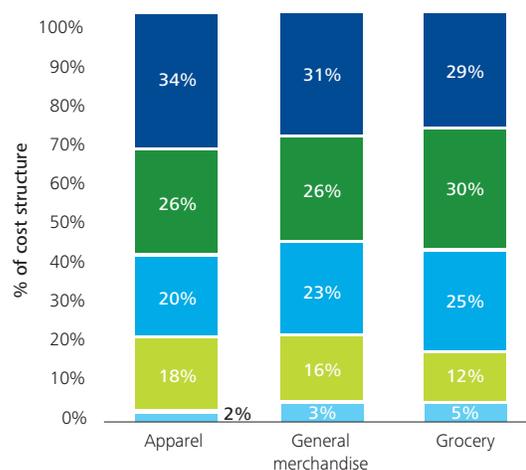
Retailers' top pressures are driven by a higher and increasingly volatile cost structure. Risks from rising Cost of Goods Sold (COGS)—raw material cost increases and volatility, rising production labor wages and fuel price volatility—trumped pressures related to product innovation, supply chain risks (e.g., supply disruptions, supply chain integrity) and tax consequences of the sourcing operating model. These pressures also correlate directly to the top three elements of retailers' product sourcing cost structures. Across retailers, raw materials, production labor costs and transportation costs account for 80-84% of landed duty cost paid.

Figure 2. Top market pressures (avg. score, 1-7)



N=607

Figure 3. Product sourcing cost structure (% of landed duty paid)



- Raw material/component cost
- Production labor costs
- Transportation costs
- Customs duty
- Other

N=383

Strategic responses

There are a multitude of strategies that a retailer can employ to achieve its sourcing objectives in the face of market pressures. However, there are generally two overarching levers that comprise a sourcing strategy: the Value Chain Strategy and the Sourcing Footprint Strategy.

The **Value Chain Strategy** focuses on deciding which players (i.e., the retailer itself or its partners like supply chain agents) are responsible for which sourcing activities, from design to logistics. Retailers can choose to take on activities themselves or collaborate with their value chain partners for a variety of reasons, including cost, sourcing volumes, exclusivity of product design, the desire to spot trends in the supply markets or the upstream complexity of their product development processes, to name a few.

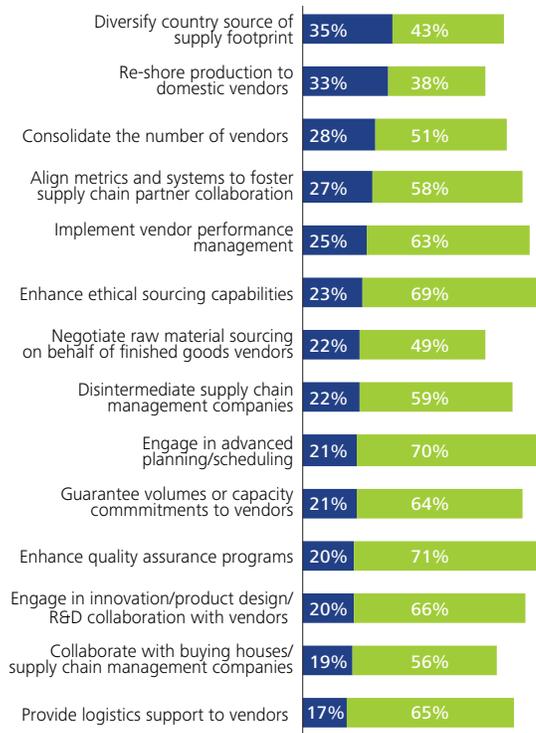
The **Sourcing Footprint Strategy** focuses on where, and from whom, retailers will source. Operating environment and costs, clustering of complimentary supply partners, and government incentives are just some of the considerations that are driving changes in global supply patterns. Factors including cost, quality, ease of doing business, and compliance to ethical sourcing requirements drive supplier selection.

Survey participants were asked to indicate across a suite of 14 responses which they currently employ, and which they plan to employ in the future. While there are many reasons that companies might pursue these 14 responses, they do generally align to the elements of either a Value Chain Strategy or a Sourcing Footprint Strategy.

