Better Buying™

Special Report

Better Buying Institute, July 30, 2020

Cost and Cost Negotiation and the Need for New Practices

Introduction

Even though the initial shock of the COVID-19 crisis has passed, ongoing challenges to business continuity, uncertainty around new outbreaks and a potential second wave, and months of hardship for buyers, suppliers, and workers have shaken the apparel industry to its core. This series of Special Reports from Better Buying™ aims to identify how business practices are being shaped by COVID-19, share emerging best practices for improving purchasing practices, and discover which practices suppliers want to see become part of minimally acceptable industry standards in the future. In this report, we focus specifically on cost and cost negotiation practices.

This report uses background data from Better Buying's annual data collection that took place in Q4 of 2019 involving 784 suppliers. In addition, new findings from a recent global supplier survey about cost and cost negotiation practices are discussed. Suppliers were invited to participate in this latest survey during the period of June 25 through July 13, 2020. In total, 147 suppliers from 30 countries participated.

Key Takeaways from this Report

The high-pressure strategies suppliers reported have the most impact on their business profitability are also the strategies that were most frequently employed by buyers rated during the Q4 2019 ratings cycle.

Some buyers are using planning and forecasting, design and development, and other types of business practices beyond cost negotiations to secure lower costs and create win-win solutions with their suppliers.

Suppliers' highest priorities for standard costing practices include providing a reasonable target price, not requesting price reductions after an order is placed or shipped, and avoiding making changes to order details once the price is confirmed.

Our Evidence

Orders Priced for Compliant Production

With the payment received for their work, suppliers have to cover not only their business expenses and operating costs, but also the cost of keeping their operations in line with social and environmental compliance standards. For this reason, a supplier's ability to comply with codes of conduct or to achieve sustainability targets cannot be divorced from the prices paid by its customers for the production of their goods.

During Better Buying's annual ratings cycle in Q4 of 2019, 36.2% of suppliers reported 100% of their orders for the customer they rated were priced to cover the costs of compliant production. For individual companies, performance ranged from a low of 14.3% of orders priced accordingly to a high of 100.0%. These findings show that even before COVID-19, it was not uncommon for suppliers to receive prices for orders that did not allow for compliant production. Furthermore, Better Buying™ found that suppliers reporting lower rates of orders priced for compliant production also reported a larger number of high-pressure cost negotiation strategies used by their buyers.[1] This leads to compounding financial pressures that place all forms of sustainability at risk.

High-Pressure Cost Negotiation Strategies

Cost negotiations are a point in business partnerships during which the power imbalance between buyers and suppliers becomes readily apparent. Without acknowledging the relative lack of power held by suppliers in the Textile, Clothing, Leather and Footwear sector, and without taking action to ensure they are treated as equal partners, negotiations can easily exploit the supplier's position and cause detrimental impacts to social, environmental, and financial sustainability.

In the 2019 ratings cycle, 55.2% of suppliers reported that the buyer they rated used high-pressure cost negotiation strategies, with individual company performance ranging from 21.3% to 100.0%. On average, 3.3 strategies were used by each buyer, with the most common strategies being take it or leave it - meet the target cost or supplier cannot win the order (56.2%), demanding level prices be maintained from year to year - no consideration for inflation (55.0%), and demanding across the board price cuts from previous orders/years (42.5%).

The high-pressure strategies suppliers reported have the most impact on their business profitability are also the strategies that were most frequently employed by buyers rated during the Q4 2019 ratings cycle.

