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KNIGHTS APPAREL AND THE ALTA GRACIA FACTORY: PAYING A LIVING WAGE

A lot of my competitors or people in the business world might think that building the Alta Gracia factory and paying workers a living wage—more than 350 percent of what is required—does not make sense. But it makes sense for us.... We know why we are doing it, and we believe we are doing it for the right reasons from a social responsibility standpoint as well as a business standpoint.

We are the ones who said, 'We will make it a reality. We don't know if it is going to work. We don't know whether the consumers will support it if we do it,' but we took the risk.

—Joe Bozich, Knights Apparel Inc. founder and CEO, April 30, 2014, Stanford University.

INTRODUCTION

In February 2014, Knights Apparel founder and CEO Joe Bozich walked through the company's well-lit and spacious Alta Gracia factory in the Dominican Republic. 140 workers sat behind sewing machines and production equipment making university branded T-shirts, sweatshirts and other apparel for shipments to over 800 college bookstores all over the United States. Knights was the number one provider of licensed collegiate logo apparel,¹ having just surpassed Nike. Alta Gracia opened in April 2010, and it provided something unusual for factories in low-income countries—a living wage. While factory workers in some low-income countries received a *minimum* wage, this was often not enough to pay for workers' basic needs and the needs of their families. For example, the minimum wage in Bangladesh was 34 cents an hour. In the Dominican Republic, the minimum wage was 80 cents an hour, but Knights was paying Alta Gracia workers 350 percent higher wages—\$2.80 an hour (the equivalent of \$500 a month), plus benefits, including health care. These wages allowed workers not only to provide consistent

¹ As measured in dollars shipped to retailers of college apparel.

Source: The Collegiate Licensing Company, August 20, 2014 (July 1, 2013 – June 30, 2014).

Debra Schiffrin and Professor Paul Brest prepared this case as the basis for class discussion rather than to illustrate either effective or ineffective handling of an administrative situation.

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food and shelter for their families, but also to save money, provide their children with a good education and build houses. Workers were also allowed to unionize. Productivity was very high at the factory. Alta Gracia's brand motto was "Changing Lives One Shirt at a Time."

Joe Bozich was the driving force behind the Alta Gracia project, and he came to it from both personal and business motivations. Personally, he was looking for a way to use what he called his "sphere of influence" to provide hope and a pathway out of poverty for people. He said that being so successful in the licensed collegiate apparel industry gave Knights the resources and reputation necessary to build the Alta Gracia factory.

From a business perspective, he saw the opportunity presented by the growing number of university students unhappy with the working conditions of the people making their schools' branded apparel. Student activist groups and labor rights groups were demanding that universities change their practices and only license to companies whose products were produced in factories with higher than sustenance-level wages and safe conditions. Bozich believed the demand for such products was expanding rapidly, and the Alta Gracia factory would put Knights in a position to respond to that demand as well as enhance its corporate image. It also opened up a new, premium sales channel for Knights. The company was already very successful selling its sports branded apparel to mid-tier market retailers, such as sporting goods stores and J.C. Penney, as well as mass market retailers such as Wal-Mart and Target. But before Alta Gracia, Knights did not have a presence in campus bookstores, where collegiate logo apparel commanded a much higher price. Many student organizers were embracing the Alta Gracia brand—actively promoting it to their peers through flyers and social media and pushing their universities to stock the factory's products in their bookstores.

However, Alta Gracia's production costs were 20–30 percent higher than at Knights' other factories, and Alta Gracia was losing over half a million dollars a year. Knights was able to keep Alta Gracia operating by subsidizing it with funds from its profitable business units. Knights worked with contract factories in other countries that did not offer a living wage (although Bozich said they were independently audited to ensure safe working conditions and met or exceeded all university and Knights Apparel codes of conduct). Knights was also providing Alta Gracia with supportive and back-end functions from its headquarters in South Carolina—another form of subsidy.

The Alta Gracia factory had capacity of 1.2 million units a year, based on its existing compliment of equipment and people, which would translate to a \$25 million retail business. But in 2013 the factory's capacity utilization rate was 60 percent, and it needed to get up to 80 percent to break even. Knights was a private company, but Bozich was still accountable to his board and the company's large multi-billion-dollar institutional investors. Over time, Bozich had convinced many of them to back Alta Gracia, but he needed to pull the factory into profitability soon in order to prove it was a viable business model. If Alta Gracia was successful, should it be expanded? Would Knights be able to replicate it? And if so, *should* the company replicate it? Other companies had tried and failed to offer a living wage and become profitable. Would Knights be different?

THE GLOBAL APPAREL MANUFACTURING INDUSTRY

In 2013, the global apparel manufacturing industry's revenue was estimated to be around \$600 billion, and it had 9-10 million factory workers.² The United States was the industry's largest market, accounting for 16.7 percent of industry revenue—90 percent of which came from imports.³ Most large U.S. and European apparel companies used contract factories in the developing world to manufacture their clothing in order to take advantage of significantly lower labor costs. China accounted for 38 percent of total industry exports,⁴ but as wages in China began to rise, large companies were increasingly turning to contract factories in nations with even lower labor costs like Bangladesh, Cambodia, Laos and Vietnam.

Overall, competition was high and market concentration was low. The four largest players each held less than 2 percent of market share, and the average operator held less than a 0.5 percent share. In emerging nations it was common to have a large number of micro-businesses that manufactured clothing.⁵ It was a highly labor-intensive industry, and while there were some productivity increases due to new technology, for the most part garments needed to be sewn by hand or with specialized sewing machines. In addition, the assembly processes required many manual steps. Because of this, there were few economies of scale.

Apparel manufacturing companies had some industry-wide challenges including: 1) continually fluctuating commodity prices, 2) quickly-changing fashions and trends, which required ever-greater needs for speed in getting clothes to the market, and 3) the cyclical nature of the industry—spring and fall were when new clothing lines hit stores.

Apparel Workers' Conditions

Workers in many apparel factories in developing countries experienced extremely difficult conditions. According to Scott Nova, executive director of the nonprofit labor rights watchdog group Workers' Rights Consortium, the most serious were:

1. Sub-poverty wages and periodic layoffs
2. Unsafe working conditions
3. Forced and excessive overtime
4. Psychological and sometimes physical mistreatment of workers by supervisors
5. The inability of workers to exercise their right to organize and bargain collectively.

