CASE STUDY

18 ZARA'S OPERATING MODEL

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La Coruña in northern Spain was once renowned mainly for its food, beaches and surfing. But it then became famous for another reason. It was there that Amancio Ortega Gaona, now the world's third-richest man, founded the wildly successful fashion company, Inditex, which became more commonly known by its oldest and biggest brand, Zara. Back in 1963 Amancio Ortega started his company to manufacture women's pyjamas and lingerie products for garment wholesalers. In 1975, after one customer cancelled a large order, the firm opened a retail outlet in La Coruña. This Zara store was popular and during the next 10 years others opened in all major Spanish cities. The Inditex corporate structure was created in 1985 and in December 1988, the first overseas Zara store opened in Porto, Portugal, followed shortly by New York in 1989 and Paris in 1990. By September 2013, Inditex had eight different business formats (including brands such as Massimo Dutti, Bershka, Stradivarius, Oysho, Pull & Bear and Uterqüe), 6104 stores in 86 countries (including 1751 Zara stores) and employed 128,000 people. Each of these brands was responsible for its own stores, ordering system, designers, factories, subcontractors, suppliers, distribution centres and systems; sharing only core corporate services, like legal and finance. But they all followed a similar operating model that focused on speed to market. There was even some degree of competition between them. Zara, the largest Inditex division, accounted for around two thirds of total Inditex sales. In 2012 the group had a consolidated turnover of €2.3 billion.

Although their first Zara store was simply intended to be an outlet for cancelled orders, a more fundamental lesson was also learnt; there were benefits of having, in the words of one Inditex executive, 'five fingers touching the factory and five touching the customer'.

This 'virtual' vertical integration, gave significant control of the production/supply process, all the way from loom to shop floor without owning all of the production assets. Today, Zara is able to offer cutting-edge fashion at affordable prices because their operating model exerts control over almost the entire garment supply chain (retailing, design, purchasing and logistics).

Retailing

At the heart of the Zara operating model, the stores (almost all of which were owned and operated by Zara) were located in expensive prime retail locations, selected after extensive market research. Inside, much of the selling space was left empty in order to create a pleasant, spacious and uncluttered shopping environment. The layout of the stores, the furniture, and even the window displays were all designed at La Coruña and a 'flying team' from headquarters was usually dispatched to a new site to set up the store. Location, traffic and layout were crucial for Zara because it spent relatively little on advertising. A typical Zara store had women, men's and children's sections, with a manager in charge of each. Women's wear accounted for more than half of sales, with

the rest equally divided between men's wear and children's wear. The store manager was usually also the head of the women's section. Zara placed a great deal of emphasis on training its sales force and strongly emphasised internal promotion. Store-employee remuneration was based on a combination of salary and a bonus derived from overall store sales. Although store managers were responsible for the 'profit and loss' of their respective stores, La Coruña controlled prices, transfer costs, and even a certain amount of merchandising and product ordering. In practice, the critical performance measures for the store managers related to the precision of their sales forecasts (communicated through the ordering process) and sales growth. A simple yet key measure followed by senior managers was the rate of improvement of daily sales from year-to-year – for example, sales on the third Wednesday of June 2016 compared to the third Wednesday of June 2015.

To its customers, Zara offered fashionably exclusive (yet low-cost) products. Individual stores held very low levels of inventory – typically only a few pieces of each item – and this could mean that a store's entire stock was on display. Indeed, it was not unusual to find empty racks by the end of a day's trading. This created an additional incentive for customers to buy on the spot (because if a customer chose to wait, the item might be sold out and may never be made again). This allowed Zara to both carry less overall inventory and have fewer unsold items that had to be discounted in end-of–season sales. Items that remained on the shelves for more than two or three weeks were normally taken out of the store and shipped either to other stores in the same country or (rarely) back to Spain. In an industry where discounting meant that the average product fetched only around 60 per cent of its full price, Zara often managed to collect almost 90 per cent. However, this approach meant that stores were completely reliant on regular and rapid replenishment of new designs. Stores were required to place their orders at pre-designated times and received shipments twice per week. If a store missed its ordering deadline, it had to wait for the next scheduled delivery. Zara also minimised the risk of oversupply by keeping production volumes low at the beginning of the season, reacting quickly to the orders and new trends that emerged during the season. The industry average 'pre-season inventory commitment' – the level of production and procurement in the supply chain in, say, late July for the fall/winter season – ranged from 45 per cent to 60 per cent of anticipated sales. At Zara it was only 15 per cent to 20 per cent. The 'in-season commitments' at Zara were 40 per cent to 50 per cent, whereas the industry average ranged from almost nothing to a maximum of 20 per cent.