Figure 5. Strategic response alignment to sourcing strategies

Primarily Associated with Value Chain Strategy	Primarily Associated with Sourcing Footprint Strategy
<ul style="list-style-type: none"> • Enhance ethical sourcing capabilities • Enhance quality assurance programs • Engage in advanced planning/scheduling • Engage in innovation/product design/R&D collaboration with vendors • Provide logistics support to vendors • Disintermediate supply chain management companies • Collaborate with buying houses/supply chain management companies • Negotiate raw material sourcing on behalf of finished goods vendors • Align metrics and systems to foster supply chain partner collaboration 	<ul style="list-style-type: none"> • Diversify country source of supply footprint • Re-shore production to domestic vendors • Consolidate the number of vendors • Implement vendor performance management • Guarantee volumes or capacity commitments to vendors

Figure 5. Strategic responses to market pressures



■ We do not currently use this response but plan to in the future
 ■ We currently use this response

N=600

The top *currently* employed responses—enhancing quality assurance programs, engaging in advanced planning/scheduling, and enhancing ethical sourcing capabilities—do not directly address the COGS risks that retailers report as their top three pressures.

On the other hand, top *emerging* strategies appear to be more directly correlated with cost pressures:

- *Country source of supply footprint diversification* may reduce labor and transportation costs
- *Re-shoring production to domestic vendors* might also reduce transportation costs
- *Vendor consolidation* can leverage buying power to drive lower labor and material prices

Sourcing footprint strategies

Source of supply

The 2012-13 Survey reveals that—of the 94 countries noted as a source of supply—China, Mexico and Canada are the most prevalent. China’s inland, northern and southern coastal provinces continue to dominate for Apparel and General Merchandise retailers. For grocers, North and South American sources of supply—Chile, Argentina, Brazil and Costa Rica—join Canada and Mexico in the top ten.

For more than a decade, China has been the undisputed leader as a sourcing and manufacturing base, especially for Apparel and General Merchandise. But over the last few years, China’s appreciating currency, economic growth and rising labor costs have started to impact its dominance in the supply market. The survey respondents suggest that other South East Asian countries like India,

Vietnam, Cambodia, and the Philippines are becoming an increasingly attractive option for sourcing particularly for labor intensive products. China is still in many ways the go-to country for supply, but sourcing organizations are looking at options for expansion.

Re-shoring to local markets is becoming an increasingly attractive option for some respondents as well. In the context of the US, this strategy is most appropriate for those seeking lower transportation costs and product with high automation and low labor content. The Survey indicates this strategic response is being adopted by Grocery and large (>\$10B revenue) General Merchandise retailers in particular.

Figure 6. Summary of current sources of supply

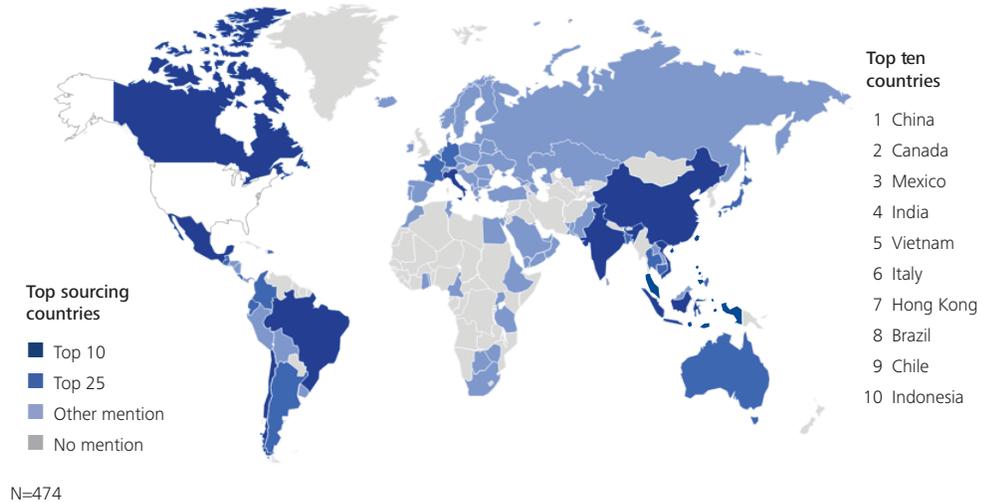


Figure 7. Vendor selection (Avg. Score, 1-7)