Major Causes of Poor Working Conditions in the Apparel Industry

Competition in the apparel industry was fierce, and in order to offer lower prices to consumers, apparel companies demanded that its contract factories produce goods at very low cost. Lower production costs also translated into higher profit margins for the apparel companies. This led many factory owners to put cost demands ahead of the well-being of its workers, which many times resulted in the harsh conditions listed above. Profit margins in the industry were slim and

² IBISWorld report, "Global Apparel Manufacturing," July, 2104.

³ First Research.

⁴ IBISWorld report, op. cit.

⁵ Ibid.

many factories were relatively small, so losing a contract to another factory could mean going out of business completely. Because of globalization, apparel companies had the ability to chase lower costs around the globe, increasing pressure on factories to compete with factories in lower-wage countries. Because the apparel industry was cyclical, low demand in non-peak seasons led factories to lay off or furlough workers for months at a time. But, as Scott Nova from the Worker Rights Consortium (WRC) explained, “Although it is true that there is less need for production work in January than there is in October, workers still need to eat in January.”⁶

The level of regulation in the industry was light.⁷ And although many countries and individual companies had codes of conduct for treating workers, factory non-compliance was common. According to the research of Brown Professor Richard Locke, in spite of non-compliance with brand codes of conduct, it was rare for a company to fire a supplier or pull out of a factory, especially if there was a strong demand for turnaround on a particular product.⁸ Factories often got multiple chances to change their behavior to comply with codes of conduct, but only got one chance to deliver goods at the low cost that companies demanded. Countries often did not enforce compliance in their factories, either because they turned a blind eye, or because they did not have the capacity or technology necessary to do so.

Factories were hard to monitor, in large part because when apparel companies, nonprofits or countries tried to do so, the factories would often close to avoid compliance and then quickly relocate and re-open under a different name or different ownership. Compounding this was the practice of factories to subcontract work to other factories, which often did not comply with codes of conduct. Apparel companies many times did not have information about these subcontractors, or might not even know their work was being sub-contracted.

The Argument Against Paying a Living Wage

Labor activists had been pushing for years for apparel companies to pressure their contract factories to pay workers a “living wage” or “fair wage.” However, industry opposition to this was strong, and activists’ efforts had been mostly unsuccessful. Industry players argued that suddenly hiking up wages in a factory could have unintended consequences. Rather than helping workers, it could result in factories closing down or eliminating jobs, and companies could move production out of an area or an entire country. Another argument was that it could destabilize the economy of the community where the factory was located.

THE COLLEGE LICENSED APPAREL INDUSTRY

In 2014, the collegiate licensed goods industry was \$4.6 billion a year at retail—about \$2 billion a year at wholesale—and apparel represented 65 percent of that market. There were many competing manufacturers, the best known of which were Nike, Champion, Adidas and Under Armour. These manufacturers could charge premium prices based on quality, reputation and

⁶ All quotes are from case author interviews unless otherwise noted.

⁷ IBISWorld report, “Global Apparel Manufacturing,” July, 2104.

⁸ Richard Locke, *The Promise and Limits of Private Power: Promoting Labor Standards in a Global Economy* (Cambridge University Press, 2013).

name recognition. Knights' model was different in that it did not have its own recognizable brand—Alta Gracia would be its first foray into developing its own apparel brand.

The collegiate branded apparel industry was split into three major retail categories: mass market (22 percent), mid-tier (38 percent), and bookstores (26 percent). In addition, e-commerce represented 7 percent, and 7 percent fell under “other.” University bookstores were managed either by the university itself or by third-party contractors. The two biggest contractors were Barnes & Noble College Booksellers and Follett Higher Education Group.

Knights was unique in the apparel industry for owning its own factory (Alta Gracia) in a low-income country. Like the rest of the apparel industry, companies making collegiate apparel (including Knights) contracted their production to local factories in developing nations because of much lower labor costs. The college apparel industry had an added motivation for using a contracting model: sales volume was quite cyclical. Most products were sold just before the school year started and in time for the December holidays. Contracting production allowed companies to seasonally adjust their volumes without having to worry about unused capacity and fixed overhead costs.

Student Activism

In the 1990s, a wave of protests took place in the U.S. against companies whose apparel was made in the developing world in factories with “sweatshop” conditions. College students played a big role in the anti-sweatshops campaign, outraged at revelations of child labor, forced overtime, unsafe working conditions, sub-poverty wages and anti-union violence—even in factories that made brand-name and high-end apparel. A contingent of students organized United Students Against Sweatshops (USAS), which convinced universities to impose labor conditions on apparel brands that made university logo goods. USAS also persuaded the universities to require the brands to disclose the names and locations of the factories where they made these goods. Once the locations were known, groups such as the Workers Rights Consortium (WRC) and the Fair Labor Association (FLA) could monitor the factories. (Note that the FLA was funded by companies and had companies on its board.) The FLA and WRC, along with other groups, developed codes of conduct for factories making collegiate apparel. However, as mentioned earlier, monitoring factories to ensure codes of conduct was rife with problems.

JOE BOZICH

In the early 1980s, Joe Bozich was a pre-med student at Vanderbilt University where he got a job keeping the university's weight room in order. A group of professional weightlifters who trained at the gym took him under their wings and got him started as a competitive weight lifter. He went on to win the 1985 NCAA National Bodybuilding championship and served as a spokesperson for Weider Enterprises, Gold's Gym, and Mattel Corporation. He began his apparel career as vice president of sales and marketing with Gold's Gym and quickly advanced to the position of president of the consumer products division. He founded Knights Apparel in 2001 and served as its CEO.

KNIGHTS APPAREL

Knights was one of the largest suppliers of sports licensed apparel in the United States, supplying close to \$400 million a year in retail dollars. It had rights to the National Hockey League and was the largest supplier of college apparel in the U.S. (See **Exhibit 1** for Knights Apparel major milestones and **Exhibit 2** for rankings of collegiate apparel suppliers.) Knights sold its products to mid-tier and mass-market retailers, and with Alta Gracia was breaking into the college bookstore channel. The company had 216 employees in the U.S. and 140 at Alta Gracia. Knights did business with 21 total contract factories outside the United States, including in Bangladesh, China, Egypt, and the United States. (See **Exhibit 3** for Knights factory location list.) All factories were independently audited, and Bozich said that although some “normal” problems had cropped up with pay issues, such as mistakes in calculating overtime, and other similar issues, Knights had not found any intentional fraud or misconduct.

