HOW TO BE AN INFLATION WINNER

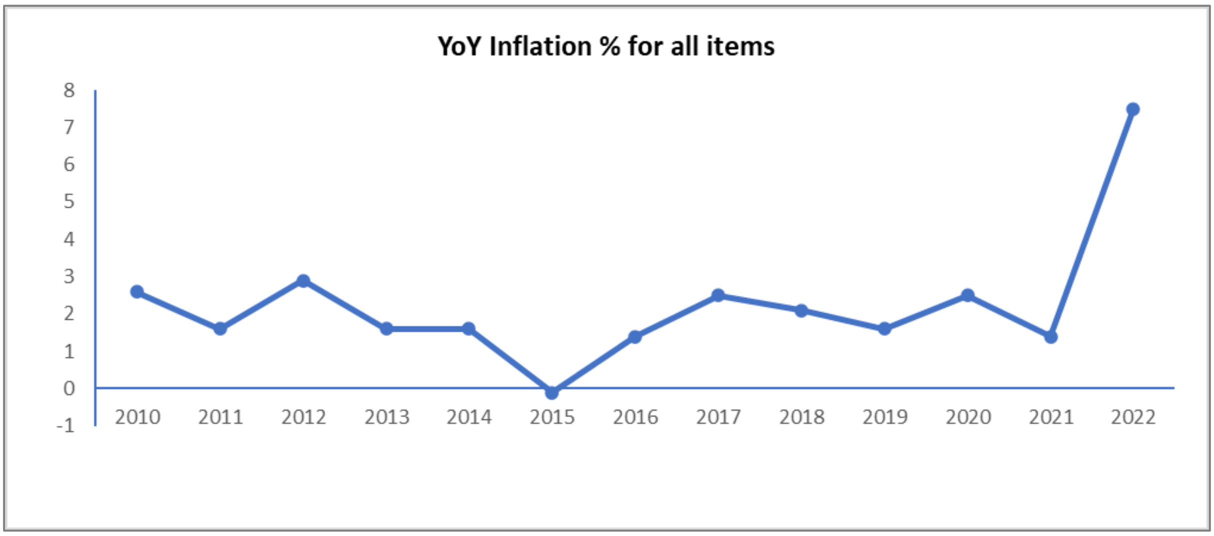
PRICING IMPERATIVES FOR FASHION RETAILERS IN A POST-COVID WORLD

Inflation isn't going away anytime soon

The US is facing an all-time high inflation not seen in the past few decades with prices rising as high as 7.5% as of January 2022 compared to last year. There are a variety of reasons behind this increase - strong demand after the coronavirus outbreak, continuing supply chain disruptions, persistent supply, and labor shortages, increasing energy prices, and more. Further, this trend of increasing prices and volatility is now expected to continue into the foreseeable future due to the Russia-Ukraine war.

The below chart shows the year-on-year increase in inflation rates from 2010-2022 taken every January. As can be seen, the current point in time 2022 inflation is like no other seen in the last decade.

Figure 1: Chart showing YoY inflation percentage from 2010-2022



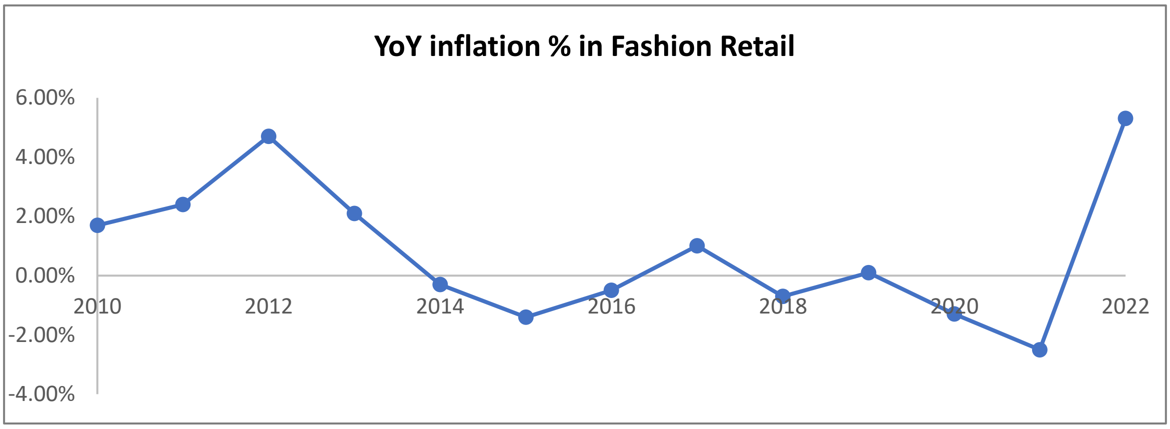
Source: Bureau of Labor Statistics, CPI index reports

There are many different industry forecasts covering inflation trends, and when we can expect a return to normal. As per a forecast by Bloomberg, inflation is expected to remain high in the year 2022 with normalization to ~2% expected as late as 2024. However, there is still a lot of uncertainty in the market, which has left Fashion retailers eager to find solutions to help them better plan their business as they feel pressure building on their margins. In the coming years, Fashion retail players will need more agile and flexible pricing models to help them navigate this unprecedented inflationary environment.

