Research Advisory
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The New Phase of Online and Omni-Channel Fulfillment for B2C and Retail Supply Chains

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Purpose

From time-to-time as developments warrant throughout the year, we have published various succinct but brief research advisories to clients and blog readers focused on specific industry, line-of-business, functional or technology trending that warrant specific attention for both management teams and supply chain management professionals.

Introduction

There have been several phases related to the ongoing explosion of online commerce and its impact on traditional retail and *B2C* focused industry supply chains. In our research advisory published in August 2016, ***The Beginning of a New Phase of Online and Omni-Channel Fulfillment for B2C and Retail Supply Chains***, we cited the beginning of the newest phase, namely impacting the long-term presence of brick and mortar retail and the accelerated need for more agility from supporting supply chains. With this *Research Advisory*, we now add information and insights gained from all of 2016 and the subsequent implications to traditional retailers' financial and operational performance.

Whereas, the prior watershed event was the August 2016 public acknowledgement by broad based merchandise retailer **Macy's** that declining foot traffic makes the cost or value of real estate and physical store operations a new determinant of long-term strategy, the results of all of 2016 added even more evidence that most all traditional retailers should fundamentally change strategies to counter the threat of the permanent move to online buying.

Our August Advisory outlined the tenets and impacts for the beginning of a new phase of an omni-channel driven retail business model. With the increasing results and implications from traditional retailers, we have updated our advisory to reflect evidence that indeed, a new phase is underway and comes with many implications for the industry's supply chains.

Consumer preferences and desires have permanently changed in retail, and online platforms and consumer loyalty programs such as that of Amazon are rapidly garnering consumer loyalty and dependence.

Initial Phase

The initial phase of online occurred when **Amazon** entered the industry in 1997. Over time, its online retail platform and associated online customer fulfillment capabilities caused millions of consumers to discover and favor the online buying experience for vast variety of products. With the increasing threat and market penetration from Amazon and other prominent online sites, retailers had little option but to respond to the threat by developing various strategies to develop and support online customer fulfillment capabilities.

Subsequent Phase

After some stumbling, classical retailers came to discover that the one advantage they had was their brick and mortar physical store presence where consumers could touch, feel, sample, operate or return merchandise. We view this phase as beginning about four years ago. The Omni-channel phase evolved when traditional retailers leveraged a combination of online and in-store merchandising and order fulfillment capabilities. Last year, such capabilities included supporting the widespread ability for shoppers to order online, pick-up or return at local store, and in some cases, have the local store serve as a shipping point for fulfilling an online order. Macy's itself was already an innovator in developing proprietary online fulfillment algorithms that weighted the consumer's ship-to address to various cost and service options related to shipping from an online fulfillment center or from a localized store. That included the trigger to allow the consumer to be able to pick-up her or his merchandise from that local store. Similarly, Wal-Mart has evolved an online strategy that leverages both its online site and widespread physical store presence that covers major geographic population centers.

After several years of experience, traditional retailers have now come to understand that the costs associated to online fulfillment are far higher and that has the impact of eroding overall business margins, impacting profitability.

New Phase Evolution

The new phase retail industry shockwave came in January 2016 with **Wal-Mart**'s announcement that it would close 260 stores globally, including 154 across the United States as part of comprehensive alignment of strategy. After Wal-Mart's January announcement, we again advised retailers to rationalize their combined physical and supply chain presence in the light of consumers' emphatically moving to prefer an online experience.

Wal-Mart has since invested over $3 billion to acquire ***Jet.com*** to jump-start its existing Omni-channel retail strategy, re-organized its executive and leadership ranks that places Jack Lore, *Jet.com's* founder, as the sole executive leading online strategy, and has shed 1000 people from corporate staff roles. The global retailer is now planning to invest an additional $2 billion over the next two years to further springboard its online fulfillment channel and counter the threat of Amazon for retail platform dominance. Wal-Mart continues in its strategy that leveraging both on online and physical stores as a combined collection of customer fulfillment capabilities is a more effective strategy.