Knights Apparel was originally owned by Milestone Partners in partnership with Bozich. In July 2011, Merit Capital Partners acquired Knights Apparel in partnership with Bozich and other top managers. Merit Capital Partners had a 75 percent stake, and the group of managers had a 25 percent stake.

ALTA GRACIA FACTORY**History**

The Alta Gracia factory was located in the small town of Villa Altagracia—two hours northwest of the Dominican Republic’s capital, Santo Domingo. In 1989, the Dominican Republic opened a Free Trade Zone (FTZ) in the town,⁹ which brought in new factories, including the town’s largest textile factory, BJ&B—a contract factory owned by the South Korean company Yupoong. BJ&B made baseball hats for retailers like Nike and Reebok.¹⁰ BJ&B’s continual violations of university codes of conduct caused the student activist group United Students Against Sweatshops (USAS) to protest and successfully pressure BJ&B to allow a union to form and permit collective bargaining. However, once BJ&B allowed a union, Yupoong began selling off its equipment and downsizing the factory, and its major customers started shifting their orders to other Yupoong factories in Asia. BJ&B began laying off employees on a large scale in 2004. By the time it abandoned the factory in 2007, 3,500 employees had lost their jobs.¹¹

A New Factory for Knights

In 2007, Bozich began exploring where to build a model living-wage factory, and he was attracted to the then-closed BJ&B factory for both business and social reasons. From a business standpoint, the infrastructure was already there, and there were many experienced and skilled garment workers who had previously worked for BJ&B who could be hired to work at Alta

⁹ John M. Kline and Edward Soule, “Alta Gracia: Four Years and Counting,” Research report, Reflective Engagement Institute, Georgetown University, August 2014.

¹⁰ Adidas bought Reebok in 2005.

¹¹ Jackie Northam, “Can This Dominican Factory Pay Good Wages and Make a Profit,” NPR, June 20, 2013, <http://www.npr.org/blogs/parallels/2013/06/20/193491766/can-this-dominican-factory-pay-good-wages-and-make-a-profit> (July 30, 2014).

Gracia. There were operational advantages to having a factory in the Western Hemisphere, such as quicker and cheaper transportation to the United States than from a factory in Asia. From a social standpoint, the area had high levels of unemployment and poverty, making it a place where a living-wage factory could have a large positive impact on people's lives.

Knights put \$500,000 upfront toward renovating the abandoned factory. When doing the renovation and allocating resources to Alta Gracia, Knights had to assess the risk and decide how much capacity it wanted Alta Gracia to have. Bozich chose a capacity of 1.2 million garments a year because he was committed to having a factory big enough to make a real difference in the community—even though the predicted timeline for breaking even would be longer than for a smaller factory.

From the beginning, Knights met and worked with Fedotrazones, one of the Dominican Republic's main garment workers' unions. Knights held discussions with the union and some former BJ&B workers about wages and safety issues, how the factory should be set up, and the best way to fairly hire new workers. According to the WRC's Nova, the union was able to function and be organized without resistance, which he said was "unprecedented in my experience in a garment factory.... The fact that Knight worked with the union from the outset speaks very well of the company and it made a significant difference in the project."

The renovations began in October 2009. Knights started hiring workers the following February, and the factory opened in April 2010. In 2013, Alta Gracia retail sales were about \$11 million, and it needed to reach \$16 million to break even. Alta Gracia could get to \$16 million if it was able to increase capital utilization from 60 to 80 percent. The factory lost a half million dollars a year for its first three years.

PAYING A LIVING WAGE

There was no single definition of the term "living wage" in the industry. Knights based its living wage on the country specific market basket analysis done by the WRC. Knights asked and answered the question of how much money employees would need to receive to meet all of life's necessities, not just for themselves, but also for their family: food, housing, energy, medical care, child care, transportation, education, clean water and clean clothing.

Wages were calculated using a legal maximum workweek of 44 hours, and voluntary overtime wages were 35–100 percent higher than base wages, depending on the time, day and prior work schedule.¹² Year-round employment was guaranteed, so when factory orders declined, Alta Gracia did not lay off or furlough workers, as was typically done in other factories.

Benefit and fringe payments for Alta Gracia workers equaled about 38 percent of wages—covering paid holidays, vacations and severance accrual as well as contribution to government funds for worker health and pension programs. Other benefits included child care, health care, and on-the-job training. The combined monthly wage and benefits for Alta Gracia workers was

¹² John M. Kline and Edward Soule, "Alta Gracia: Four Years and Counting," Research report, Reflective Engagement Institute, Georgetown University, August 2014.

about \$750. That was in sharp contrast to the minimum Free Trade Zone (FTZ) wage in the Dominican Republic, which was about \$215 (including benefits).¹³

When Knights was setting up the factory, it hired the independent Maquiladora Health and Safety Network to analyze the factory from a safety perspective. Knights followed Maquiladora's recommendations about the factory layout, ventilation, chairs, and lighting. The result was expensive, ergonomic chairs for every employee. The factory was airy and light, and workers could play the music of their choice. As mentioned earlier, Alta Gracia workers were allowed to unionize and engage in collective bargaining, and lawyers regularly came to the factory to explain workers' rights to them.

Transparency and Monitoring

Knights was transparent about the workings of the factory, including wages, benefits and health and safety conditions. Knights allowed NGOs, labor rights groups, student activist groups and universities to communicate directly with factory management and employees without the presence of Knights' management. Alta Gracia had an open-door policy, and those groups visited the factory on an ongoing basis.

It was strategically important for Knights that a credible third-party verify its labor practices and wages. Bozich decided to work with the WRC, which he described as one of the toughest critics of Knights and other companies in the industry. Bozich and the WRC agreed that the WRC would carry out monthly on-the-ground monitoring of the factory to verify Alta Gracia's compliance with the standards the factory had agreed to. Bozich gave WRC unfettered access to Alta Gracia's books and records, so the group could audit those monthly and put all its findings on its website. Each Alta Gracia garment had a WRC tag stating the product was sewn by workers who were paid a living wage, were represented by a union and had fair working conditions.

