Warehousing: Charting the Way to a Winning Strategy

Strong headwinds are challenging how companies operate their warehouses. Successful navigation hinges on optimizing capacity, improving utilization, and boosting productivity.
An Economic Necessity

Warehouses play a significant role in the supply chain—from matching supply and demand, reducing inventories, and shortening the time required to order, fulfill, and deliver products to lowering service costs and improving customer service. Although warehouse demand took a hit during the Great Recession, the economy has rebounded. Now, with higher incomes, more spending, and an added push from strong manufacturing, wholesaling, and retail, the demand for warehouses is on the rise.

Warehousing revenue reached $710 billion at the end of 2016 and is expected to grow an average of 3 to 6 percent a year over the next five years, supported by a strong economy, growth in manufacturing, higher turnover of retail stock, and more outsourcing to third-party logistics (3PL) providers. Employment levels and the number of industry operators are also expected to grow.

Nor is the need for warehouse and distribution space expected to slow down any time soon. In fact, at the end of 2016, US vacancy hit a record low of 5.6 percent with major urban areas running low on options for class A warehouse space. The markets leading the way for occupancy growth are Atlanta, Chicago, Dallas, Philadelphia, and Southern California's Inland Empire. Mega-box and big-box spaces continue to be in high demand with logistics and distribution and retail companies (both e-commerce and traditional) accounting for 28 percent of all leasing activity in the fourth quarter of 2016 (see figure).

Figure

Warehouses seeing more demand from consumer industries

Leasing activity as a % of total volume (Q4, 2016)

<table>
<thead>
<tr>
<th>Industry</th>
<th>Leasing Activity</th>
</tr>
</thead>
<tbody>
<tr>
<td>Paper and packaging</td>
<td>3.9%</td>
</tr>
<tr>
<td>Healthcare</td>
<td>3.9%</td>
</tr>
<tr>
<td>Auto, auto parts, and tires</td>
<td>3.9%</td>
</tr>
<tr>
<td>Food and beverage</td>
<td>4.4%</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>5.2%</td>
</tr>
<tr>
<td>Third-party logistics</td>
<td>6.2%</td>
</tr>
<tr>
<td>Logistics and distribution</td>
<td>8.8%</td>
</tr>
<tr>
<td>E-commerce</td>
<td>8.9%</td>
</tr>
<tr>
<td>Construction</td>
<td>9.6%</td>
</tr>
<tr>
<td>Traditional retail</td>
<td>9.9%</td>
</tr>
<tr>
<td>Consumer durables</td>
<td>12.3%</td>
</tr>
</tbody>
</table>

Sources: JLL; A.T. Kearney analysis

1 “Logistics Markets Continue to Strengthen,” JLL, February 2017; Inland Empire is a 27,000-square-mile area that includes Riverside and San Bernardino counties and more than 50 cities, towns, and unincorporated areas.
Here we discuss the trends affecting the warehousing industry and the approaches companies are taking to navigate in this new landscape.

Consumers’ Demands Causing Shifts in Direction

Strong headwinds are challenging the ways companies operate their warehouses. Because warehouses make up a significant portion of a company’s assets, inadequate utilization and low productivity can have a big impact on the overall return on assets. With Wall Street pressuring companies to improve their returns, forward-thinking logistics managers know they need to keep their warehouses running at or near capacity. Seventy-five percent of logistics professionals reported that their inventory exceeded capacity during 2016; 70 percent of warehouse professionals on the other hand do not have a solution when there is more space than inventory.

Several economic mega trends are affecting capacity utilization:

Super-powered consumers

One of the biggest trends affecting most industries is the shift in power to one end of the value chain: consumers. This requires not only improving service levels, such as reducing lead times, but also offering more variety and customization. More people also prefer bundled and discounted consumer packaged goods.

Product proliferation

To address consumers’ demands for variety, companies are offering more products, resulting in a proliferation of stock-keeping units. Between 2011 and 2015, the total retail inventory-to-sales ratio increased 2.2 percent. In the fresh-food grocery industry, for example, growth in the organic food category has resulted in higher demand for variety, and demand for cold storage increased 4.2 percent CAGR since 2014, according to the Global Cold Chain Alliance.

Changes in global demand

Changes in consumer demands in one part of the world affect warehousing needs in other parts of the world. For example, according to the World Bank, GDP per capita and meat consumption per capita are correlated. So as disposable incomes rise in certain markets, consumers there will purchase more high-value food items such as meat, demand for which is expected to increase at 1.3 percent CAGR until 2025, and dairy, which is expected to see a rise in demand of 2.2 percent CAGR until 2025. As a result, buyers will need to be able to store more food items safely, increasing the demand for refrigerators. This also often leads to a boom for US agribusiness as companies can now safely ship higher-dollar products such as pork and apples to those markets, according to The Washington Post.

Omnichannel fulfillment coupled with seasonality

Demand has also increased in terms of the channels consumers use to place orders. Over the past decade, preference for the online channel has skyrocketed with 65 percent of online shoppers making purchases using multiple channels. Add seasonality into the mix, and demand patterns have become even more complex and variable.
Adjusting the Sails

These headwinds have created significant challenges. Companies trying to navigate this new environment have adopted a variety of approaches but with limited effectiveness.

**Forward-deployed networks**

To address consumers’ demands for faster delivery, some companies have shifted their inventory from large, single points of distribution to smaller hubs located closer to areas of greatest demand. However, based on our experience with a variety of companies, these forward-deployed networks often struggle to manage spikes in demand. Centralized networks are better suited to withstand changes in demand as variations across regions tend to even out.

**Omnichannel fulfillment from one distribution center**

Having pursued omnichannel strategies, some companies have been using one facility to serve a variety of customers. For example, a beauty products company we worked with was fulfilling orders for consumers, retailers, and big-box stores from the same warehouse. However, given the inherent variability in these diverse orders, the distribution center’s capacity was being underused by about 35 percent.

**Centralized networks are better suited to withstand changes in demand** as variations across regions tend to even out.

**Outsourcing**

Another common approach is to outsource warehousing to 3PL companies. Outsourcing has been on the rise, with 65 percent of companies that need warehousing outsourcing some of their services. In 2016, 73 percent of companies used some form of logistics outsourcing compared with 68 percent in 2015, which has resulted in significant growth in the 3PL market. However, this approach comes with its own challenges. Using warehousing service providers requires close oversight, and providers might not have the same incentives as the companies that outsource to them, leading to a decrease in productivity and an increase in inventory.

**Use of temporary space**

Some companies are storing goods in temporary space such as trailers. For example, one confectionery company’s distribution centers, which were not designed for long-term storage, were constantly at or over capacity, so temporary overflow locations were being used. This is an expensive and unsustainable approach. Overflow locations usually charge much higher rates than standard warehouses. In addition, overflow locations that are not close to distribution centers can result in high costs for transportation, which raises costs for the entire network operations.

Based on our experience, what's needed is an all-encompassing approach to improve warehouse productivity within a company's overall operations.
Charting a Way Forward

With more power in the hands of consumers, more omnichannel ordering, and global changes in demand patterns, the economic landscape has forced warehouse operators—both in-sourced and outsourced—to adopt unique approaches. Although these methods are valuable in the short term, a clear map is needed to successfully navigate this shifting landscape. Companies that engage in an all-encompassing strategy for warehousing operations will emerge as winners and satisfy shareholders’ requirements for returns.

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