Better Buying™ suspected that the extent to which each of these and other high-pressure negotiation strategies impacted suppliers' businesses differed, with some strategies more impactful than others. Therefore, in the latest global supplier survey suppliers were asked to rate the impact of each high-pressure strategy on their

[1] Pearson's r=-.11, p=.001

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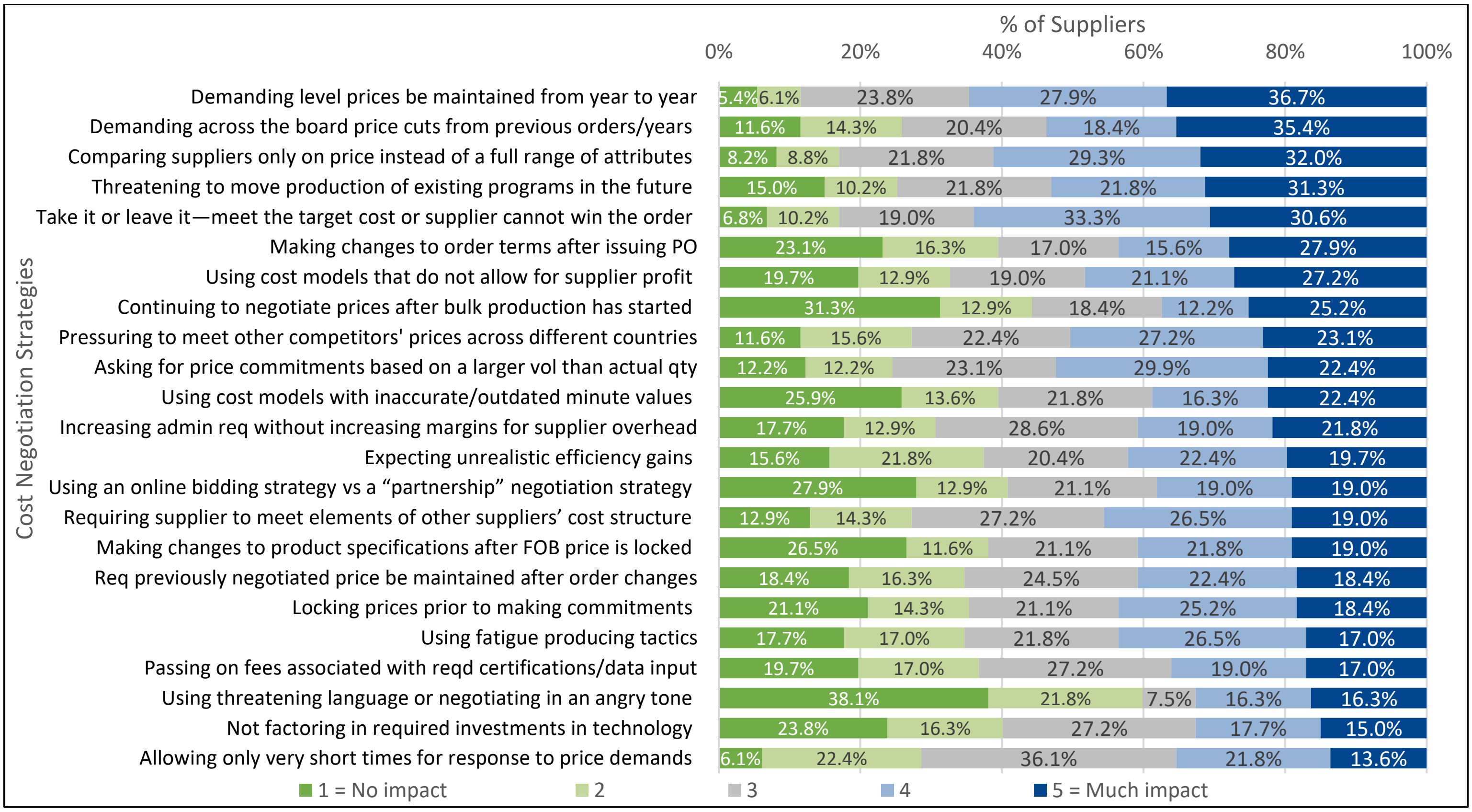
business profitability (Figure 1). The two strategies most frequently rated as having a high impact (a 4 or 5 out of a scale of 1 to 5) were demanding level prices be maintained from year to year - no consideration for inflation (64.6% of suppliers rated this as a "4" or "5") and take it or leave it - meet the target cost or supplier cannot win the order (63.9%). Therefore, the high-pressure strategies suppliers reported have the most impact on their business profitability are also the strategies that were most frequently employed by buyers rated during the Q4 2019 ratings cycle.

