McKinsey&Company

McKinsey on Marketing & Sales

Next day shipping wars: Can etailers compete with Amazon?

By Brian Gregg, Dianne Esber, Mirko Martich, Alexandra Sack

In the well-worn fable, the tortoise beats the hare. But in the e-commerce shipping world, speed is money and tortoises lose. This reality is evidenced by the rapid evolution of shipping offers and race to decrease order fulfillment time – from Target announcing it will launch buy online, pick up in-store to Urban Outfitters' announcement to build a new distribution center in eastern Pennsylvania to service online orders on the East Coast faster. Companies that can offer speedy delivery without breaking the bank will have a sharp competitive advantage. And there's every reason for companies to get this right.

Shipping issues represent almost half of the top 12 reasons consumers do not shop online. Chief complaints include not wanting to pay for delivery costs (29 percent) and needing the product the next day (26%)[1]. Despite the fact that 90 percent of companies' offer next day shipping, it typically costs four times the amount of standard shipping, which is often free.[2]

This means most consumers still do not see online shopping as a viable option for occasions when time is of the essence – e.g., buying the last minute party gift or the right shoes for this weekend's wedding. However, Amazon is poised to fill this void and once again revolutionize e-commerce by changing consumer expectations.

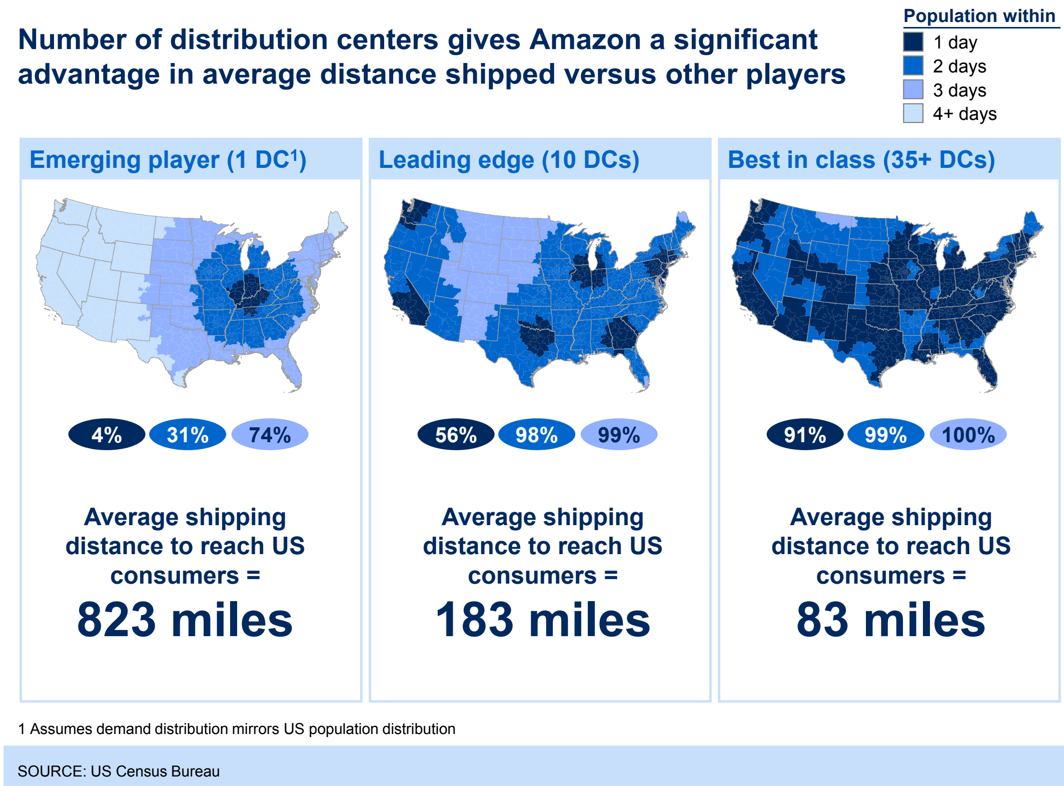
Fastest hare in cyberspace

Most etailers are unable to offer next day shipping at an attractive price. This is because the cost of shipping is largely dependent on the distance shipped, which is directly related to the number of distribution centers (DC) used to fulfill online orders. The more distribution centers, the lower average distance shipped to consumers. And most etailers are not large enough to operate more than a handful of DCs.

The numbers are striking. A retailer with one DC would have an average next day cost of about $27 per package. With 10 DCs, the cost decreases more than 60%, to roughly $10. And with 35 DCs, a number Amazon easily exceeds, the cost decreases to under $5.00.

1 comScore Retail Survey (Sept. 2010)
2 Competitive Benchmarking Database (Feb. 2013)

This is because with more than 35 separate DC/fulfillment locations, a large etailer like Amazon can reach 91% of consumers within one day via Ground shipping. In contrast, typical e-commerce companies with only two optimally placed fulfillment centers are within one-day reach of just 11% of the population via ground shipping, leaving them with only prohibitively expensive overnight air shipments to match service using their fulfillment centers.



And consumers have already started to vote with their "feet", or in this case with "clicks". Amazon is leading the industry when it comes to the number of customers using this service. Approximately 10% of orders filled by Amazon in 2012 were next day. This is 5 times the industry average of 2 percent[3]. We expect this will only increase as more consumers become aware, accustom, and even addicted to this service.

How can the tortoise keep pace?

So far Amazon is clobbering other retailers in the shipping race. Given the cost and scale required to support such infrastructure, building and operating 20-30 new fulfillment centers is not feasible. However, we do see a few ways retailers can keep pace with Amazon's shipping lead:

1. **Run with your stores.** For companies with a brick-and-mortar presence, fulfilling from stores might be a mid-term answer for processing time sensitive purchases. Today, 55 percent of retailers allow customers to buy online and pick-up in store. Most (83 percent) also let shoppers check in-store availability. However, sophisticated inventory tracking is crucial when offering this option and may be a barrier for some retailers.

3 comScore Online Shopping Customer experience report (May 2012)

2. **Segment shipping offers.** Retailers can use their data to be more targeted in what products they offer fast, cheap shipping and then use that data to deploy targeted products in stores. Aligning shipping offers to product profitability can help keep margins in-line, while still providing a sufficient speed / cost shipping equation.

3. **Offer shipping as a service.** Another option for some retailers may be to offer a Prime-like guarantee on speed and cost for a subset of products for an annual fee. Retailers such as Sephora, Bed, Bath, and Beyond, and Gap Inc. have already begun to experiment with these types of programs.

Admittedly, there are challenges with executing any of the above; however, Amazon is changing the rules—and speed--of how customers shop. Now, when the hare looks back, he can no longer see the tortoise. This leaves many retailers asking, “Where is the market headed and what will be considered ‘table stakes’ to run the course?”

You can find related insights on our McKinsey on Marketing & Sales site: http://mckinseyonmarketingandsales.com .
Please follow us on Twitter @McK_MktgSales