

Travel, Logistics & Infrastructure Practice

Unlocking the omnichannel opportunity in contract logistics

As e-commerce volumes surge, contract-logistics companies face increasing complexity. How can they capture more value in a \$600 billion opportunity?

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More of us are shopping by clicking. E-commerce sales have soared by 160 percent between 2014 and 2019, six to eight times the rate of growth in traditional retail. This global trend has only been accelerated by the pandemic—e-commerce rose from 13 to 17 percent of total retail within a year.¹ And the shift is likely permanent. Our COVID-19 retail- recovery survey finds that online penetration is expected to stay six to 13 percentage points above pre-COVID-19 levels.

This presents a huge opportunity for contract-logistics companies. Consumer goods and retail make up almost half of the logistics market,² and the rise of e-commerce has driven up demand for

omnichannel distribution, which depends on a single inventory-management system to fulfill orders from both traditional stores and e-commerce. We project that the total value of omnichannel distribution will continue to grow 7 percent every year, from \$600 billion in 2019 to \$840 billion by 2025.³ This means a strategic pivot toward e-commerce and omnichannel logistics will likely unlock higher growth for contract-logistics companies, which collectively account for a fifth of omnichannel logistics' total value in revenues today, while the rest is handled by in-house logistics of big brands, e-commerce giants, and tech start-ups (see sidebar, "Who's leading in omnichannel logistics?").

¹ Euromonitor International, accessed November 6, 2020.

² *GSCI contract logistics market report*, Transport Intelligence, 2019, ti-insight.com; *2019 annual report*, Deutsche Post DHL Group, March 10, 2020, dpdhl.com.

³ McKinsey analysis in which we sized the total value pool for omnichannel warehousing by applying warehousing cost shares from a representative set of benchmark companies to global revenues of consumer-packaged-goods and retail.

Who's leading in omnichannel logistics?

With increasing logistics complexity, omnichannel offers a large opportunity to capture a growing logistics value pool. Our models estimate that contract logistics currently captures just over 20 percent of the omnichannel fulfillment market within the consumer-goods and retail sector.¹ The rest of the space is dominated by three kinds of players: e-commerce giants, start-ups, or in-house logistics by brands.

In the United States, Amazon is estimated to account for 60 percent of the e-commerce

third-party logistics market—including the 86 percent of marketplace sellers on Amazon.com that use Fulfillment by Amazon.² With 430 warehouses worldwide and an additional 100 or so Amazon Prime Hubs near city centers,³ Amazon has created the necessary footprint to offer fast fulfillment for both itself and marketplace sellers. Several consumer-goods manufacturers and retailers are also operating insourced warehousing logistics. For their e-commerce businesses, these warehouses are

often co-developed with large automation players.⁴

Additionally, we see well-funded start-ups entering omnichannel logistics to operate e-commerce warehouses and offer fulfillment software with strong platform IT and predictive data. Crunchbase reports that ShipBob in the United States, for example, has received over \$130 million in funding, and similar start-ups are appearing in Europe.

¹ McKinsey analysis in which we sized the total value pool for omnichannel warehousing by applying warehousing cost shares from a representative set of benchmark companies to global revenues of consumer packaged goods and retail.

² "FBA usage among Amazon Marketplace sellers," Marketplace Pulse, February 21, 2021, marketplacepulse.com.

³ "Amazon global supply chain and fulfillment center network," MWPVL International, mwpvl.com.

⁴ McKinsey analysis based on press releases of automation players and brands in the past 12 months.

Since e-commerce fulfillments are significantly more complex, contract logistics can charge around 50 percent more than for traditional store fulfillment. Therefore, those companies that overcome the complexities stand to gain the most. As a result of smaller average order sizes, e-commerce fulfillments typically require more touchpoints than do traditional retail logistics. The packing process also often requires extra steps, such as gift wrapping or promotional inserts. The storage capacity required tends to increase to accommodate a long tail of products typical for e-commerce, and e-commerce goods are frequently stocked in decentralized locations to allow for faster last-mile delivery. Furthermore, omnichannel fulfillment involves more complex processes to efficiently handle the full gamut, from single-unit promotional e-commerce orders to large fill-in orders for stores. This drives up complexity, labor, and inventory costs, and many contract-logistics companies have found it difficult to move toward more agile and diffused operations in a cost-effective way while still catering to their traditional brick-and-mortar customers.