Impact of inflation on the Fashion segment

The apparel segment has been experiencing its highest level of inflation in the past decade, at 5.3% in January 2022. With continued supply chain challenges, an average price increase of at least 3% across all clothing and apparel is expected in 2022. Some surveys predict an even higher price increase of up to 10%. Inflation in fashion is primarily attributed to transportation bottlenecks, rising shipping costs and material shortages.

Figure 2: Chart showing YoY inflation percentage of Fashion product prices from 2010-2022



Source: Bureau of Labor Statistics, CPI index reports

As the impact of inflation becomes more visible to consumers, it plays out in some very specific ways for Fashion retailers –

- **Shift to online shopping**- The pandemic along with inflation has pushed the consumers to shop online. Brands are increasingly pushing innovation for digital solutions and use of AR to enhance the whole shopping experience. Consumers often compare prices before finalising their purchase and hence fashion brands need to be very flexible in their channel strategy in order to attract customers.

- **Shifts across divisions and classes –** Historically, the women's wear segment dominated the fashion industry. However, as per US Census Data, menswear is gaining traction with men spending more on clothes and becoming more fashion conscious. Men's footwear is now becoming as big a business as women's.

- **Change in core price elasticities –** A consumer shift in price sensitivities can be seen for sub-categories which were historically price elastic but now have become inelastic and vice versa. Example: lounge/ sleepwear and swimwear are increasingly becoming less elastic (inelastic) as these shoppers are becoming price insensitive. However, for categories such as women's outerwear, accessories, and tops, consumers are increasingly becoming elastic which is pushing price sensitive customers to discounters and fast fashion brands (H&M, Zara, Forever 21, TJX).

- **Shift towards sustainable products –** There is a growing demand for sustainability and, in particular, for circularity and the closed-loop recycling of clothes. While currently less than 10% of the global textile market is composed of recycled materials, according to Textile Exchange, sustainability-focused clothing is expected to become mainstream in 2022. H&M now provides information (e.g., “50% recycled polyster”) to users to highlight their commitment towards sustainable fashion.

- **Interest in metaverse –** Customers are picking up the “metaverse” trend, which offers opportunities for audience growth and income generation for fashion brands—without physically producing anything. Creating and selling NFTs of clothing, accessories and allowing virtual avatars/ gamers to buy, keep, and trade virtual fashion products is expected to grow in 2022, with 37% of fashion executives expecting it would be one of the top three things to impact their businesses. Recently, Gucci announced that it has purchased land in The Sandbox (SAND) metaverse to create and offer virtual experiences.

Fashion retailers need to grab any opportunity to maximise their customer base by pricing their products right otherwise they might end up losing to the competition. Also, the fashion industry evolves a lot with age, example- millennials today will have entirely different choices today compared to ten years down the line. Hence, it is important for the Fashion retailers to price right in every category – womenswear, menswear, children wear, accessories, etc. and avoid mistakes.

- **Protect margins:** Price inflation along with the two years of disruption due to the pandemic has impacted fashion retailers and is pushing companies to adapt to different consumer priorities in tandem with digitalization for fuelling growth. As the industry still faces supply chain challenges, patchy demand and persistent pressure on bottom line, it is important for the industry to price right and avoid mistakes.

    - **Blanket price increases do not work** – Most brands plan to maintain their margins across categories by loading their customer pricing directly in proportion to the increase in input costs (yarn, griege, fabric, labor wages, transportation charges, etc.). However, different fashion categories (menswear, womenswear, children wear, accessories) along with their sub-categories share different price elasticity. Hence, a uniform increase across categories might lead to decreases in demand and missing out on opportunities for higher price increase in a particular category.
    - **Selective price taking maximizes sales and margin –** Based on the carefully studied consumer behavior in times of inflation for different categories and their sensitivity towards increase/ decrease of prices for a particular category, fashion brands can make better pricing decisions. Being selective in increasing

prices can help brands maintain customer base as well as continue to maintain their bottom line.

- **Increase market share and sales while preserving margins** – When competitors take blanket price increases because they don't know better, smart fashion brand chains will selectively price to preserve margin, and lead with winning prices in the categories that matter for price comparison and to drive traffic.