Vendor Selection Criteria	Cross-Category Average	Apparel	GM	Grocery
Total cost (including conversion costs, logistics, overhead)	5.9	5.8	5.9	5.9
Product quality	5.8	5.7	5.8	6.1
Customer service/ease of doing business/flexibility	5.7	5.7	5.7	5.6
Ability to scale production	5.5	5.7	5.6	5.1
Ethical sourcing compliance	5.3	5.3	5.4	5.0
Exclusivity of production	4.8	4.8	4.9	4.5
Proximity to cluster of complementary suppliers	4.7	4.6	4.9	4.6
Proximity to retail markets	4.5	4.2	4.5	5.2

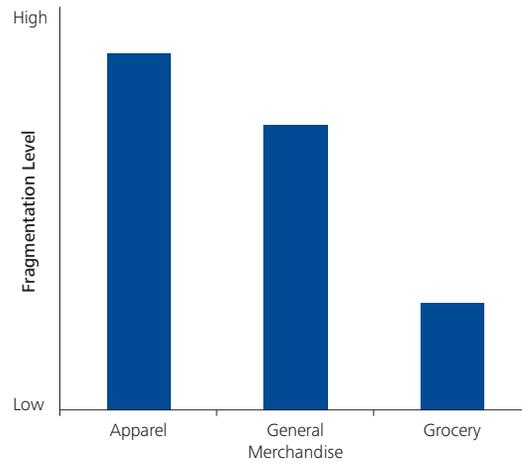
N=598

Vendor Selection & Fragmentation⁸

Vendor selection criteria held generally steady across Apparel, General Merchandise and Grocery respondents, with total cost, product quality and customer service/ease of doing business rounding out the top three.

Vendor consolidation was highlighted as a top-three emerging strategic response for retailers. Survey results show that Apparel companies currently exhibit the most fragmentation, whereas Grocery retailers, particularly large (>\$10B revenue) retailers show limited vendor fragmentation. Fragmentation will remain an interesting metric to watch, particularly if two trends continue to play out: COGS pressures may incentivize retailers to aggregate spend with fewer suppliers to improve bargaining leverage, and Omnichannel strategies may drive the need for more flexible, responsive, supply chains and closer ties between retailers and vendors.

Figure 8. Average vendor fragmentation



N=202

⁸ Fragmentation calculated based on the number of suppliers representing 80% of spend.

Optimizing sourcing capabilities to respond to the market

Generally speaking, strategy should drive operating model design. As decisions are made on the Value Chain and Sourcing Footprint Strategies, capabilities in talent, governance processes and technology should be transformed to enable those strategies.

Retailers are employing a mix of operating models to manage the sourcing function. In-house sourcing by company employees (at headquarters or satellite offices) was prevalent among Survey respondents. Third parties and/or intermediary models are employed, but to a lesser extent, possibly driven by a retailers' desire to disintermediate their supply chain relationships. Through disintermediation, retailers can bypass buying agents and go direct to suppliers, a tactic that has anecdotally resulted in COGS savings of 3 to 12%. A separate, recent Deloitte poll corroborates this trend: Respondents indicated a planned reduction of the use of buying agents from 33% currently down to 16% in the future.¹⁰

Although in-house operating models are prevalent, outsourcing continues to play a significant role across all sourcing activities. Some or all of virtually every sourcing

activity was supplemented more than 50% of the time, and in activities like raw material and finished goods sourcing, that number rises to more than 60%.