WORKERS' NEW OPPORTUNITIES

For workers earning a living wage at Alta Gracia, the immediate benefit was being able to reliably provide food for their families and have food that was much higher in nutritional value. Higher wages allowed for other life improvements as well: home renovations and improvements to make homes safe and more livable; primary, secondary and college education for children; adult education for workers; transportation, such as putting a down payment on a motor scooter; and paying off old debts to food vendors, family and friends.¹⁴

Bozich described what workers told him about how the higher wages and benefits made a difference in, or even saved, their lives. For example, a factory worker diagnosed with cancer was able to get treatment because she had medical insurance through Alta Gracia. She was cured and went back to school to become a medical assistant because her experience made her want to work in that field.

¹³ Ibid.

¹⁴ John M. Kline, "Alta Gracia: Branding Decent Work Conditions: Will College Loyalty Embrace 'Living Wage' Sweatshirts?" Research report, Walsh School of Foreign Service, Georgetown University, August 30, 2010.

Another factory worker was building a new home for her family, and also one for her father, who was 85 and had Alzheimer's. Bozich said he could see the joy on her face when she said, "I can take care of my dad. He took care of me when I was a child and if it were not for the money I earn at Alta Gracia, he would have to be in an asylum. We could not take care of him. But now I can take care of my father."

(See **Appendix 1** for photos of Alta Gracia workers and **Appendix 2** for stories about two Alta Gracia workers.)

"OUR CELEBRITIES ARE OUR EMPLOYEES"

Knights used workers' pictures and stories in a manner similar to how other companies might use celebrity marketing. At every retailer selling Alta Gracia garments, point of purchase signs told the story of a factory worker and what it meant for that worker and his or her family when a consumer bought an Alta Gracia product. For example, "My son goes to school because of these clothes," or "These clothes have changed my family's life. I hope you enjoy wearing them." In addition, each garment itself had a picture of a worker telling his or her personal story and how the decision of consumers to buy the garment over another company's garment impacted his or her life.

A PERSONAL MOTIVATION FOR ALTA GRACIA: JOE BOZICH

Bozich said he had always been socially conscious, but the Alta Gracia project gave him the opportunity to take that to a new level. It was very personal to him because of his experiences in the few years before he started the project—experiences that shaped and changed the way he thought:

I went through a series of personal tragedies in a very, very short time period. I had two family members pass away. A child of mine got really sick and almost gave up hope of having a normal life. Another family member was given six months to live—diagnosed with ovarian cancer. And that is when I got diagnosed with multiple sclerosis. And all that happened in a short time frame. It really did make me think. I knew how fortunate I was that I had so many resources available to me, but I thought, "What would someone do if they had to go through this and didn't have these resources and didn't have any hope whatsoever?" Because that is what got me through it—I always had hope.

Bozich said his biggest fear at the time was that if he became disabled he would not be able to support and take care of his family.

I thought about people just like me in the same situation with a sick child. They might know there was a cure but could do nothing because they could not afford it. Most people cannot imagine what poverty really looks like, but I have seen it, so I do. I thought—what if they were going through this, and on top of that their kids are also going to bed hungry at night because they can't put food on the table. They don't know where the next meal is going to come from. They can't afford

shelter. They can't afford water—the basics in life. It was the first time that I ever thought of it in those terms and it just motivated me to say, 'You can do something about it. Maybe you can use what you do every day to provide hope for someone who might be hopeless today.'

He added that there were many ways of “doing something about it,” including donating money and doing charity work, but the work he wanted to do and the Alta Gracia project came together. “I see this opportunity as exact—that is what Alta Gracia is really about. In simple terms, it is about providing hope and a pathway out of poverty for generations to come.”

THE BUSINESS CASE FOR ALTA GRACIA

Knights was a private company, but it had large institutional investors, including a private equity firm and a large public company. Therefore, Bozich had to convince his board and investors that Alta Gracia would be a good investment and that he had a viable business model. In 2008 and 2009, Bozich began having these conversations with internal stakeholders:

You can imagine when I went into my board meeting and told them that I had this great idea that we will invest millions of dollars in a third world country building a factory when it does not make sense for a company like ours to actually own a factory because of the cyclical nature of the collegiate apparel business. But we are going to go ahead and do it anyway, and then we will pay our employees 350 percent higher wages than what is required by law—absolutely guaranteeing that our factory cannot be competitive with any other apparel factory in the world in terms of price. I remember them looking at me like ‘We’ve invested all this money in you and your business and you think this is a good business idea?’

Bozich did think it was a good idea. And he built the Alta Gracia business case.

A Growing Market: The Power of Student and Labor Activists

In 2005, when Bozich began developing the business case for the Alta Gracia factory, there was a big movement on college campuses called DSP (Designated Suppliers Program). Student groups and labor rights organizations wanted universities to require that every licensee of college apparel buy its products from just a few designated factories. The idea was that consolidating all of the collegiate business into very few factories meant that licensees should be able to pay workers in those factories a living wage. This would create a level playing field so companies would not have to engage in a “race to the bottom” to lower costs and prices. These factories could also be closely monitored by labor rights organizations. Bozich said he was in favor of the reasons behind why those student and labor rights groups wanted to institute the DSP, but did not believe that particular solution was operationally feasible, nor did he think it addressed the root causes of price compression.

I got in very healthy, what I will call constructive conflict/debates with these groups. What I tried to explain to them was that from an operational supply chain standpoint, it is not as simple as you think. It won't work to have only a few factories make all the products that are needed in the collegiate market in our

industry because the cyclical nature of it can't sustain factories. So there were all these very, very aggressive debates, and the more meetings I went to and the more passionate I saw these labor rights groups and the students were about this issue, the more it started making me really think that if they are this passionate about it, maybe there is enough support from consumers who really want to be able to buy a product made under the highest standards in terms of fair, safe working conditions. Maybe we could actually build and brand a market for this.

Bozich did not want to go down the DSP route, but thought Knights could build a model factory and let consumer demand dictate how big the market was.

In presenting his business case to his board and investors, Bozich used the Fair Trade Movement and the Ethical Market as a basis of comparison. The fair trade industry had started only a decade previously, and had grown to a multi-billion dollar industry. Similarly, the ethical market (which included being socially and environmentally responsible) grew to \$57 billion by the end of 2011. The Alta Gracia project gave Knights the ability to have its own brand in what Bozich believed would become a new product category: socially conscious apparel.