Figure 1. Extent to which High-Pressure Cost Negotiation Strategies Impact Suppliers' Business Profitability



Better Buying™ also investigated whether there were similarities among the different strategies in terms of their impact on supplier business profitability. From our analysis, three groups emerged that we labeled: pressuring suppliers through price competition, off-loading additional costs onto suppliers, and buyer-centric costing.[2] Of these groups, the strategies that involve pressuring suppliers through price competition have the highest average impact on suppliers' business profitability. The strategies in each group are shown in Table 1.

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[2] We used principal components analysis with varimax rotation to identify three factors that accounted for 65.4% of the variance and had strong reliability (Cronbach's alpha between .86 and .94).

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Table 1. Groupings of High-Pressure Cost Negotiation Strategies

Groups	High-Pressure Cost Negotiation Strategies	Mean	S.D.
Pressuring suppliers through price competition	Take it or leave it—meet the target cost or supplier cannot win the order	3.5	0.9
	Demanding level prices be maintained from year to year, no consideration for inflation (e.g., no consideration for higher raw materials, energy, or wage costs)		
	Demanding across the board price cuts from previous orders/years		
	Comparing suppliers only on price instead of a full range of attributes		
	Allowing only very short times for response to price demands		
	Requiring supplier to meet specific elements of other suppliers' cost structure		
Off-loading additional costs onto suppliers	Increasing administrative requirements without increasing margins for supplier overhead (e.g., requirements for constant reporting on Work in Progress or to justify every cost element)	3.1	1.3
	Passing on fees associated with required environmental certifications and data input (e.g., Better Cotton Initiative data portal fees, Bluesign® certification fees)		
Buyer-centric costing	Making changes to product specifications after FOB price is locked	3.0	1.2
	Continuing to negotiate prices after bulk production has started		
	Using threatening language or negotiating in an angry tone		
	Using cost models with inaccurate/outdated minute values		
	Making changes to terms (e.g., payment, ship dates, quantities, factories) after issuing purchase order		
	Expecting unrealistic efficiency gains		
	Using cost models that do not allow for supplier profit		
	Requiring previously negotiated price be maintained after changes are made in the order		
	Constantly calling/emailing, asking for lower price, multiple rounds of negotiation, or other fatigue producing tactics		
	Threatening to move production of existing programs/cut orders in the future		

Note: Mean for each group shows the average impact level of related high-pressure cost negotiation strategies on suppliers' business profitability on a scale of 1 (no impact) to 5 (much impact).

The impact of high-pressure cost negotiation strategies is not limited to suppliers' business profitability; pressure on supplier businesses overflows onto workers and the environment. Over half of the

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suppliers in the latest global supplier survey reported that their business profitability had a high impact (a 4 or 5 out of a scale of 1 to 5) on their ability to provide good working conditions and better wages, with 28.6% of suppliers reporting the maximum level of impact. On average, the extent to which suppliers' profitability impacted their ability to provide good working conditions and better wages was 3.5 on a scale of 5.[3] Meanwhile, 43.5% of suppliers reported their business profitability had a high impact on their company's environmental performance. The average extent to which suppliers' profitability impacted their environmental performance was 3.2 on a scale of 5.[4]

Figure 2. Extent to which Suppliers' Business Profitability Impacts their Ability to Provide Good Working Conditions and Wages