So, how can contract-logistics players address these challenges and carve out a larger slice of the omnichannel pie? Logistics companies that already operate at a certain scale and with the financial means can start by understanding their customers' needs, which have evolved alongside shifts in consumer behavior and the logistics landscape. In this article, we profile four emerging customer types—each with a specific set of logistical needs and requirements—and identify five levers for omnichannel-distribution success that companies can pull to increase their competitiveness while solving for some of the aforementioned complexities. The bar is high and rising, and players should act now to develop their strategy.

Four possible customer profiles

The specific logistics needs of customers will vary, depending on their size, industry, and existing

fulfillment competencies. The appeal of omnichannel distribution is an agility that serves retailers and manufacturers across the spectrum of needs. First, a single inventory lowers costs by eliminating inventory duplication in separate online and offline warehouse facilities. Second, stock is flexibly allocated between channels, decreasing planning complexity and write-offs. Finally, omnichannel logistics pools manpower and capacity to cope with the differences in demand peaks more efficiently. For instance, e-commerce tends to spike around Black Friday in November, while store orders are typically shipped out in October for the Christmas season.

We envision four customer types whose needs contract-logistics players should be able to meet:

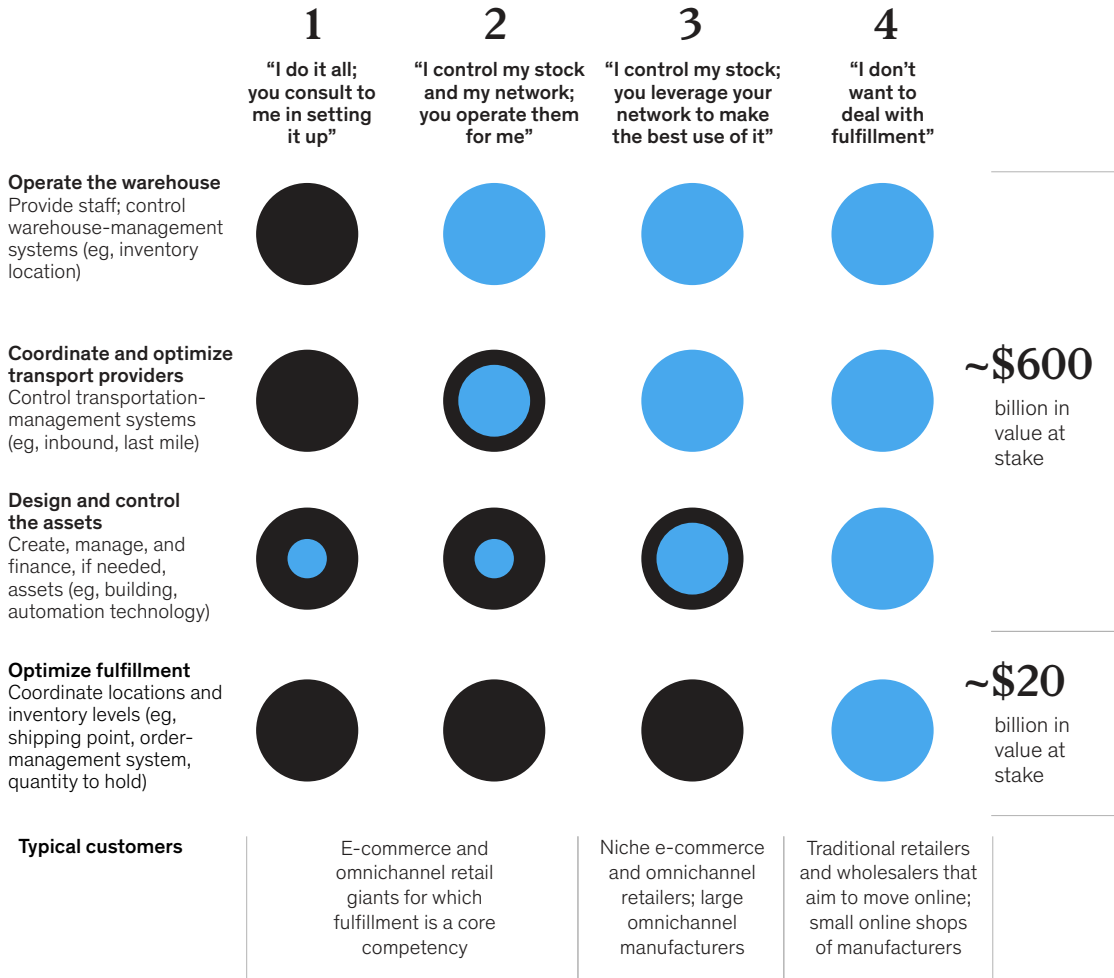
- ***“I do it all.”*** Logistics are insourced entirely by the customer. The logistics company—at maximum—consults in infrastructure development.
- ***“Operate for me.”*** The logistics company operates the warehouse, while the customer controls transportation, inventory levels, and warehouse and automation investments.
- ***“Make best use of my stock via your network.”*** The logistics company controls the fulfillment of all the stock the customer decides to place in the warehouse. It is responsible for warehouse management as well as inbound and outbound transport.
- ***“I don't want to deal with logistics.”*** The logistics company offers fulfillment as a solution, holistically optimizing inventory and fulfillment across locations.

