

Chapter 11 Reducing Markdowns

Markdown is the difference between the price on the hangtag and the average amount that the store receives after all sales and discounts. Markdowns occur for the simple reason that the goods do not sell. Some styles arrive at the store and sell out in a few days. Other styles don't sell at all. The blue and green sell but the red and the navy die. Sizes small and medium walk out of the store, while large and extra-large just lay there.

There are three major causes of markdowns:

- a. Systemic: The factory is excluded from markdown reduction strategies.
- b. Structural: The business model adopted by brick and mortar stores requires markdowns.
- c. Unaccounted soft costs: soft costs are important factors leading to markdowns. Their exclusion from garment costing precludes any ability to reduce markdowns.

Systemic Causes

Once again, this is to a large degree a costing problem. Because retailers and brands do not think of markdowns as a garment cost, markdowns do not appear on the cost sheet. They fail to recognize that not only are markdowns the single largest cost factor (more than twice total FOB), markdown costs can be substantially reduced by the factory. As we see in the cost sheet below, the markdown reduction on a garment with a \$10.00 FOB price is \$14.51 (\$20.82 minus \$6.31). It is as if rather than the customer paying the factory \$10.00, the factory is paying the customer \$4.51.

Markdowns are seldom the result of untalented designers or incompetent merchandisers. The main cause is time. If lead times for product development are six months and production and postproduction times adds another five months, markdowns are inevitable. Who is so talented that they can predict what the consumer will want to buy a year in advance?

There are a number of strategies available to reduce markdowns but virtually all require SPEED-TO-MARKET. The most well-known strategy is Zara's strategy of DESIGN AFTER SALES. If the factory has FAST TURN capability with production lead

times under seven days from FABRIC SPREADING to stock GOODS FINISHED, READY FOR SHIPMENT, it can follow the Zara model.

There are other benefits of speed-to-market:

- Trial orders: These are small quantities of multiple styles, produced and shipped by air in days. On receipt the retailer places the goods in pre-designated branch stores. If five styles sell well, the customer will place bulk orders for those five styles. If three styles sell, the customer will place bulk orders for three styles. If zero styles sell, the customer will redesign and place new trial orders. Risk is minimized and money is saved.
- Quick response: When producing bulk orders, the factory retains a portion of the fabric for re-orders. Once the customer has detailed sales information from all stores, he is able to determine which styles, which colors and which sizes have the greatest sales and can place reorders with the knowledge that within six days the goods will be ready for air shipment.

Of course, fast turn capabilities require not only new skill sets but often a new factory layout. This is very costly both in time and capital but the returns are truly impressive. In our cost sheet below comparing costs when the factory does or does not offer markdown reduction services, **on the customer side, net profit (after markdowns) increases by 37.5%** (\$26.50 to \$36.47). **On the factory side net profit increases by 250%** (from \$0.50 to \$2.50 per unit).

Full Value Costing: Factory With or Without Markdown (MD) Reduction Services					
		No Markdown Reduction		With Markdown Reduction	
			Cost	Cost	
1	Material		\$6.00	\$6.00	
2	Trim		\$1.00	\$1.00	
3	CM Labor		\$0.64	\$0.64	
4	CM Overhead		\$1.86	\$1.86	
5	Cost of Markdown Reduction Service		\$0.00	\$1.00	
6	CM Total Cost		\$2.50	\$3.50	
7	Total Factory Cost		\$9.50	\$10.50	
8	Added Value Markdown Reduction Service		\$0.00	\$2.00	
9	Net Factory Profit		\$0.50	\$2.50	
10	Total FOB Cost		\$10.00	\$13.00	
11	Agent Commission	5.0%	\$0.50	\$0.65	5.0%
12	Freight		\$0.25	\$0.25	
13	Duty	16.2%	\$1.62	\$2.11	16.2%
14	Clearance		\$0.10	\$0.10	
15	Transport		\$0.15	\$0.15	
16	Total DDP		\$12.62	\$16.26	
17	Product Development Loading	20.0%	\$2.52	\$3.25	20.0%
18	Distribution Center Loading	5.0%	\$0.63	\$0.81	5.0%
19	In-Store		\$15.78	\$20.32	
20	Markup	75.0%	\$47.33	\$42.78	68.8%
21	Retail		\$63.10	\$63.10	
22	Markdown	33.0%	\$20.82	\$6.31	10.0%
23	Net Retail		\$42.28	\$56.79	
24	Net Customer Profit		\$26.50	\$36.47	\$9.97

- Line 5: Assumes factory MD reduction services cost of \$1.00 per unit.
- Line 6: CM without MD reduction services \$2.50. With is \$3.50.
- Line 8: Factory added profit for providing MD reduction services is \$2.00.
- Line 9: Total factory profit including MD reduction services \$2.50. Without is 50¢.
- Line 10: FOB cost including MD reduction services \$13.00. Without is \$10.00.