Figure 9. Product Sourcing operating model (% of respondents)

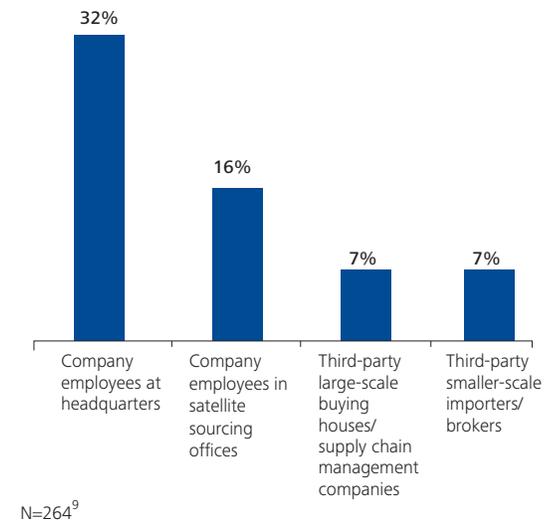
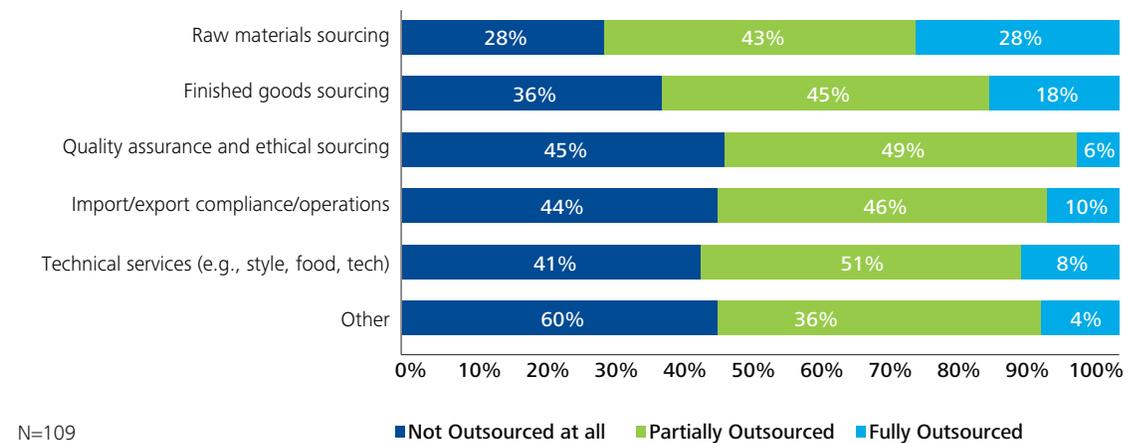


Figure 10. Outsourcing of functional areas (Avg. % for Respondents)

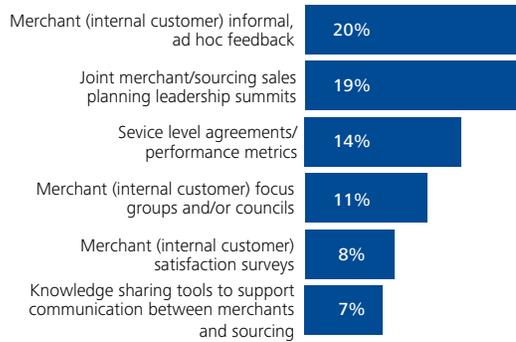


⁹ Analysis excludes responses that are not applicable or not known by respondent.

¹⁰ For respondents using buying agents more than 50% of the time; Poll conducted as part of a Deloitte Dbrief presentation on Private Label sourcing trends, held in September 2012 with an audience of ~1,100.