Design

Zara designed all its own products. It took its design inspiration from the prevailing global trends in the fashion market, trade fairs, discotheques, catwalks, magazines and, particularly important, their customers by using extensive information received from their stores. At its headquarters, the 'commercial team' comprised designers, market specialists (also known as 'country managers') and buyers. Together, they produced designs for approximately 180,000 items per year from which about 10,000 were selected for production. Unlike their industry peers, these teams worked both on next season's designs and, simultaneously and continuously, also updated the current season's designs. Women's wear, men's wear and children's wear designers sat in different halls. In each of these big open spaces designers, organised by products (e.g. dresses, T-shirts and denim etc.) worked in the perimeter areas of the room. Country managers

and the 'buyers', who sourced and planned production, sat around a long table in the middle area. This layout hall was designed to encourage spontaneous meetings and an air of informality and openness. The firm tried hard to encourage a collegial and dynamic atmosphere among its young team with no design 'prima donnas'. Designers produced sketches by hand and discussed them with colleagues. The sketches were then redrawn using CAD where further changes and adjustments, for better matching of weaves, textures, colours and so on, were made. Before moving further through the process, it was necessary to determine whether the design could be produced and sold at a profit. The next step was to make a sample, often completed in the sample making shop in one corner of each hall.

Market specialists had responsibility for dealing with specific stores. As experienced employees, who have often been store managers, they emphasised establishing personal relationships with the managers of 'their' stores. They were in constant contact, especially by phone or Skype, discussing sales, orders, new lines and other matters. Equally, stores relied heavily on these discussions with market specialists before finalising orders. Augmenting their extensive phone conversations, store managers were supplied with hand-held tablet devices to facilitate the rapid and accurate exchange of market data. Final decisions about what products to make, when and in what volumes were normally made collectively by the relevant groups of designers, market specialists and buyers. After the decision was taken, the buyers oversaw the total order fulfillment process: planning procurement and production requirements, monitored warehouse inventories, allocated production to various factories and third-party suppliers and kept track of shortages and oversupplies.

Production/sourcing

Unlike most competitors, Zara manufactured around half of its products – mainly the most fashionable – in its own network of 22 factories in Spain, Portugal and Morocco. Ten of its factories were located around the Inditex complex near La Coruña. These factories generally worked a single shift and were managed as independent profit centres. The rest of its products were procured from outside suppliers. Around a third of this volume came from Eastern Europe and Turkey. The more 'basic' products were sourced from Asia. With its relatively large and stable base of orders, Zara was a preferred customer for almost all its suppliers. The make or buy decisions were usually made by the procurement and production planners. The key criteria for making this decision were the required levels of speed and expertise, cost-effectiveness and the availability of sufficient capacity. If the buyers could not obtain desired prices, delivery terms and quality from Zara factories, they were free to look outside. For its in-house production, Zara obtained much of its fabric supply from another Inditex-owned subsidiary, Comditel. Over half of these fabrics were purchased undyed to allow faster response to mid-season colour changes.

After in-house CAD-controlled piece cutting, Zara used subcontractors for all sewing operations. The subcontractors themselves often collected the bagged cut pieces, together with the appropriate components (like buttons and zippers) in small trucks. There were some 200 sewing subcontractors in very close proximity to La Coruña (in the Galicia region). Many worked exclusively for Zara, who closely monitored their operations to ensure quality, compliance with labour laws and above all else adherence to the production schedule. Subcontractors then brought back the sewn items to

the same factory, where each piece was inspected during ironing (by machine and by hand). Finished products were then placed in plastic bags with proper labels and sent to the distribution centre. A system of aerial monorails connected the ten factories in La Coruña to the distribution centre. Completed products procured from outside suppliers were also sent directly to the distribution centre.