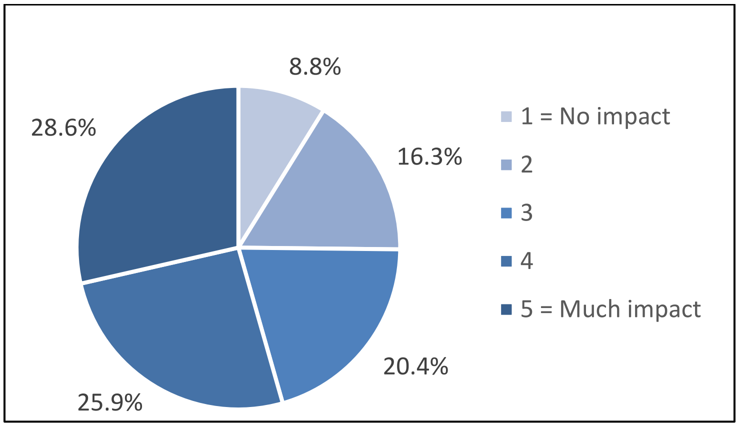
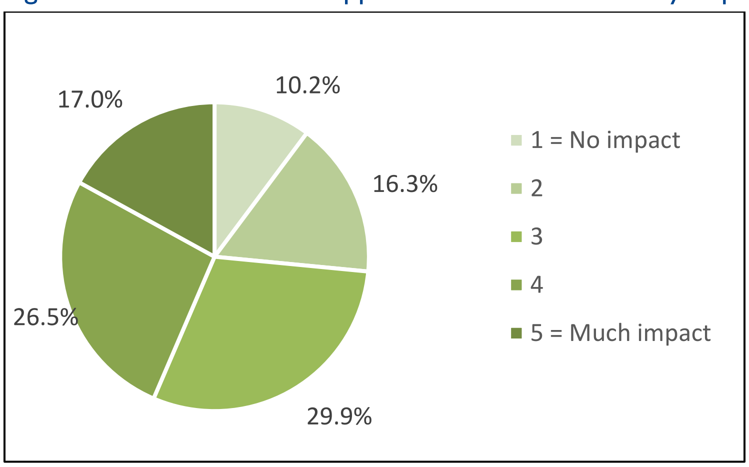


Figure 3. Extent to which Suppliers' Business Profitability Impacts their Environmental Performance



[3] SD=1.3, n=147
[4] SD=1.2, n=147

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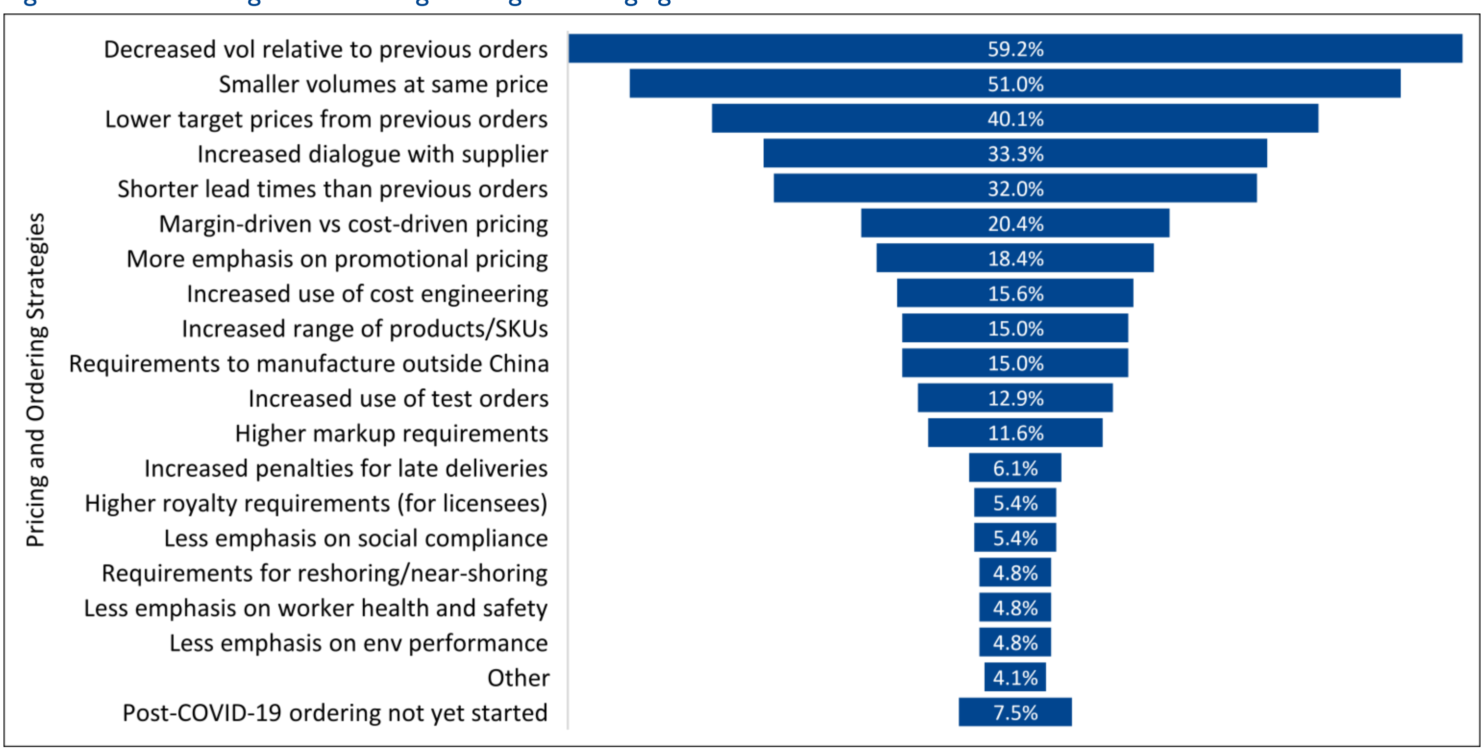
Cost and Cost Negotiation Practices During COVID-19