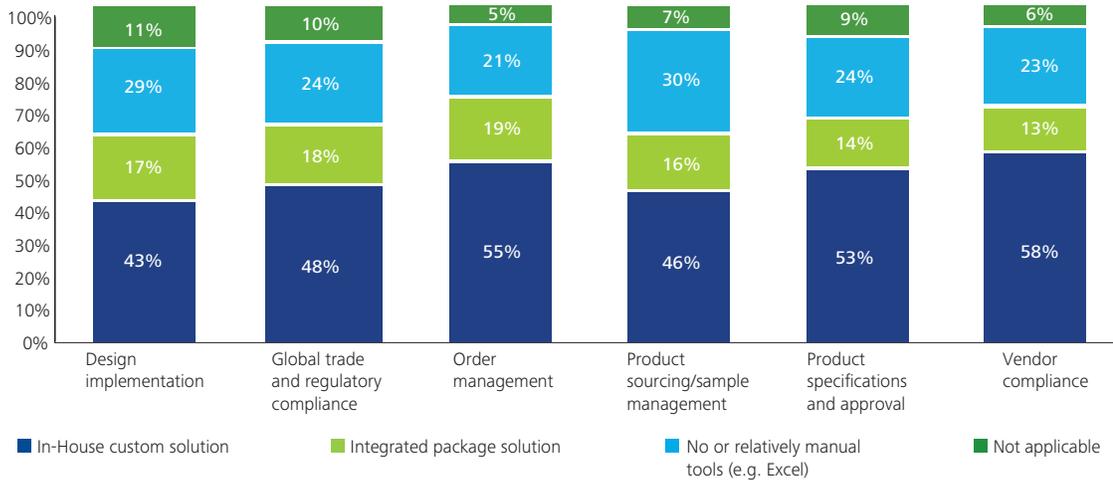
A clear governance structure helps sourcing organizations make pressing decisions. The Survey nevertheless indicates that overall use of governance tools to drive accountability and facilitate decision making is low. Among the governance tools actually employed, informal ones like merchant ad hoc feedback were more commonly employed than other, more structured tools like SLAs, focus groups, satisfaction surveys and formal knowledge sharing tools. There may be an opportunity for sourcing organizations to further enhance their governance structure and controls.

Figure 11. Governance methodologies



N=264¹¹

Figure 12. Technology tool use across sourcing activities



N=597¹¹

With regard to technologies that enable the sourcing process, Survey results note a relatively large reliance on manual tools (21-30% of respondents) and on in-house custom solutions (43-58% of respondents). In the case of the former, organizations may be stranding valuable data

that could be used to inform decision making on hard drives and/or utilizing tools unmatched to the complexity of the task. The latter figure may represent an opportunity for applications providers to more comprehensively meet the needs of the Sourcing function.

¹¹ Analysis excludes responses that are not applicable or not known by respondent.

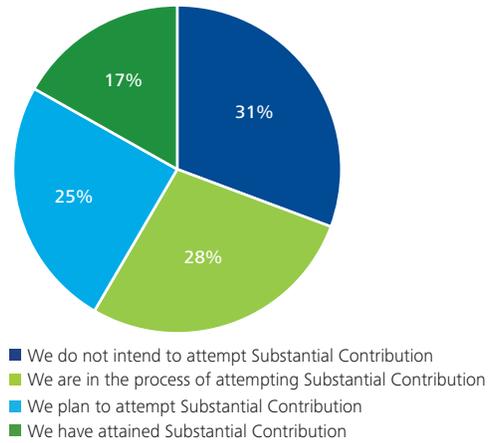
Managing tax consequences of sourcing decisions

Sourcing decisions drive significant direct and indirect tax implications for retailers.

With regard to direct (income) tax, respondents were asked about activities related to Substantial Contribution. A portion of the income earned by a foreign operating company will be treated as Subpart F income and consequently, taxed currently in the US unless an exception applies. If, however, the operating company can be treated as a “manufacturer,” under the US Substantial Contribution test, the income would not be considered Subpart F income and not taxed in the US. To meet this test, a retailer must “substantially contribute” to the manufacture of the product it sells. According to the Survey, over 50% of respondents are pursuing or plan to pursue Substantial Contribution as a tax strategy.

Customs duties, an indirect tax, represent 12-18% of respondents' landed duty cost paid.¹² According to the Survey, Free Trade Agreements and Free Trade Areas are the most commonly used mechanisms to minimize duties. This is likely related to their increased availability: In the last 10 years, the proliferation of trade agreements has increased significantly. 113 global trade agreements were entered into force from 1958-2002, however in the last 10 years, that figure was 225. In Southeast Asia, intraregional trade agreements have grown fourfold over the past ten years, and by 2012, there were eight agreements.

Figure 13. Substantial contribution adoption (% of respondents)



N=36

Figure 14. Product sourcing duty minimization programs (% of respondents)



N=264¹³

¹² See Figure 3.