Distribution

Speed was clearly an overriding concern for Zara logistics: as one senior manager put it: 'For us, distance is not measured in kilometers, but in time.' Contractors, using trucks bearing Zara's name, picked up the merchandise at La Coruña and delivered it either directly to Zara's stores in Europe or, for items to be shipped by air, to the airport at La Coruña (10 kilometres away) or a larger airport in Santiago (70 kilometres away). The trucks ran to published schedules (like a bus timetable), which made it easy to plan shipments without making special demands for transportation. Typically, stores in Europe received their orders in 24 hours, in the US in 48 hours and in Japan in 48 to 72 hours. Compared to similar companies in the industry, shipments were almost flawless – 98.9 per cent accurate. Zara's first large distribution centre was located near La Coruña and had 400,000 square metres of storage space and about 1000 permanent staff, who worked there on four shifts, five days a week. During peak demand periods, it added additional temporary workers and added more shifts. This distribution centre used some of the most sophisticated and up-to-date automated systems available. Up to 2003, almost all products of Zara passed through this distribution centre. However, continued expansion of the company had necessitated the addition of new distribution centres. When Zara announced that it would build an additional distribution centre in Zaragoza (Spain) it caused some comments because the existing distribution centre was working at only 50 per cent capacity. Costing €120 million, the 390,000-square metre Zaragoza distribution centre was completed in October 2003. It was allocated to distribution of selected women garments for the entire world. In 2011, Zara opened a third major distribution centre, also with 390,000 square metres of storage space, in Meco, near Madrid. This one specialised in children garments and online sale. Zara also had three other small distribution centres, in Brazil, Argentina and Mexico, as well as even smaller ones that operated like 'docking stations' for transshipping deliveries in some of the Asian and North and South American regions. Although all these centres were not running at full capacity, a new one had been planned to open in Guadalajara (Spain). This one would be shared with other Inditex's brands.

Zara online and the future

Compared with some of its competitors, Zara was relatively late in establishing its online offering. But in 2008, Amancio Ortega decided after 5 years of careful consideration that it was time to launch their online offering. Zara's online store officially opened in September 2010 for customers in France, Germany, Spain, Italy, Portugal and the UK, after which it quickly built an online presence in 18 European markets, the US, Japan, China, Canada and Russia. Talking to analysts in March 2013, a company spokesperson said 'Inditex's online operations have seen a very rapid rollout in recent years. Our business model allows a swift expansion of our online sales platform globally.

We will continue to roll out online sales progressively in all the markets in which we are present with stores'.

Analysts at Citigroup concluded in 2013 that the results indicated that Inditex was 'one of the few beneficiaries of the ongoing, rapid channel shift to online from store-based apparel sales'. In effect, Zara's online operations acted like macro stores (1 per country) and followed the standard ordering procedure. Products were sent to the distribution centre at Meco and then shipped to a specific warehouse in the corresponding country. From there, the orders were sent according to customers' preferences: pick up in a physical store for free (delivery in 3–5 days), standard delivery at home (2–3 days) or express shipment (48 hours) with some additional cost. In line with Zara's high-end image, there was a distinctive emphasis on attractive and exclusive packaging (i.e. boxes not plastic bags) and a great deal of focus on client service both during and after sales.

During the last decade, Zara had repeatedly defied the predictions of those who had suggested that it had reached the limit of its business model. In 2014, it seemed to be continuing its phenomenal growth into the future. Nevertheless, some observers still wondered whether it needed to modify its business model and operating systems to account for its increasing size and global footprint. For example, would its current system of design, production, and order fulfillment help or hinder serving the growing markets in Asia? Would it facilitate growth of online sales? Did it require a major overhaul of its well-organised operating processes?

A more intriguing question was why, after many years of people observing the phenomenal growth of Zara and learning about its model, competitors did not seem to be following its operating practices as much as one would expect. Was it because they believed these practices did not fit their business strategy? Or did they find it difficult to implement them?