After doing research about the \$750 million (at retail) college bookstore market, "I put some math to it and said, 'If we can capture a small percent of this market, we could potentially build a business.' So that is how I built the business case."

A New Brand in a New High-Value Channel

Alta Gracia gave Knights the opportunity to create its first brand. This was attractive because brands were higher value and traded at a much higher multiple than the license business, in which Knights had been operating. Bozich explained:

All of our other business is based upon licensing other brands. Whether it is a college brand or an NHL brand—they have the valuable brand. We license it and provide great service and products to generate revenue. But owning a brand where the brand itself has value—that is meaningful to a company. Purely from an investor standpoint, a company is much more valuable when it has a revenue stream tied to a brand that consumers want to own.

Alta Gracia apparel also allowed Knights to expand to a high value channel—university bookstores—one of the largest channels of distribution for college apparel in the U.S. It opened up a whole new revenue stream for the company. The price point for apparel in this distribution channel was substantially higher than in the mid-tier and mass retailers where Knights sold the bulk of its products.

Creating Goodwill Without Spending Public Relations Dollars

The Alta Gracia project was creating goodwill with customers and retailers (and gaining high-level positive media attention) without Knights having to spend public relations dollars to promote the Alta Gracia brand or Knights as a company. Dan Pansing, Knights Apparel board chairman and managing director of Merit Capital, was a supporter of Alta Gracia and said there

were continuing benefits from the goodwill created with Knights' customers, with licensors and with groups like the WRC:

There is a halo effect with our licensors and retailer customers that is worth something. While not perfect, one way to quantify that benefit is to think about it in comparison to the cost of a PR firm. What would it cost us annually to hire a PR firm to generate positive attention around Knights and its everyday Corporate Social Responsibility efforts? The Alta Gracia effort is actually better than that as we have the opportunity to turn a profit (eliminating that potential cost altogether) and the chance to create a brand, which, if built correctly, could ultimately be quite valuable. And, of course, beyond all of that, we're actually helping people on the ground with better wages and the opportunity for a better life for themselves and their families.

Relationships with Universities

When he was proposing the Alta Gracia factory, Bozich predicted that the living wage issue would become increasingly important and visible—not just for Knights but for universities, which would expect their biggest licensees to help them address the problem. Having Alta Gracia garments on their bookshop floors would allow universities to show they were doing something. Bozich said this would be a political benefit to Knights. Corporate Social Responsibility (CSR) was becoming more and more important as one of the key factors that universities were using to determine whether or not to extend or renew a contract with a licensee.

At the time, Bozich predicted that universities would also start narrowing their licensing base:

And in fact it appears that this is happening. Every university is narrowing and using labor rights compliance as one of the main reasons to decide whether a company gets to keep the rights or not. If companies can't prove now that they have the infrastructure to ensure that the products are being made under fair and safe conditions, companies are losing their licenses, and they should. Because you can't just sign a piece of paper saying to a university, 'We will meet your code of conduct.' Now you have to actually demonstrate that you have the infrastructure to do it. And we do.

Weighing Costs and Benefits

Bozich knew from the start that Knights would be funding Alta Gracia, a living wage factory, through its other profitable business units for a period of time. "If I didn't have this bigger business, Alta Gracia never could have been sustainable. Who would have kept writing these type of checks?" But he added, "If we could never make this factory break even and we were going to lose six figures every year on this factory, I would still do it. There are other benefits for doing this for our business besides just this factory and looking at it from the revenue and profits that we can make."

BUSINESS CHALLENGES

When Knights started the Alta Gracia project there was no business for the factory yet, because Knights had no customers in the bookstore channel. Knights did have relationships with some universities, bookstores and retailers who agreed to test and try Alta Gracia products, but Bozich said the volumes they guaranteed were not going to be enough to make Alta Gracia sustainable in a year or two. Plus, Bozich said, “We had no guarantee that after we put the apparel in stores customers would actually buy it.”

New Model and New Country

One hundred percent of Alta Gracia garments were going to be produced in a Knights-owned factory, so it was a new operation for a company used to a contracting model. Bozich said one of his top worries was the impact of the cyclical nature of the business. In addition, Knight did not have any other operations in the Dominican Republic, a country with different rules and laws than other countries in which Knights had contracted factories. Going into a new country increased the risk of unknown issues arising.

The Quest to Break Even

There was a separate P&L for Alta Gracia, so Knights knew exactly how much revenue it needed for the factory to break even. Pansing said Knights had to develop a strategy that laid out, over a reasonable time period, a clear path to profitability for Alta Gracia—independent of the base Knights business. On top of the higher costs stemming from higher wages, a major difficulty was that demand for college-branded products was seasonal while costs for the factory were relatively fixed month-to-month—because Alta Gracia paid employees whether they had work to do or not. This was unique in the apparel industry, as Pansing pointed out: “We’re paying our employees no matter what. If we don’t have enough volume we still have to pay them. So, a high fixed-cost business where every month you have the same costs to cover, combined with a highly seasonal revenue stream, is not necessarily optimal.”

Alta Gracia had to function at 70–80 percent of capacity to break even, but it stood at 60 percent at the end of 2013. Knights was subsidizing Alta Gracia merely to keep it running—mainly by shifting production of goods from other contract manufacturers (with cheaper labor costs) to Alta Gracia. Bozich said it would have made more financial sense to just pay overhead and wages to employees for doing nothing, but added, “I did not want the employees, until we got to a sustainable level, realizing how much of the factory was empty and how much we were subsidizing it. I did not want them to think it was charity.” However, carrying out these types of shifts—making apparel to be sold at a lower price in a higher-cost factory—was not sustainable over the long term.

Pricing and Brand Loyalty

Given its higher production costs, the company needed to price Alta Gracia’s products at a level similar to premium brands such as Nike and Under Armor. Students and alumni were not necessarily used to paying high prices for college T-shirts from non-premium brands, so there was a concern that consumers might not buy the Alta Gracia brand on a large enough scale to

support the factory. Many consumers are loyal to premium brand-name college apparel, and they had come to expect a certain level of quality, performance, and caché from those brands. They might perceive it as a sacrifice to give those things up—even if the Alta Gracia products were in reality competitive from quality and performance perspectives.

