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VIEWPOINT

Upping the Ante: How the Amazon Effect is Changing Everything

Hyper-efficient customer service in the form of online ordering, free same- and next-day delivery, and other conveniences made possible by modern technology drives the trend known as the "Amazon Effect." Defined by whatis.com as "the ongoing evolution and disruption of the retail market, both online and in physical outlets, resulting from increased e-commerce," the name acknowledges Amazon's "early and continuing domination in online sales."

Despite the name, this sea change in the market is not only about Amazon and equally massive competitors such as Walmart and Target. The disruption to the retail and consumer goods industries extends all the way to mid-sized and mom-and-pop retailers, manufacturers and suppliers that must find a way to keep pace. While every move of the retail giants is well-documented and dissected, the impact on everyone else goes far less recognized. Worse yet, many of the companies deeply affected by this rapid and massive change in basic business operations were unprepared for it and remain at a loss for how to respond.

To avoid being a collateral casualty of the Amazon Effect, retailers and consumer goods companies need to fully grasp how the new realities of ecommerce truly affect their business, and then devise a strategic response uniquely suited to the characteristics and challenges of their business.

"It ups ante for the whole industry," says **Donny Paslowski**, senior vice president in **Cresa's Consulting Group (CCG)**. "They either have to match Amazon's service commitment or justify why they can't. Do they need to have better in-stock levels? Increase the number of products available for one- and two-day service? It forces some companies to change their distribution network entirely."

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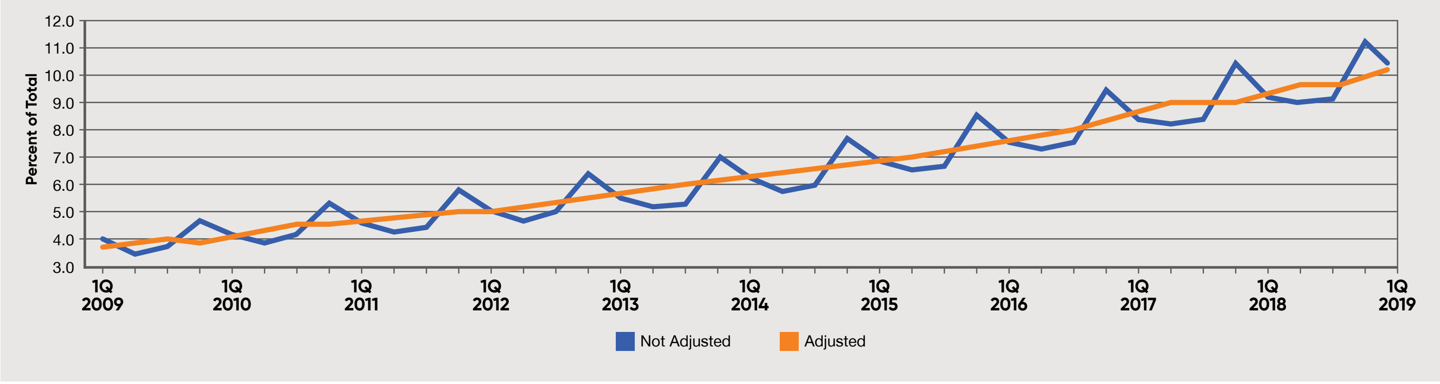
Customer Expectations and Last-Mile Delivery

In the first quarter of 2019, the percentage of total U.S. retail sales that were completed online exceeded 10% for the first time. The 10.2% seasonally adjusted figure was 0.6% higher than the first quarter of 2018 and 1.8% above the first quarter of 2017, according to the U.S. Department of Commerce. Though the U.S. lags other economic powers in online sales as a percentage of the total – over 35% of China's retail sales are done online, for example – Forrester Research projects that more than 17% of all U.S. retail purchases will be done online by 2021, with total online sales increasing over 30% from 2018.

This rise in ecommerce has been accompanied by an increase in customer expectations. Retail Touchpoints, an online publishing company for retail executives, reported in March 2018 that 83% of retailers responding to a survey said that customer experience (CX) is now a company-wide goal and that they "feel pressure to improve it."

The Retail Touchpoints Survey, which was conducted jointly with technology giant Oracle and logistics solutions company Convey, also reports that customer expectations around delivery times is the leading challenge of the retailers surveyed, with nearly half (49%) expressing this view. Rising shipping costs (47%) came in second among their chief concerns, while customer expectations of free/low-cost shipping was third, at 44%.