In January 2017, Macy's again alerted investors to disappointing holiday sales indicating that comparable sales declined 2.1 percent in November and December. The broad-based full line retailer further announced a series of actions to streamline its retail store presence, intensify cost reduction efforts and execute a revised real-estate strategy. Included was the closure of 68 retail stores, part of the 100 retail store closings previously announced in August 2016. Most of the store closures are expected in early 2017. The reorganization of the retailer's field structure accompanied the store closures to manage remaining retail stores. An additional 3900 workers are expected to be displaced or reassigned because of such closures. The retailer's ongoing strategic real estate strategy calls for securing added value from existing store real-estate. Macy's remains under pressure from activist investors to garner more cash from its real-estate holdings and reports began to circulate of a potential acquisition or link-up with Canada based traditional retail holding firm **Hudson's Bay**.

Traditional retailers **J.C. Penny, Sears** and **Kohls** are now in the process of shedding additional unprofitable stores or revamping Omni-channel strategies. RBC Capital Markets indicates that since 2013, Macys, JC Penny, Kohls and Sears Holdings have collectively shuttered 750 stores or 20 percent of existing physical store footprints.

Target, on the other hand, plans to invest $7 billion over the next three years to improve its stores, compete more aggressively on pricing, launch new private brands and enhance its existing online capabilities. Target's CEO Brian Cornell indicated to the retailer's investors a renewed sense of urgency to quicken the pace change. Contrasting his plan with other retailers who are closing stores: "*There will be winners and losers in this new era of retail. This plan is about coming out on top.*"

What to Expect

Revenues for **Amazon**'s North America retail segment were reported as nearly $80 billion in 2016, representing the second consecutive year of 25 percent market growth. By some accounts from online market analysis firms, Amazon's online platform may have captured upwards of 40 percent of all online customer fulfillment in 2016, increasing its leadership as the preferred online platform. According to a report from *The Wall Street Journal,* if Amazon's North America retail revenues were to grow an additional 25 percent annually, it will take only three more years to add an additional $75 billion in revenues, the proverbial multiplier effect.

According to U.S. government data, as recently as 1999, traditional department stores had total sales of $230 billion, while in 2016, that revenue number has shrunk to $155.5 billion. Retailers will collectively continue to pump billions into online customer fulfillment capabilities while shedding existing non-strategic physical stores.

More importantly, Amazon's investors continue to tolerate lower profitability margins for the promise of accelerated revenue growth and platform dominance. Wal-Mart's overall revenues grew marginally in fiscal 2016 and operating margins fell to 4.7 percent from 5 percent in the equivalent period in 2015. *Amazon.com* retail margins averaged 1.7 to 2 percent during 2016, and obviously benefits from the cushion of higher margin products and services reflected by its other operating entities such as *Amazon Web Services* (*AWS*). Revenues garnered from ***Amazon Prime*** members further help to offset the costs of transportation, fulfillment and last-mile customer fulfillment.

These continuing industry forces will directly impact existing supply chain capabilities.

The prior strategies of pushing vast amounts of similar inventory into stores hoping that merchandise managers made the correct call, while having to deeply discount merchandise that did not capture consumer interest must change. *Fortune* recently noted that strategies for building "*oceans of sameness*" in identical, non-differentiated inventory must transform to combination of differentiated merchandise and uniqueness along with far quicker cycles in inventory planning and production based on the sensing of consumer buying tendencies. Too many large-scale retailers offer the same selection of merchandise without differentiation.

Fewer and more strategic focused physical stores must be more about consumer experience and differentiated services while online strategies are more about broader selection, inventory, and price, complementing or adding to the physical store experience. Industry supply chains must adapt to business models involving a comprehensive Omni-channel strategy, where physical stores represent more shared, product concessions footprints for the consumer to touch and feel service and product experiences while online platforms support volume buying and Omni-channel inventory management. Ironically, the strategy that former Apple retail executive Ron Johnson tried to implement as CEO of JC Penny with disastrous results, may have had substance. The difference is in managing the rate of change and expectations for consumers along with the capabilities of the supply chain to support differentiated business models.

New Phase Strategies and Preparedness

We continue to advocate that this new phase for *B2C* and Omni-channel retail capabilities will include the following:

- Acknowledgement that consumer preferences and desires for online shopping are indeed permanent including implications for declining physical store foot traffic.