Pansing said when he became Knights' chairman of the board of directors in 2011, he had some healthy skepticism around the ability to continue to develop the Alta Gracia brand and the level of customer acceptance—particularly at the price points that challenged the premium competitors. “Our price is much more at a level like a Nike or Under Armor. Given that we are paying more than three times minimum wage at Alta Gracia, we definitely face higher costs than those companies. And while our margins are probably lower, we are forced to price at a level that can compete in the stores.”

When Knights initially approached bookstores and retailers about buying Alta Gracia brand products, they generally received one of two responses. Barnes & Noble, Follett Corporation and Duke University, for example, gave Knights immediate support in the form of orders. Bozich said others had the opposite reaction, “They said, ‘Why should we support this? The name means nothing. Nobody’s ever heard of Alta Gracia. It is not a brand, and you want us to pay more. You want to be at the same price as the well-known brands, but why is a consumer going to pay?’”

Display Space

An important question was how much display space college bookstores would devote to Alta Gracia garments. As with any new brand, Knights had to prove to bookstores that customers would buy Alta Gracia products. In order for Alta Gracia to grow, it would have to displace another brand, said Bozich, “and we knew that would be a risky proposition because nobody had ever done this before.”

Marketing

Telling the Alta Gracia Story

The company confronted a marketing challenge around how to tell a positive story about Alta Gracia without implying something negative about Knights' other products and other companies' products, which were made at contract factories that did not pay living wages. Bozich said that college bookstore retailers raised the same issue. They were concerned that consumers would be negatively incentivized to purchase other products on the floor—both from Knights and other companies. “The challenge in marketing was making sure the retailers were comfortable that the marketing was going to be a positive message about what makes this product special, but not talk about what somebody else might or might not be doing. It is not a simple messaging.”

Dependency on External Marketing Sources

Alta Gracia's success was dependent on advocates, such as students and campus organizers, to spread the word about the brand and what it stood for. Social media was an important component of this strategy. But with many issues and problems competing for students' attention, labor rights and living wages needed to remain a hot topic. Further, it was important that students and advocates support Alta Gracia with their wallets, not just their voices. As

Pansing noted, “If students lost enthusiasm for the project, then at some point it could fall away to a level that was not sustainable from our perspective. And the bigger issue would be whether this would lead the universities to lose interest as well. Then we would really have a business model that did not make sense.”

TRADE-OFFS OF SOCIAL GOOD AND PROFITS

Bozich said the main trade-off for Knights in building a model plant like Alta Gracia was the amount of time, energy and money that went into the project.

You cannot underestimate the amount of time and energy it takes to do something like this—especially in the beginning of a start-up. Purely from a business perspective, if I put that effort into some other segment of our business that was already working, we would not have been losing half a million dollars a year of our time and money. We would be making money. I’d be growing some other segment of our business that is already profitable. That is the big risk. Maybe it is a seven-figure swing—losing half a million here, and also you might have generated half a million more in profits in another area of business.

He added that the other big risk was that Knights could put all of this time, energy and money into Alta Gracia and it might not work at all. On top of the financial aspect, he said the worst thing Knights could do from a social good perspective was to try it, create hope for those families, and then shut it down. “To me the biggest risk was creating hope and then snatching it away from the workers two to three years later.”

STAKEHOLDER SKEPTICISM

Many Knights stakeholders expressed skepticism when Bozich proposed the Alta Gracia factory. The most-often cited argument was that although consumers might say they cared enough about factory workers to pay more for Alta Gracia clothing, in actuality they did not. Bozich outlined the argument he encountered:

It is easy to say the right thing when you know what the right answer is when you are asked it in the form of a questionnaire or a study. People will say the right thing, but how many will actually act upon it when it comes to their money? This is even more true with students, who say they care about it, but when it comes to discretionary spending, how many of them will really pay more?

To counter this argument, Bozich presented his business case to show why it would work, and also highlighted the negative criticism of student activists to show why Knights should move forward with Alta Gracia.

Look at how hard the student activists beat up companies like Knights and how critical they are. They have been doing this for 10 years, and if they are this passionate about it, they are going to continue to beat up companies like us over and over. These are not permanent jobs for them. Students are there for four

years and then new students come in to pick up where they left off. That is not a fad—it is a movement.

Another area of skepticism Bozich encountered was about the impact of higher wages on worker motivation. The argument was that if Knights put a model in place where workers did not have pressure to produce, they would not produce more just because they were already getting paid more. Instead, they would say, “I do not have to meet a quota, therefore I am getting paid this money whether I work hard or not.”

EXPANSION POSSIBILITIES FOR ALTA GRACIA

The Alta Gracia factory had the ability to expand to handle whatever volume it grew into. Even if demand doubled in the next year, for example, Knights could open one of the empty buildings next door and add another 100 machines and another 100 workers. Expanding was not cost prohibitive, and there was a large pool of available labor. However, in the collegiate market, demand came only during peak times, so bigger peaks meant bigger valleys. Hence the impact of the seasonal nature of the sales cycle would be proportionally greater. As mentioned earlier, at one point Knights moved some production from a factory with cheaper labor to Alta Gracia to avoid laying off or furloughing employees. This came at a financial cost to Knights, and having to do the same thing for a higher capacity factory would mean an even larger financial burden.

Therefore, Bozich said that if the factory was to expand, at some point Knights would have to take Alta Gracia outside of the college market and also get other businesses, customers and industries involved to level out the load and balance the factory. Potential industries included corporate uniforms, which had a different buying pattern than licensed sports apparel, and the music industry, where there was a lot of activism in support of social responsibility.

But reaching beyond the college market would require developing Alta Gracia into a much larger brand, and Pansing said that would mean developing a sustainable brand with lasting value. “But I’m not convinced right now that we have done that yet, that we have developed a brand that the consumer knows and wants to own. There may be a small subset of truly socially conscious students that is familiar with Alta Gracia and believes in it. But that is a long way from a full-blown consumer brand that has enduring value, like Coca Cola.” However, Bozich strongly believed Alta Gracia was at a tipping point, and with the right investment and strategy, it could become a valuable brand.