Estimated Quarterly U.S. Retail E-commerce Sales as a Percent of Total Quarterly Retail Sales
1st Quarter 2009 - 1st Quarter 2019



A study by eft (eye for transport), a supply chain and logistics business intelligence company, confirms that these concerns are reasonable. It found that 65% of consumers want greater flexibility for deliveries and 61% want faster deliveries. The Last Mile Retail Study, which surveyed 129 North American and European supply chain executives, also reported a 50% increase in last-mile services among respondents in the 18 months prior to the report's March 2018 release.

The same organization's D3: Dynamic Distribution Disruption 2019, State of Retail Supply Chain Report revealed that "keeping up with customers' demands for fast, convenient delivery" outpaced all other challenges in fulfilling last-mile deliveries. It had an average score of 6.3 among the 205 respondents, who ranked nine specified challenges in order of importance. "Reducing delivery costs" was second at 6.0.

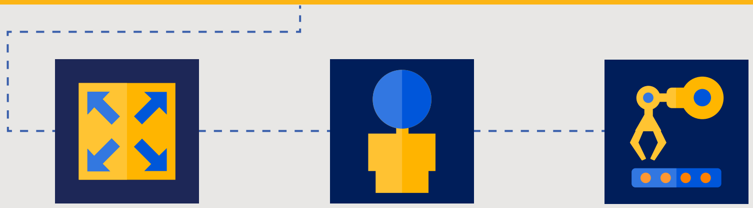
"Retailers, brands and manufacturers [recognize] that they need to match customers' expectations, which are increasingly set by the leading e-commerce brands," wrote eft's Head of Research, Alex Hadwick. "This is creating more integration of assets across the supply chain, better measurement of demand-side metrics, an increasing need for visibility on all sides and major investment in warehouse technology across the world. The big hope for retailers is that these efforts will make their supply chains faster, more resilient and more responsive to customer demands."

Signs Were On The Horizon

The upsurge in customer expectations, and with it the evolution of distribution networks from next-day delivery for a fee to free and discounted same-day delivery, was not as abrupt as people may believe. In March 2013, the magazine Ad Age noted, "Same-day shipping services are changing consumer behavior fast." In an article by Lauren Sherman, titled "E-Commerce: Three Ways Same-Day Delivery Will Change Retail," Jeffrey Cole, director of the Center for the Digital Future at University of Southern California's Annenberg School, predicted that drugstores, from corporate behemoths such as CVS to small independent stores, would need to "work 10 times harder to keep their customer's business" due to the competition coming from Amazon and other e-commerce outlets. This includes offering same-day delivery, either on their own websites or through a service such as Google Express. Those that don't keep up, Cole said at the time, will not survive.

The big drugstores apparently heard Amazon's footsteps. In 2015, Walgreens partnered with delivery service Postmates to offer same-day delivery for a flat fee of $4.99. Since then, Walgreens and CVS have been expanding and improving their rapid delivery options, with both offering next-day and same-day delivery options for everything from prescription drugs to over-the-counter medicine and groceries.

This commitment to "last-mile delivery" is why it now has more than 175 fulfillment and sortation centers around the world, with over 110 of these in North America and over 40 in Europe. The fulfillment centers exceed a combined:



150 million square feet of space

Employ over 250,000 people globally

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These moves came none too soon, as Amazon entered the prescription drug market with its purchase of online pharmacy PillPack in 2018. Shares of the major drug chains immediately tumbled with the news, and financial results were disappointing for the pair through the first two quarters of 2019. In August 2019, Walgreens announced it was closing 200 of its approximately 10,000 U.S. stores, and CVS is also shuttering unprofitable stores and considering the fate of up to 500 more per year, according to CNBC.

Know Your Business...and Theirs

Meanwhile, the industry's giants continue to slug it out. After Amazon cut its standard free two-day delivery time for Prime members in half, Walmart responded by rolling out its own free next-day service for items over $35, but without the $119 membership fee paid by Amazon's upgraded customers. For its part, Amazon boasts that it has 10 million items eligible for free next-day shipping compared with only about 2 percent of that number for Walmart.

For everyone else observing this battle of the titans, the quest to keep up with the Bezoses and Waltons is a daunting task. It requires foresight, nerve and a solid understanding of not only their own business and customers, but of the motivations and practices of the principal players behind the Amazon Effect.

It all begins and ends with Amazon's insatiable desire for ever-improving customer service. "The expectation is increasingly that there will be free shipping," says CCG Principal **John "J.C." Renshaw**. "How fast, and how free can they get it?

Warehouse Distribution and Allocation

In 2017, 23.5% of the respondents said that "distribution is by channel with separate facilities for retail, wholesale, e-commerce," but that percentage plummeted to 9.3% in 2018.