As our industry continues to wrestle with COVID-19, Better Buying™ asked suppliers what type of pricing or ordering strategies they were starting to see emerge with their buyers. Most suppliers (92.5%) confirmed that their buyers have already started placing new orders. The most frequently reported change, an overall decrease of order volume relative to previous orders or seasons (59.2%), reflects ongoing uncertainty around how phased re-openings and the emergence of new outbreaks across the globe will impact consumer demand. The next two most frequently reported pricing and ordering strategies, smaller volumes at the same price (51.0%) and lower target prices from previous orders (40.1%), highlight the financial hardship the industry continues to face – as well as the prevailing strategy of offloading financial pressures onto suppliers. An encouraging finding from this survey question was that 33.3% of suppliers reported increased dialogue with their buyers about pricing and costs, an engagement practice that Better Buying™ has been advocating for with buyers. These findings are captured in Figure 4.

> *The next two most frequently reported pricing and ordering strategies … highlight the financial hardship the industry continues to face – as well as the prevailing strategy of offloading financial pressures onto suppliers.*

> *33.3% of suppliers reported increased dialogue with their buyers about pricing and costs.*

Figure 4. New Pricing and Ordering Strategies Emerging from COVID-19



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Regional Analysis

The eleven countries or regions with the largest survey participation included China, Hong Kong, India, Bangladesh, United States/Canada, Pakistan, Portugal, South Korea, East Asia, Western Europe/United Kingdom, and EEMEA (Eastern Europe/Central and Western Asia, Middle East, Africa). Responses from suppliers headquartered in other regions were grouped into the "Other regions" category.

There were only a few regional differences in responses, meaning that suppliers globally are facing similar situations. There were a few regions that reported slightly larger impacts of business profitability on their ability to provide good working conditions and wages and on their environmental performance.

Reducing Costs without Squeezing Suppliers

Best Costing and Pricing Practices

In the latest global survey, suppliers reported which methods their customers use to lower costs without creating additional pressure on suppliers' businesses. The most frequently reported methods included providing long-range buying plans (61.9%), taking suppliers' suggestions in altering product specifications to reduce costs (61.2%), providing accurate forecasts in advance (57.1%), and meeting minimum order quantities when placing orders (57.1%). In their comments, one supplier mentioned the benefits of sourcing raw materials locally, while another said their customer used existing fabric that was leftover due to order cancelations. A small percent of suppliers (6.1%) reported that their customers did not use any best practices to lower costs without pressuring their business. These results are captured in Figure 5.