- Line 16: DDP cost including MD reduction services \$15.76. Without is \$12.62.
- Line 17: Product Development where factory provides service = \$3.15. Where customer charges PD loading = \$2.52¹
- Line 19: Cost in-store where factory provides MD reduction services is \$19.70. Without is \$15.78.
- Line 21: Retail price for both cases is the same = \$63.10. Markup where factory provides MD reduction services is 69%. Markup where factory does not is 75%.
- Line 22: When factory helps reduce MDs, it can drop to 10% of retail or \$6.31. Otherwise MD stays at 33% or \$20.82.
- Line 24: Retail net profit where factory provides MD reduction services is \$36.47. Without the factory services, retail net profit is \$26.50.
- Customer's net savings when factory helps reduce MDs is \$9.97.

Structural Causes

Fashion garment retail has only two basic models:

- Selling something to everybody
- Selling something to somebody

Today brick and mortar retail follows the something-for-everybody model. It is simply a question of geography. The retail store by definition has a fixed location. Its potential customer base is limited to the distance a customer will travel to get to the store. A customer might travel 50 miles but not 500 miles.

Success is based entirely on increased market share, the ability to draw the potential customer away from other brick and mortar competitors. To maximize its customer base, the store must sell fashion that appeals to the greatest number of potential customers and at prices that will further attract those customers.

But reality is different. In fact, the something-for-everybody model defined as fashion-for-everybody strategy has put the major retailers in a hole for two reasons:

¹ *The importer customer does not know the actual product development costs and for good reason. Instead they will use a loading, a percentage added to the cost of every imported garment, usually about 20% of DDP.*

- To succeed the retailer must reduce design to the lowest common denominator because the more individualized the design, the smaller the potential customer base.
- To succeed the retailer must have sufficient stock of every style, in every color and every size to meet potential consumer demand. The retailer cannot afford to sell out of any style because every lost sale reduces market share.

In this regard, markdowns are not evidence of a failure of design, merchandising or sourcing skills, but rather the necessary result of the never-ending fight for lower costs. This in turn limits the ability of the designers to create the best designs, the sourcing specialists to work with the best factories and the merchandising executives to select the best style rather those with the lowest cost.

Markdowns will continue to grow, resulting in ever-increasing retail prices until brick-and-mortar retailers change their business model or are replaced by other retailers with a more rational business model.

Unaccounted Soft Cost Causes

Soft costs come in two distinct types but have one thing in common: We can quantify the added cost but not the added value. Positive soft costs such as quality and design come with cost. Higher quality and better design will invariably add cost which is quantifiable. At the same time, these added costs will be more than offset by higher value, which is not quantifiable.

If we look back, the data is clear. As we saw in the Gap case study², under Drexler when high quality was a primary goal, the company reached its peak in 2005 with sales of \$16.3bn and profits of \$1.2bn (7.1% of volume). In the post-Drexler era, when quality was sacrificed in order to reduce costs, the company declined. For 2018, sales totaled \$15.9bn with profits of \$848mn (5.3% of volume).

Negative soft costs pose even greater problems. For example, greater compliance, sustainability and transparency all come with added cost but those costs are difficult to calculate because they are offset by other factors. A factory operating with high level corporate social responsibility (CSR) may be able to attract better quality customers who demand high levels of CSR from the

² See Chapter 9, *The Incomplete Cost Sheet*

suppliers. In this case, the added cost of CSR could be offset by the increase in value they provide to their customer who is willing to pay a higher FOB price.

The difficulty comes at the consumer level. The consumer may require greater compliance, sustainability and transparency, but they will not buy just because the retailer and brand has good CSR. That same consumer may well reject retailers and brands with low levels of CSR.

We live in a world where the consumer is looking for reasons not-to-buy. Today a consumer looking for a blue wool overcoat need only input that request on their computer and 800+ pictures will immediately pop up. No one wants to go through 800 photographs before deciding on their overcoat of choice. It is much easier to narrow down the selection by blocking whole groups. The consumer can easily find lists compiled by NGOs for factories which are deemed unsustainable or who allegedly mistreat their workers. Put in the names and let the computer do the work. Searching for the so-called good CSR factories is also easy. Ethical behavior becomes a game allowing the consumer a double benefit. Not only can they pat themselves on the back for their ethical behavior, they also reduce the time spent surfing the endless choices available on the internet.