Meanwhile, the percentage reporting "fully integrated distribution with all channels sharing inventory and fulfillment engines in the same facility" climbed from 17.6% to 30.2%.

The percentage of those reporting that "ecommerce distribution is separate, but operated out of a retail or wholesale [distribution center]" decreased from 19.1% to 16.3% from 2017 to 2018.

While those saying that "some combined distribution occurs, but [it is] not fully integrated" edged up from 39.7% to 44.2 %.

More and more consumers have it in their mind that so many of the products they want and need can be acquired on Amazon, and they can have it the next day for free. So why can't so-and-so offer the same thing?"

This question is at the core of the angst running through the C suites and board rooms of retailers and consumer goods companies across the U.S. and the world. Which leads to the other big question: how are the largest and most successful e-commerce companies doing it?

For Amazon, one answer is to be closer to the target audience. This commitment to "last-mile delivery" is why it now has more than 175 fulfillment and sortation centers around the world, with over 110 of these in North America and over 40 in Europe. The fulfillment centers exceed a combined 150 million square feet of space, employ over 250,000 people globally, and feature more than 100,000 robotic units.

Amazon also saw its long-standing relationship with FedEx end in June of 2019. Fortune reported in an August 7, 2019, article, "Behind FedEx's Strategic Decision to Leave Amazon at the Curb," that "Amazon's ever growing demands, its developing position as a competitor, and low margins for delivery work were all factors."

The Wall Street Journal predicted that the split would result in a "windfall" for FedEx's rivals. "Shipping experts said UPS's expanded parcel network and the online retail giant's growing in-house logistics operation would likely provide enough capacity to avoid delivery delays during the busy peak season," writes Jennifer Smith, author of the August 8, 2019, article. "Regional delivery operators like OnTrac and LaserShip Inc. could also get a holiday bump from overflow volumes, they said."

Though it relies on its growing network of independent partners and suppliers to populate its vast inventory of available products, Amazon is increasing efforts to stockpile goods in its fulfillment centers to better control and facilitate same-day and next-day service. To encourage this, from June 2019 to January 2020, it offered a select group of sellers up to 75% off warehouse storage costs if they agreed to store their goods with the company.

"This forces some suppliers to make a tough decision," says CCG's Paslowski. "If they don't currently use Amazon, should they start to leverage Amazon to stay competitive. If they are using Amazon, do they ramp up production to keep their product stocked in their warehouses and benefit from the discount. Amazon requires a minimum of four to eight weeks of supply on hand, which can increase the cost of inventory for suppliers in exchange for a decreased cost of warehouse space. This is one of the pressures that Amazon's push to meet one-day service is putting on suppliers."

Amazon's focus on stockpiling items in their warehouses offsets, at least partly, the advantage held by retailers such as Walmart and Target that can use the space in their large network of brick-and-mortar locations to help fulfill online orders. In the same way that Amazon is expanding its network of warehouses to be closer to large population centers, the big box retailers access inventory in their stores to quickly and efficiently deliver products to the front steps and mailboxes of e-commerce customers nearby.

"It's really having an impact on real estate; it's a new model," says Renshaw. "We're seeing fewer very large warehouse and distribution facilities in rural areas. The big retailers used to build these massive 1.5-million-square-foot buildings in out-of-the-way places with low labor and low land costs. Now, with the pressure of same day and one-day service, they're looking to sublet facilities with a much smaller footprint that are closer to large, urban areas."

With ecommerce reducing the need for big box retail outlets, some buildings originally purposed for retail are being converted into warehouse spaces and distribution centers. It is a function well-suited to the task, says Renshaw. "The potential re-use of retail sites is an interesting development," he says. "It fits the narrative of having smaller distribution centers in some of the bigger urban markets. That's what what Walmart is doing with the Sam's Clubs locations they closed."

The D3 survey by eft supports the notion that integrated distribution is the future wave. In 2017, 23.5% of the respondents said that "distribution is by channel with separate facilities for retail, wholesale, e-commerce," but that percentage plummeted to 9.3% in 2018. Meanwhile, the percentage reporting "fully integrated distribution with all channels sharing inventory and fulfillment engines in the same facility" climbed from 17.6% to 30.2%.

The percentage of those reporting that "ecommerce distribution is separate, but operated out of a retail or wholesale [distribution center]" decreased from 19.1% to 16.3% from 2017 to 2018, while those saying that "some combined distribution occurs, but [it is] not fully integrated" edged up from 39.7% to 44.2 %.

Many retailers find themselves needing to be able to hold or accommodate more inventory due to the trend to buy-online, and pickup in store (BOPIS or BOPUS)," says Renshaw. "Sometimes retailers' locations are more of a showroom for product demonstration, with the consumer ordering the product through the store or online for home delivery through a fulfillment center."