Figure 5. Best Practices Used to Lower Costs Without Pressuring Suppliers' Businesses

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These findings reveal that some buyers are using planning and forecasting, design and development, and other types of business practices beyond cost negotiations to secure lower costs and create win-win solutions with their suppliers. This holistic approach to purchasing practices can help address the multidimensional financial pressures that increase suppliers' administrative and operating costs and contribute to decreased efficiency and productivity. Such methods reflect strong collaboration between buyers and their suppliers and serve as alternatives to pressuring suppliers into accepting prices that do not cover the costs of compliant production.

In their open-ended comments describing best practices in buyers' costing and pricing strategies, suppliers continued to highlight the importance of their customers engaging in dialogue rather than using one-way directives. Some suppliers also commented how their customers are paying for or making use of canceled liability materials. For example, "They are redesigning or developing into new product to use existing fabric that's been leftover as a result of cancellations, so that there's no additional costs and dollars spent to go buy additional fabric and help the cash flow turn over quickly." A full list of themes from suppliers' open-ended comments is included in Table 2.

Table 2. Best Practices in Cost & Cost Negotiation

Themes	# of mentions	Sample quotes
Engaging in dialogue with suppliers	6	Consistency and willingness to listen to inputs from supplier Notify the target ahead of time and allow factory to do suggestion to bring down the cost before kicking off new styles' tech package.
Taking liability for left over fabrics or canceled orders	5	Buyer is re-working the shell fabric/trim price with nominated mill/supplier to reduce the cost. Comparing to other retailers, our buyer is doing better by paying a liability of cancelled inventory that they ordered but not take them.
Implementation of new technology to lower costs	4	Virtual approvals prior on the costing stage. Use better technology, environment & efficiency
Not creating downward pressure on prices	4	ONCE A YEAR PRICE NEGOTIATION Understanding that if the price for a style for one season is lowered and then the style is re-ordered the next season that the price cannot continue to be lower in the same way.
Flexibility in shipment dates and lead time	2	Got Support from some of the customer in order to have a flexible shipment time, Higher Lead time, no charge back on delayed shipment.
Good payment practices	2	They has been no change in payment terms nor have there been payment delays as in the case of other brands.
Simplifying styles and revising packaging	1	Simplifying the styles and getting well prepared for online sales packaging
Meeting Minimum Order Quantities (MOQs)	2	Combining styles across same base fabric to meet MOQs.

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Taking responsibility and being responsive	2	Great responsibility Smart and fast action
Providing buying plans	1	Provided Fall/Winter & 2021 Spring/Summer buying plan.
Too early to tell	6	Covid 19 is still continuing impacting business globally. We are still not into Post Covid scenario. Hence too early to comment on any best practices from customers yet. Didn't discuss the unit price because no new order.

A New Vision for Standard Cost and Cost Negotiation Practices

In keeping with Better Buying's previous Special Report on payment and terms practices, suppliers in the recent survey were asked about minimally acceptable costing practices. A majority of suppliers (68.7%) believed that such practices should be expected, and there were no significant regional differences among suppliers that share this belief. The highest priority practices (a 4 or 5 out of a scale of 1 to 5) included providing a reasonable target price (90.1%), not requesting price reductions after an order is placed or shipped (85.2%), and avoiding making changes to order details once the price is confirmed (84.1%). The full results are displayed in Figure 6. These priorities are not particularly surprising, nor are they unreasonable. Suppliers know their businesses, including where increased efficiency or productivity could lower costs. Listening to suppliers and working with them toward win-win solutions can help raise the bar for cost and cost negotiation practices, eliminating the need for high-pressure cost negotiation strategies and impossibly low target prices.