The smaller and more traditional the customer, the easier it will be for contract-logistics companies to offer more, if not all, of the services in the value chain (exhibit). On the other hand, big e-commerce companies, such as Amazon, see fulfillment as one of their core competencies and will most likely continue to operate their own logistics. If contract-

Exhibit

Contract-logistics companies can offer most, if not all, of the services in the value chain to traditional customers moving their business online.

Share of logistics services needed for 4 customer profiles (illustrative) ● Customer ● Logistics player



Source: McKinsey analysis

logistics players want to capture a larger share of the opportunity, they should focus on tailoring their services to meet customers where their needs are, from consulting e-commerce giants on best practices to covering the entirety of a traditional retailer's logistics needs. As it is likely a futile effort to go against e-commerce juggernauts, logistics companies can opt to specialize in niche categories by developing specific technologies to service particular needs. Whatever the case, they will have to strengthen their value proposition by executing each stage of the omnichannel logistics value chain at a high level of efficiency.

Five levers for omnichannel logistics success

In theory, contract-logistics players should be well positioned to capitalize on the growth of omnichannel logistics to meet their customers' different needs. They benefit from specialist knowledge in order fulfillment and strong industrial-engineering teams. They're also better equipped to add scale. And, by deploying optimizing technology and leveraging their networks, they should be able to reap economies of scale and offer better price points than they would if individual merchants were to handle their logistics needs on their own. Yet many have been stumped by the complexities of omnichannel distribution.

By having a firm grip on the following five levers, contract-logistics companies should find themselves in a good position to devise omnichannel-service offerings that best cater to the needs of their customers—both e-commerce and traditional retailers—while having a positive effect on their top and bottom lines.

Warehouse automation

Many logistics players still operate predominantly manual warehouses, even though warehouse automation is essential to cost-efficiently meet increasingly exacting customer expectations around cutoff times. Automation is becoming even more critical, given e-commerce's wide range of SKUs and increased touchpoints. Automation technologies vary and have different cost trade-offs between space efficiency and labor requirements. Naturally, choosing the right technology will depend on the type of product the contract-logistics company is handling—its size, fragility, and storage needs all factor in. Contract-logistics players can consider partnering up with automation providers to develop customized blueprints to allow for flexible automation that can handle a variety of customer needs. Over time, companies will build the necessary experience to plan and tailor their automation technologies according to strategic business decisions on customer segments and locations.