The portfolio of fashion products can be categorized based on elasticities, such as:

- Highly elasticity products – Men's bottomwear, Kidswear, Kids footwear, Women loungewear/sleepwear, swimwear, etc.
- Low elasticity products – Men's Outerwear, Women's tops, Women's Outerwear, Women's sportswear, etc.

Let us take a very simple example of how two fashion retailers (P1 and P2) react to inflation on two of their products - a). a high price elastic product (Women sleepwear) b). A low-price elastic product (Women Outerwear - Coat).

Figure 3: Example showing different reactions of two retailers (P1 & P2) while responding to inflation

							P1 (Blind across the broad increase)		***R_2 (Elasticity optimized increase)***	
1	**2**	**3**	**4**	**5**	**6**	**7**	**8**	**9**	**10**	**11**
Fashion Product	Price Elasticity	Cost (USD)	Historic Margins	Old prices (USD)	% increase in costs (fuel, wages, etc)	Revised costs (USD)	Revised margins	Revised prices (USD)	Revised margins	Revised prices (USD)
Women sleepwear	Price Elastic	25.00	8%	27.00	5%	26.25	8%	28.35	6%	27.83
Women Coat	Price Inelastic	60.00	11%	66.60	5%	63.00	11%	69.93	12%	70.56
Total		85.00		93.60		89.25		98.28		98.39
Profits				**8.60**				**9.03**		**9.14**

Winning solution

Let us assume that price inflation of 5% (as shown in column 6) has increased the costs of both the products shown in column 7. P1 increases the prices of the products by keeping its margins same as before (as can be seen in column 4 and column 8) and listing a revised price as shown in column 9, a traditional across the board price increase. However, P2 revises prices keeping in mind the price elasticity of products, an elasticity optimized increase. Since women's sleepwear is more price elastic, any significant increase in prices may decrease its demand and hence P2 takes a margin of only 6% as compared to 8% previously. Similarly, the margin for women's coat is increased to 12% from 11% since it is a price inelastic product. P2 will end up gaining the higher absolute margin of 9.14 USD as it did before inflation however P1 is at a risk of a weak demand for sleepwear and might end up with lower absolute margins.

Hence, the winning formula for fashion retailers will be to categorize every SKU in the store, and take pricing action based on elasticity, competitive positioning, and consumer behavior.

How can AI help?

AI driven pricing can help predict the ups and downs in the market in terms of input costs, demand fluctuations, supply bottlenecks and provide a more agile pricing strategy.

- **Determine accurate estimation of elasticities** – AI models can help determine the price sensitivity for each sub-category and determine consumer price elasticities. This will help in understanding which segments of customers are sensitive towards price increase/ decrease of which category of apparel subcategory.

- **Optimize pricing** – AI driven solutions can help determine optimal price increases/decreases across categories along with optimizing profit margins. Since a uniform inflation impact cannot be transferred directly to consumers via prices, AI will help optimize target prices across different categories based on their elasticities.

- **Forecast channel demand** – AI solutions will help fashion brands determine the right mix between channel (online, offline) sales. Once brands build strong forecasts by channel, they can plan their inventory, manufacturing, and other overhead costs effectively and thus be more competitive.

- **Roll out changes through test and learn** – Before fashion brands take pan-chain pricing or assortment decisions, they should use best practice AI and machine learning to test multiple pricing options in select representative outlets to determine optimal price levels. AI can help select the right portfolio of test-outlets (location, size, menu items, customer profile), items, and promotions that can yield the most powerful pricing outcomes. Once the test results are optimized, pricing decisions can be rolled out chain wide.

At Impact Analytics we have built solutions to accurately forecast demand, test pricing strategies and pick the best portfolio factoring in all the external variables including volatile consumer trends and micro & macro-economic behavior. Our tools such as PriceSmart, TestSmart, ForecastSmart, and AssortSmart are automated platforms backed by robust analytics, artificial intelligence, and machine learning to help organizations run seamless experiments, design pricing strategies and recommend store assortments, to maximize gain and deliver highly accurate forecasts for quick decision making.

Impact Analytics has also pioneered a real time price index which tracks top moving fashion products across the elasticity spectrum. This price index will help firms make a more realistic prediction about average pricing across competitive products and categories so they can make better business decisions related to pricing.

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Impact Analytics is a proven leader in enterprise AI SaaS solutions, that combine the art and science of merchandising and supply chain optimization. Our cloud native integrated platform's planning, pricing & promotion, inventory management, and intelligence suites, are built on the foundation of an innovative AI & ML guided forecasting engine with robust predictive algorithms. Impact Analytics is a trusted partner for top retailers, CPG and manufacturing companies across the globe, and is empowering them to make smart data-based decisions, unlock process efficiencies, transform their businesses, and achieve unparalleled business benefits. Our unique engagement model allows for implementations to be executed in a quick and cost-efficient manner.