¹³ Analysis excludes responses that are not applicable or not known by respondent. 214 respondents did not answer or answered “No” to all tax related questions.

Conclusion

Rapid population shifts, the rise of Omnichannel retailing and increased consumer connectedness are driving radical shifts in the retail environment. As discovered through Deloitte's 2012-13 Private Label Survey, retailers are responding through two key approaches: revamping their value chain strategies and diversifying their source country footprints. They are choosing to enable their strategies through operating model reconfiguration, strengthening internal governance and decision rights, and making investments in strategic talent and technologies.

Given these conditions, there is little doubt that the strategic importance of the Sourcing function is increasing. As retailers look to Sourcing to drive more differentiation on the shelf and to defend market share, margin and brand reputation, they should be asking themselves:

- Are we strategically positioned to react to and take advantage of market pressures?

- Are we actively managing our Value Chain Strategy?
Are we making best use of the capabilities of our own organization and those of our supply chain partners to drive innovation and profit while mitigating risks?
- Does our sourcing footprint consider both emerging sources of supply and our planned retail footprint?
- Are our operating and governance models positioning us to enable our Sourcing strategy?
- Do we have the right talent skills to face off appropriately against market pressures?
- Do we need to refine processes or invest in enabling technologies to get the most out of our Sourcing organization?

Given the increased importance of the strategic sourcing function and the increasingly dynamic retail environment, answering these questions may help retailers reap the benefits from an enhanced Sourcing function.

Survey methodology

The 2012-13 Private Label Sourcing Survey was commissioned by Deloitte and conducted online through self-hosting and an independent research company throughout 2012. 266 respondents provided input across three spend categories (Apparel, General Merchandise and Grocery) and 11 sub-categories (e.g., Apparel > Fashion Accessories, General Merchandise > Home Softlines, Grocery > Frozen). Because respondents could submit responses for multiple sub-categories, over 600 responses were collected.

Approximately 75% of respondents are from companies with annual revenues greater than \$100M, and nearly 50% of the companies represented have more than 25,000 employees. The collective vendor supply base for respondents is greater than 150,000 vendors.

The table below summarizes the topics and provides sample questions.

Figure 15. Private Label survey topics and sample questions

Topic	Analysis area	Illustrative questions
Current sourcing landscape/future strategic priorities and responses	Market pressures	To what extent are each of the following pressures impacting your organization's product sourcing efforts in this category?
	Strategic responses	Please indicate if you currently use the following strategic responses to address pressures identified in the previous question or plan to in the future (e.g., by 2015).
	Vendor fragmentation	Approximately how many finished goods/assembly vendors make up 80% of product sourcing spend in this category?
	Sourcing geography	What are the top ten countries/regions your organization sources from in this category today in terms of dollar volume? For each country/region selected, please indicate if you expect volume to increase, decrease or stay the same.
	Vendor selection criteria	How important are the following factors in selecting the vendors from which to source product?
	Breakdown of cost structure	Please approximate the cost structure for this category's product sourcing. Please indicate each cost component below as a percentage of landed duty paid cost.
Governance and organizational design	Operating model	Which of the following operating model(s) does your organization use to manage product sourcing spend?
	Sourcing decision rights	For an individual buy, who decides which of the previously mentioned sourcing methods to use?
	Governance methodologies	Which of the following elements are parts of your organization's governance structure for product sourcing?
	Outsourcing of functional areas	To what degree does your organization outsource functional areas of your product sourcing program?
Technology trends	Technology tools	For each of the following sourcing activities, please characterize the type of technology tools your organization currently uses.
	Integrated packaged solutions	If your organization is currently using any integrated packaged solutions, what are the names of those packages?
	Websites	Please list any websites your product sourcing organization uses to identify new vendors and/or trends.
Sourcing income tax and customs/duties	Substantial Contribution adoption	Has your organization attempted to achieve Substantial Contribution to treat your company as the manufacturer of the products as part of your product sourcing tax strategy?
	Product Sourcing duty minimization programs	Please indicate which of the following product sourcing duty minimization programs your company uses.

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