- Physical stores themselves are to be evaluated relative to the impact towards two key financial metrics: *Return on Invested Capital* (*ROIC*) or revenue and profitability growth. Other factors to be weighted are needed presence in key strategic geographies, importance as a strategy component for Omni-channel fulfillment, or offsetting value of the real estate itself. The presence of activist investors will obviously add weighting to either or both. Retailers who sell or re-purpose real-estate holdings now gain the benefit of leveraging current values, whereas, those that delay risk the dynamics of real-estate market supply and demand.

- The continued build-out on online fulfillment capabilities, manifested by online systems and technology investments, online fulfillment center capital and/or outfitting costs, as well as incremental transportation and logistics costs not offset by billed shipping charges to consumers. With the cost of *E-fulfillment* focused warehouse and distribution costs skyrocketing across key areas of the United States, the ROIC metric looms large, and may influence decisions to outsource fulfillment to a third party.

- Much more sophisticated inventory management that will leverage more customer order sophisticated fulfillment algorithms supported by advanced forms of predictive and prescriptive analytics to support decision-making.

- More developments among global online retailers Alibaba and Amazon will continue to manifest in growing and expanding their own capabilities, including more options to support owned parcel transportation and last-mile fulfillment. Each has the benefit of leveraging premium buying subscriptions from online consumers willing to up-front a premium payment to insure *Free Shipping* throughout the year. Both are in the process of developing the next iterations of universal online fulfillment network capabilities that include leveraging owned or leased assets for dedicated air, surface and same-day delivery resources along with global-wide fulfillment capabilities. Alibaba's Founder and CEO has already called for collaboration in creating a single global-wide online fulfillment platform.

Actions to Consider

Unified Organizational Leadership- Too often, senior management leaders allowed or tolerated separate organizational teams to manage both physical and online business fulfillment needs. This led to obvious internal competition and conflict for resources and investment budget. Both spheres of influence often have different vision and tactics and the challenge was often organizational energy and precious time focused too much on alignment vs. execution. Earlier this year, when Wal-Mart made its strategic assessment, it elected to merge both online and physical store IT and technology groups under a singular leadership model with a direct reporting relationship to the head of the E-Commerce division. In its most recent announced acquisition of online platform Jet.com, Wal-Mart CEO Doug McMillan announced that Jet.com's founder and CEO, Marc Lore, will jointly lead both online sites in strategy and future development, another effort toward singular leadership.

Supply Chain Alignment- Similarly supply chain strategy, business processes and infrastructure require a singular alignment, especially in the light of a shrinking physical store replenishment distribution model with one that supports larger orders volumes and more cross-dock distribution flows. Too often, major supply chain capital or operational investments are made with narrow-scope assumptions without factoring broader strategic needs and considerations, especially in an industry environment that is so explosive to change and disruption. The takeaway is to avoid one-dimensional decisions and factor support for flexibility and agility to ongoing Omni-channel customer fulfillment needs.

Augmented Investments in Supply Chain Agility- Retail and *B2C* supply chain capabilities must be far more agile in the ability to support an integrated Omni-channel strategy. We caution that this is not solely investments in further distribution and fulfillment center automation, since that may well be one-dimensional. Instead, it should include more sophisticated Omni-channel planning and inventory optimization supported by advanced analytics related to being more predictive and responsive to constantly changing customer fulfillment needs.

Supply Chain Leadership- Retail and B2C line-of-business groups need to insure that the supply chain has a layered depth of leadership talent to meet new challenges involved in the ongoing transitional phases of retail. That includes proven experience in supporting both online and physical store supply chain network design, planning, logistics and distribution needs. The new era of retail is more about consumer demand driven response processes as opposed to traditional merchandise management driven, including specifically how supply chain resources and capabilities respond to daily and weekly needs across all retail channels. Leadership traits should include creativity and balanced risk management, an ability to positively engage in cross-organizational collaboration, and an ability to positively and effectively challenge inbred industry thinking. Technical skills should at a minimum include skills that can leverage various aspects of advanced analytics to support ongoing integrated business planning decision-making as well as the ability to leverage advanced technology.

Contact Information

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For additional updates and sights regarding industry, technology, and business developments, please visit the *Supply Chain Matters blog*.