Contracting for high capital expenditures with volatile volumes

It can be tricky for logistics companies to make significant automation investments while facing volatile flows in volume (for instance, the capacity demands for e-commerce in November are often twice or even triple those of nonpeak periods). Many automation investments have longer paybacks than the typical two- to three-year contracts that most customers sign. To meet customer demand, contract-logistics players could offer flexible contract structures that allow customers to adjust their storage capacity. To balance out their risk/return profile, contract-logistics players can consider operating multiuser warehouses for smaller customers, which can then switch to a dedicated warehouse when volumes reach a critical mass over time. Contract-logistics providers can also explore

other solutions, such as investment co-sharing with their customers, automation provider, or other investors; process standardization to reduce automation complexity; longer contract periods; or structuring their pricing to allow for a greater share of investment recovery in the initial years.

Multicustomer networks

Same-day or next-day deliveries can only work through distributed networks when the inventory is close to the end consumer. Such nodes are economically feasible only when there is enough volume, and smaller retailers will likely struggle to maintain such a network on their own, particularly in low-population-density regions like parts of North America or the Nordics. In such scenarios, multicustomer facilities can be a potential value proposition for contract-logistics players. However, logistics players may need to first invest in risky nodes without securing initial volume flows. They may also have to develop a flexible-footprint model where the size of the nodes can be adjusted as, and when, new customers join or leave the network. In a nutshell, contract-logistics companies might want to think of their warehouses as a “product offering” on the market. A strategic decision to create a competitive advantage in specific areas or geographies can guide investment priorities; decide whom you want to cater to and think of how to differentiate your product from your competitors'. This would represent a change in both risk profile and marketing—different from simply responding to requests for proposals.

IT integration and advanced data analytics

The challenge of IT integration grows as the number of warehouses and customers in the network becomes larger. At the most basic level, logistics players need to integrate three systems: the warehouse-management system; the transportation-management system; and the order-management system (OMS), which provides an interface for customers. Contract-logistics companies may either develop open APIs on their own platforms or actively integrate their services within external major enterprise-resource-planning (ERP) systems and e-commerce platforms, such as Shopify, Magento, and WooCommerce.

Having a modular approach for service offerings helps customers make decisions tailored to their specific needs. While larger customers tend to have a lot of order-routing logic in their own ERP systems and may want to plug in their own OMS, smaller customers often prefer the contract-logistics company's OMS to provide functionalities such as holding back orders or checking for the best fulfillment location. Logistics players may also consider offering data-analytics products such as inventory and demand analytics to help their customers predict consumer-behavior trends based on the volume flows across the logistics company's network.

Last-mile delivery

Seamless integration with last-mile and inbound transport facilitates high-speed deliveries and smooth inventory flows. The closer the warehouse is located to sortation centers for last-mile deliveries, the later orders can be placed for next-day deliveries. While it may be tempting for contract-logistic companies to partner with last-mile players to place warehouses directly next to sortation hubs and share sorter capacity, many customers prefer choosing their couriers, so it may be more prudent to leave them with multiple carrier options.

If a warehouse enjoys large enough volume flows, providing direct "zone skip" injections to the destination terminal can shave off distribution time. In some regions, such as India, hyperlocal delivery riders on motorized bikes and small vans can also be an important partner for fast delivery and forward-stocking locations. Additionally, logistics players can advise retailers on how to leverage their logistics networks for fulfillment (with options such as dark stores, micro-fulfillment, and so forth). When it comes to inbound logistics, contract-logistics companies can explore similar optimization options, such as integrating with deconsolidation facilities or breaking shipment containers at the warehouse.

Getting a handle on these five levers is a complex, iterative process that calls for contract-logistics players to collaborate and experiment with customers, investors, and technology providers—often hyperlocally—over a significant period. But the payoff is more than worth it. These levers are not only likely to help contract-logistics companies draw more value from the continued growth of omnichannel logistics but will also defend their market share in a crucial category.

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