CONCLUSION

Alta Gracia was indeed at a tipping point. Bozich had predicted the factory would be profitable in three years—but it was not there yet, at the almost three-year mark. Would all of Knights’ efforts succeed in proving that Alta Gracia had a viable and sustainable business model? Or would it remain a money-losing factory—one that provided many benefits for the company, but still could not sustain itself? Had Bozich and Knights been more willing to take a financial risk on Alta Gracia because of the social responsibility element? If so, was it still a good decision? Should Knights replicate Alta Gracia?

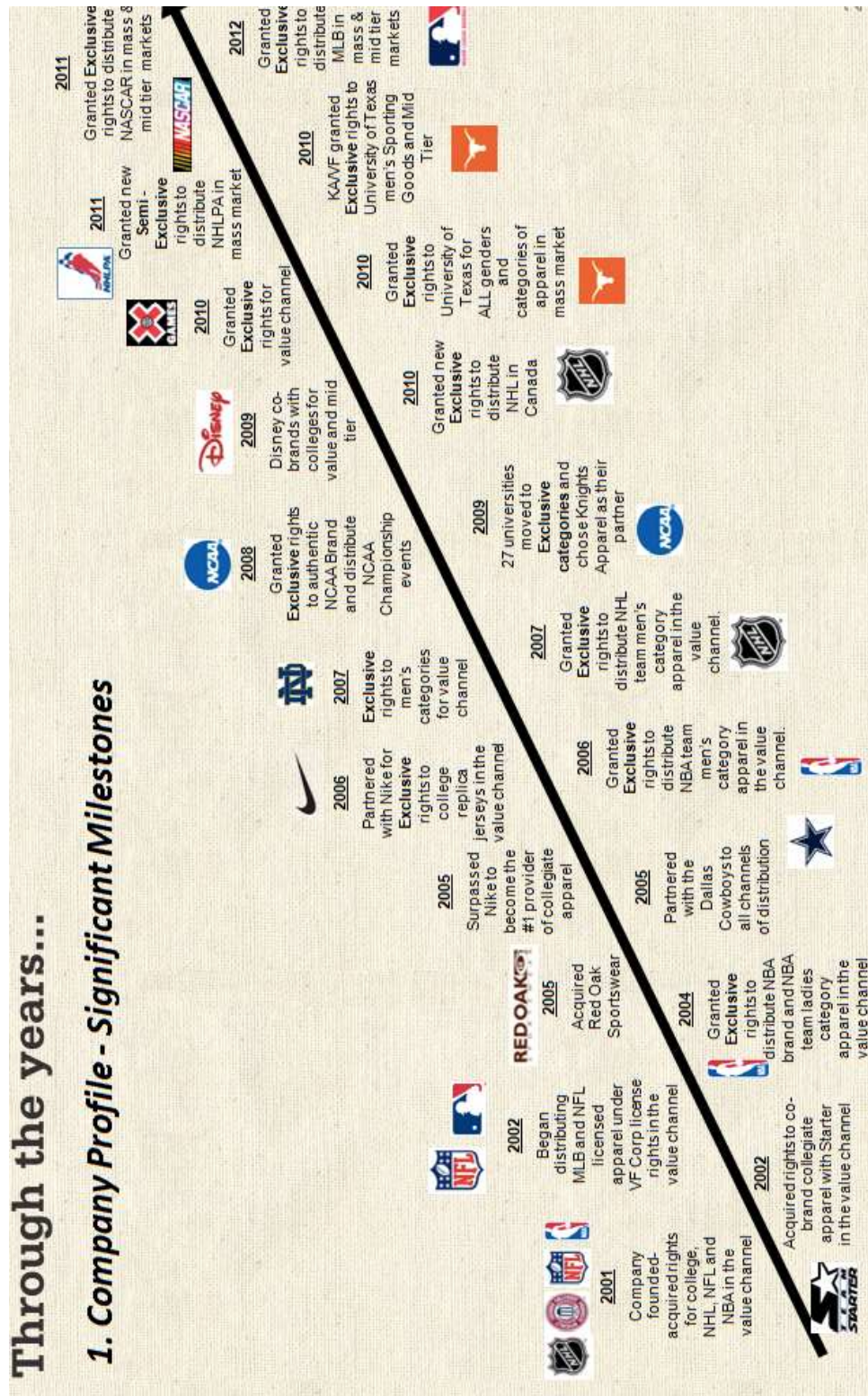
The size and success of Knights is what allowed the company to build and maintain Alta Gracia despite financial losses. If Alta Gracia was Knights' "model factory," could companies without as big pockets replicate it? If not, then changing the industry's treatment of workers would require the bigger companies to follow Knights' lead. If those companies did not – how big an impact could a factory like Alta Gracia have? Lastly, Bozich did not have to answer to shareholders in making decisions about Alta Gracia, but what might have been different if Knights was a public company?

Exhibit 1

Knights Apparel Milestones 2001 – 2012

Through the years...

1. Company Profile - Significant Milestones



Source: Knights Apparel.

Exhibit 2
Overall Collegiate Licensee Penetration
Fiscal Year (July 1, 2013 – June 30, 2014)

Knights Apparel, Inc.	7.16%
NIKE USA, Inc.	6.87%
Sports Licensed Division of the Adidas Group, LLC	3.82%
Colosseum Athletics Corporation	3.15%
Champion Custom Products	2.81%
Under Armour by Gear For Sports	2.69%
Top Of The World	1.67%
Nike by Haddad Apparel Group	1.38%
Commemorative Brands, Inc. dba Balfour	1.34%
JASR, LLC dba J America	1.24%

Note: Includes Nike's Second Quarter Data.

Source: The Collegiate Licensing Company.

Exhibit 3
Knights Non-U.S. Factory Locations

Country	Number of Factories
Bangladesh	3
China	5
Dominican Republic	2
Egypt	5
Honduras	2
South Korea	1
Macau SAR	1
Pakistan	1
Vietnam	1
Total factories	21

Source: Knights Apparel.

**Appendix 1
Photographs from Alta Gracia**

Joe Bozich (right) Speaking with Alta Gracia Workers Outside Their Home



Source: Knights Apparel.

Alta Gracia Factory Workers at Their Stations



Source: Knights Apparel.

Alta Gracia Workers Outside the Factory



Source: Knights Apparel.

