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Is Direct Sourcing Right for You?

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A shifting landscape

Product cost is the largest component of Cost of Goods Sold (COGS), making up 60-70 percent of total cost. For the majority of retailers and consumer packaged goods (CPG) organizations, products are sourced and not manufactured, so building internal capability in this space is a significant lever to drive performance improvement.

Expanding "Direct Sourcing" to agents/factories will enable retailers and CPG organizations to improve margins, quality control, increase speed to market and assure social compliance.

Key considerations for going Direct

There are five key considerations when assessing Direct Sourcing:

1. **Margin Improvement**: If the margin requirements are over 500 bps or Freight on Board (FOB) price improvements of 10-20 percent, it is unlikely to come from traditional cost negotiations and a strategic sourcing shift will be required.
2. **Diversify Sourcing Risk**: If over 80 percent of product is concentrated in one geographic location (e.g. China), minimizing supply risk and counter-shifting macroeconomic trends, tariffs and regulations and currency changes becomes important. That's why it is imperative to have a diversified portfolio of regions.
3. **Corporate Social Responsibility (CSR)**: Consumers demand adherence to social compliance standards. Many retailers find that their expected standards are not fully met by suppliers and would like to have more control in educating and enforcing the behavior.
4. **Private label**: If part of the growth strategy is to grow a private label business/category, retailers need to have the ability to design and establish a direct relationship with the suppliers to ensure flexibility and speed to market.
5. **Wholesale/Trader Value**: It is important to evaluate the value being provided (e.g. new product, design support, packaging and logistics support) by the wholesaler/trader relative to the margin lost.

Key attributes for a category to be relevant for Direct Sourcing

Based on the considerations above, if an organization decides to source directly, the next critical step is to determine what portion of the business and/or categories have the most potential opportunity to benefit from Direct Sourcing. Typically, the following attributes minimize the supply risk while maximizing the margin improvement in the shortest time:

- **Commodity items/low design complexity**: A commodity category is characterized by products that are currently purchased from trading partners with very little value addition (e.g. design, PD, packaging) and can be obtained "off the shelf" from supplier factories. It is unlikely that an entire category has a commodity characteristic; but within each major category, there are usually sub-categories that would fall into the commodity classification.
- **Scale**: Typically, high volume, low breadth (SKUs) enables an easier transition from vendor selection, product sampling and quality assurance. High volume, low breadth also provides a bigger "bang for the buck" and poses the lowest risk.
- **High degree of replenishment business**: Categories/products that are replenished compared to a fashion category ("one and done") is of low risk to business continuity and should be prioritized to Direct Sourcing until the organization builds additional internal design and product development capabilities.
- **Minimal domestic assembly/logistics requirements**: There are certain categories that need to have domestic assembly (e.g. fluffing throw pillows) or small items that need to be broken from a bulk package into smaller packages that may not be part of the initial wave of products to be Direct Sourced.
- **Mature factory base**: Products that have a broad ecosystem and supply base are easier to go Direct and is easy to find alternate vendors.

How can I go about Direct Sourcing?

Once the assessment has been completed to determine the Direct Sourcing opportunity, and the categories have been identified to initiate the process, a **systematic six step approach** can be used to successfully drive a Direct Sourcing program:

1. **Secure C-level support**: Direct Sourcing initiative is NOT a merchandising-driven initiative. It needs the merchandising support but needs to be driven from the top (e.g. CEO, COO, CFO, CMO, HR and Legal) as this will impact all aspects of the business.
2. **Assess and identify gaps**: The team should understand current process, summarize the need and pinpoint the opportunities and challenges before embarking on the initiative. External resources are frequently used to support the gaps until a robust Direct Sourcing organization is stood up.
3. **Prioritize categories**: Determine the categories and sub-categories and products that need to be targeted for the Direct Sourcing opportunity. Organize the categories both "bottom-up" from a SKU level, and "top-down" from the category level on what portion of the business has the potential for conversion to a Direct Sourcing model.
4. **Get internal buy-in from merchandising**: Collaborate with the merchandising team (Buyers) to get their "buy-in" as frequently as possible because they have the relationships with the incumbents. It's important that the merchandising team is confident that going Direct will not diminish its role or product quality, and that pricing will be the same or better than before.
5. **Identify and select agent factories**: The critical step after the "buy-in" is to determine the best partner(s), and to choose the factories or the agents to work directly with the factories. Depending on the category spend, it is beneficial to evaluate multiple partners in multiple geographic regions to understand capability of agent/factory, pricing and quality from suppliers in different geographic regions. For example, furniture can be sourced competitively in China, Vietnam, India, Indonesia and the Philippines, but core competencies and price points vary by country and regions within a country. Factory visits to validate CSR is a pre-requisite and a core requirement.
6. **Execute in waves**: The biggest risk for Direct Sourcing is the disruption of the business due to quality or non-availability of product. Therefore, it is best to pilot the easier categories and then expand to categories with more design, product development or logistics requirements as a stronger internal capability and deeper supplier relationships are built.

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Key capabilities to sustain/ institutionalize Direct Sourcing successfully in the long term:

1. **Build an internal Direct Sourcing team**: A Direct Sourcing organization should be designed to address the primary organizational gaps in sourcing support. This organization should be dedicated to Direct Sourcing, but should be both independent from and collaborative with the Buyers. Additional resources will be needed to support identification, negotiation and selection of new agents/factories both in the U.S. and in other countries. In particular, sourcing resources need to be added to aid buyers in finding factories, negotiating product costs, managing PO and ensuring product quality and flow.
2. **Establish sourcing processes and support infrastructure**: From supply planning, forecasting, vendor selection, cost negotiation, PO management, to quality and product liability and social compliance, all Direct Sourcing-related roles and responsibilities need to be addressed and modified.
3. **Establish category financial plans**: It's important to establish a long-term plan for each category and make the DMMs commit to a certain percent of Direct Sourcing buy for their categories in the financial plan.
4. **Protect IMU Gains**: It is easy to take the IMU gains and lower the product price at retail and erode the gains. Occasionally, it will make sense in certain products to use the margin improvement to share with the consumer but it should be a conscious choice. A stringent and accountable process needs to be established with top leadership and finance to ensure that IMU gains are not eroded by Buyers by lowering retail price.

Conclusion

In summary, Direct Sourcing merits serious consideration from retail and consumer goods companies. It is an effective strategy when used to adapt to the shifting competitive landscape, achieve higher margins and service customers better.

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