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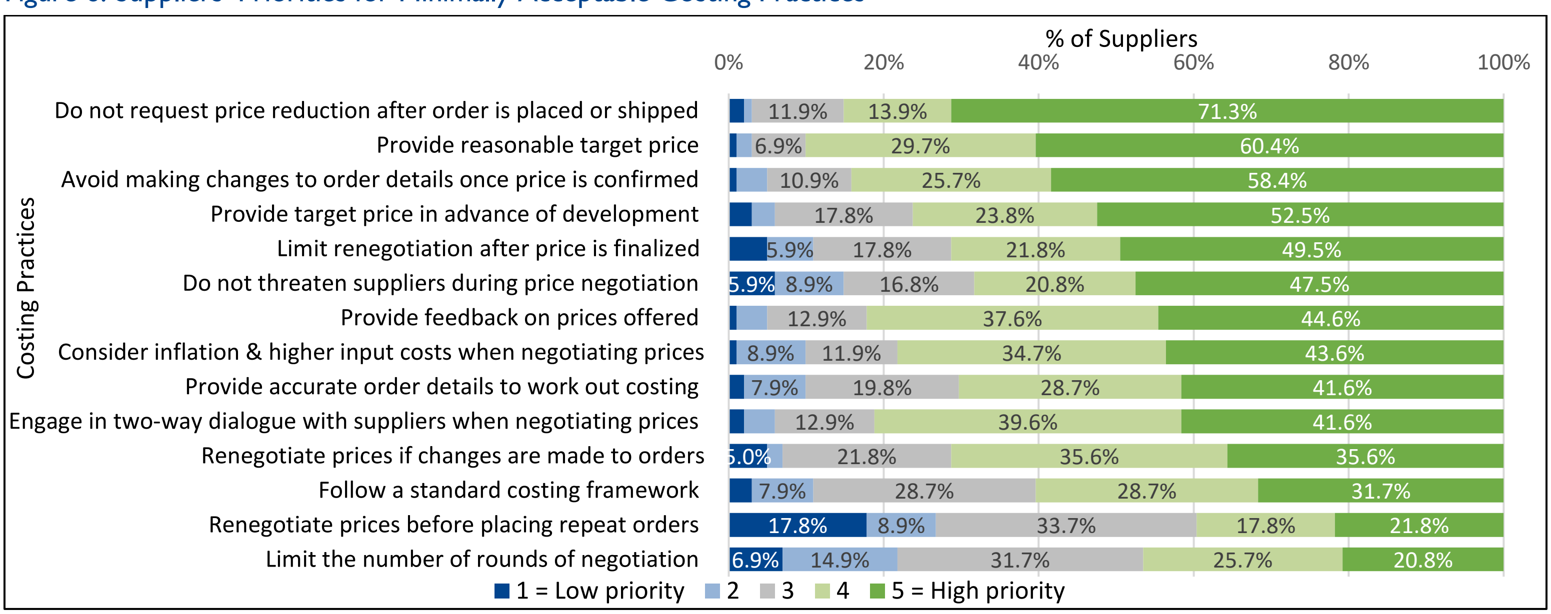
Figure 6. Suppliers' Priorities for Minimally Acceptable Costing Practices



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What is a Reasonable Target Price?

Providing a reasonable target price is suppliers' highest priority for improvements to costing practices, but this begs the question - what is reasonable? The basic assumption is that a reasonable target price aligns with what it actually costs to produce a garment, allowing suppliers to cover their costs and achieve a profit margin. In Q4 2019, suppliers' open-ended comments highlighted several components they are paying attention to when they analyze how actual costs compare to the prices they received from their customers. From their responses, Better Buying™ compiled the following list of components that contribute to suppliers' cost calculations. While this list is not exhaustive, it provides a sense of breadth regarding all that goes into the cost of production and a starting point for answering, what is a reasonable target price?

- Raw materials, trims, and accessories costs
- Operational costs
- Wastage or rejection costs
- Management costs
- Testing or lab costs
- Washing costs
- Labor costs
- Shipping and logistics costs
- Packaging costs
- Banking and financing costs
- Sample making costs
- Warehousing costs

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