Alta Gracia Worker and Her Children Inside Their Home

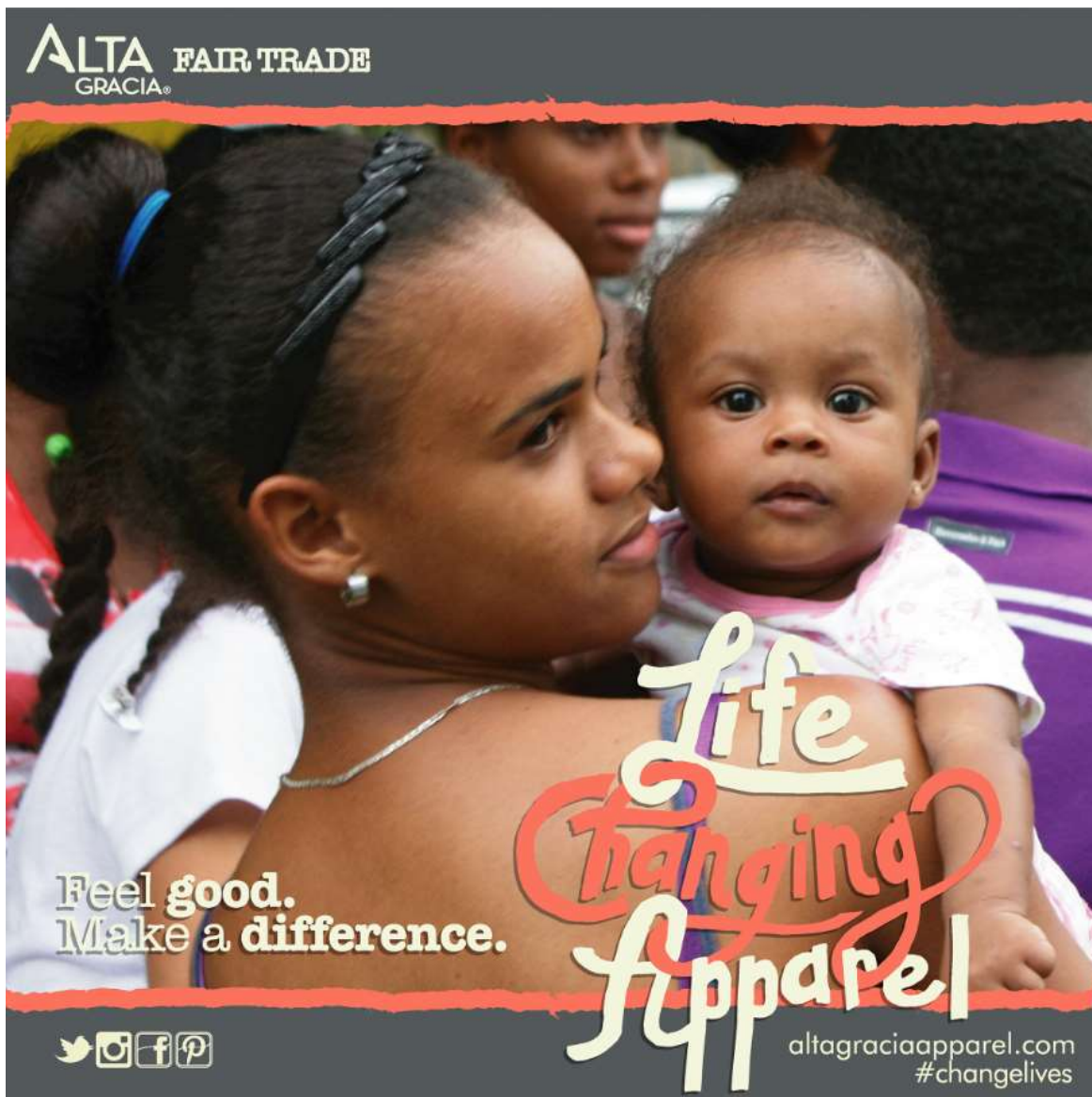


Alta Gracia Worker and His Family Outside Their Home



Source: Knights Apparel.

Alta Gracia Promotional Photo



Source: Knights Apparel.

Appendix 2

Alta Gracia Worker Stories

Georgetown Professors John M. Kline and Edward Soule closely followed the Alta Gracia factory and interviewed its workers about how Alta Gracia made a difference in their lives. Kline and Soule presented these workers' stories in three research reports for Georgetown's Reflective Engagement Initiative.

Isabel's Story¹⁵

Isabel lost her job when she was laid off from an apparel factory in the Villa Altagracia's FTZ. She worked as a maid, cleaning and cooking in other homes, to secure some income. Life became harder when her wooden house burned down in 2008. She was able to move into her mother's house next door but her husband had to live with his family in their house. After being hired for a job at Alta Gracia, Isabel was able to secure a loan to help rebuild her house and reunite her husband and young daughter. She even added internal walls in the rebuilt house to replace the hanging sheets that previously were used to separate rooms. Isabel is now building an outside restroom so that it can be shared with her mother, since neither house has a bathroom. She reports that people in the community are surprised that she was able to come out of her situation so well; they are not jealous of her good fortune but hope the factory can hire more people. For herself, Isabel hopes to return to school and study to be a nurse.

Ana's Story¹⁶

After losing her apparel job in Villa Altagracia's FTZ, Ana worked for four years making men's boxer shorts at a factory near the airport in Santo Domingo. She had to live away from home and went up to 15 days without seeing her two children, now ages 9 and 6, who stayed with her mother. She then spent nearly two years unemployed, although she found some temporary work as a cashier and in a hotel daycare center. She could only afford to rent a place so small the children still had to live with her mother. After starting a job at Alta Gracia, Ana rented a larger house. Now she can see her children every day and keep them close. She can also provide them a better education and she dreams of owning her own home one day. Ana believes the factory's economic effects flow into the town's economy, where the hardware firm and corner stores are doing well. She helped finance construction on a part of her mother's house. "In this way I am passing along the wealth." Working at Alta Gracia enables Ana to stay close to home and assist her extended family—both ways to maintain family bonds, which is an important value for her. Ana wants to return to school and become a teacher.

¹⁵ John M. Kline and Edward Soule, "Alta Gracia: Work with a Salario Digno," Research Progress Report, Reflective Engagement Initiative, Georgetown University, December 5, 2011.

¹⁶ Ibid.