The "My Company Effect"

The takeaway for most others in the retail and consumer goods industry is that reducing the cost and time involved in delivering products may become a matter of survival. At minimum, it needs to be acknowledged as a competitive factor to be addressed strategically. "Anyone who competes with or does business with Amazon, or who wants to do business with Amazon, is being affected by this," says Renshaw. "They need to make sure that their delivery network is aligned properly, that their service commitments are cutting edge and that they're generally keeping up."

What are some of the most critical considerations for companies undergoing the changes brought on by the Amazon Effect?

Customer Expectations. The extent to which companies must adjust their businesses to enable faster, more efficient and inexpensive or free delivery depends largely on how susceptible they are to customers perceiving Amazon and other e-commerce providers as an alternative. If theirs is a niche product, or a custom version of a more common product, the threat presented by Amazon and their ilk is far less of a concern. If customers can receive the same or a similar product faster and for the same better price elsewhere online, there is a major issue that needs to be addressed immediately.

Efficiency in Operations. Is the distribution network as tight and efficient as it could be? Is the best, most cost-effective technology being used in the right ways and in the right places? Are all facilities located in the most optimum places for customer access and ease of delivery?

Flexibility in Space. Amazon is large enough to build different facilities for different purposes –one facility for sortable goods, another for non-sortable larger products, one for last-mile delivery, and so on. Most companies do not have this luxury, and instead require flexibility in their spaces.

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Companies that can right-size their facility to meet current needs, as well as future needs, are a step ahead in meeting the challenges of the Amazon Effect.

Navigating the Amazon Effect

There is no generic answer, no set playbook for how to counter the impact of Amazon’s efforts to satisfy an instant gratification culture. Each organization has to devise its own strategy based on its unique circumstances and challenges. There are, however, certain areas of the business that companies should assess, and common pitfalls they can avoid.

Don’t Panic. Many companies fall into the trap of reacting to the changing ecommerce landscape before sufficiently thinking through the ramifications of their actions. Kneejerk decisions are likely to fall flat, so it is imperative to plan well and make sure all the pieces are in place before upending the business model.

Don’t Procrastinate. The opposite mistake is to stand pat or to wait too long to act. Sometimes it’s the proverbial “analysis paralysis.” Change is a constant in the Technology Age, particularly in retail, so standing still means falling behind. It is critical to strike the right balance between a rash, misguided reflex and a failure to recognize that the ground underneath the business is shifting.

Know the Customer’s Perspective. The only way to meet customer expectations is to know what those expectations are. By survey, poll or some other form of research, getting the word straight from the customer’s mouth can help a company create a more insightful ecommerce strategy.

Determine brick-and-mortar needs. Will the ecommerce strategy result in the need for more space, less space or no change? Is the current facility flexible enough to accommodate a new ecommerce strategy, and in particular, the technology and personnel necessary to execute it?

Determine optimum locations. Large, sprawling facilities set apart from population centers tend to be less costly, with more conveniences (e.g., parking) and fewer hassles (e.g., traffic, crowds). However, with the growing emphasis on convenience, and next-day and same-day delivery becoming ubiquitous, locating nearer to a greater number of people may be the better approach.

“Many companies are being forced down the path of having a more localized model,” says Renshaw. “They need to look at creative ways to get a local presence in markets where customers are nearby to achieve the level of service that is now expected. Where before they may have offered three- to five-day delivery by ground, now if they’re competing with Amazon, they’re shortening their delivery time frame and often lowering their costs to consumers.”

This results in pressure for these companies to improve efficiencies and trim operational costs to avoid margin erosion, adds Renshaw.

Plan for tomorrow...and beyond. Given the rate of disruption that the Amazon Effect is triggering in retail and consumer goods companies, it would be a fool’s errand to address current competitive concerns without anticipating future challenges as well.

Amazon's approach to customer service and product delivery is well documented, so companies that can determine how their next innovation – whether that is delivery drones, unmanned vehicles, or something else – will have the best chance of successfully countering it.

"There are so many different ways this could go," says Renshaw. "We've been hearing for years that they're testing drones for delivery, and that could complicate matters significantly. It's hard to predict, but the goal is to figure out what the next brilliant and big idea is going to be. What's going to stand the industry on its ear?"

Ultimately, the one surefire strategy is to stay lean, keep costs down and continue improving customer service, says Renshaw. This is clearly the direction the ecommerce giants are heading. And why not? Regardless of the pressures they're under, companies that can achieve these three goals are better for it, Amazon Effect or not.

About Cresa

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