Don’t Go It Alone: The Right 3PL Partner Makes a Difference in E-Commerce Distribution
Companies that couple brick-and-mortar stores with an e-commerce channel share a common dilemma with online-only retailers: In-house distribution can be extremely costly and inefficient for both.

While old distribution networks may have handled traditional logistics just fine, they are not designed to accommodate the complex and labor-intensive fulfillment of online orders. Online sales growth calls for expanding scale, too, which leads to costly capex investment that retailers may not want or are unable to make. The Wall Street Journal recently noted that nine of 15 major retailers (including Lululemon and Kohl’s) tracked over a two-year period saw margins decline while e-commerce grew as a percentage of overall sales. Retailers that made investments in their e-commerce supply chain saw declines of up to 25 percent in operating earnings as a percent of total sales.

Using a third-party logistics (3PL) provider is a logical and increasingly advantageous alternative. The global 3PL market is expected to grow 4.4 percent year-over-year, from $734 billion in 2014 to just over $1 trillion by 2022. There are opportunities and pitfalls for retailers to consider, however, on the way to choosing the right 3PL, from establishing the relationship to maintaining it for optimal performance and cost-effectiveness.

Here we evaluate each step in the process and outline five of the most important things that both traditional and newer online retailers should consider for beefing up their e-commerce distribution capabilities.

Don’t Throw the Brick at Your Network

Consumers’ online expectations are forcing retailers to evolve their distribution networks. The typical reaction is to use or retrofit what retailers have used for years, but that is a bit like trying to shop online with a rotary-dial phone. Old systems support truckload or less-than-truckload shipments into retail or wholesaler operations. Pallets contain case, layer, or full picks of typically homogeneous products that are shipped together. E-commerce orders, on the other hand, are direct-to-consumer small-parcel orders requiring extensive each-picking, order management, packaging, and personalization. Depending on what you sell, e-commerce orders can contain a range of product types, from heavy to fragile, which adds another challenge during picking and shipping the product in a single package so that everything arrives safely and damage free. Directing more labor or capex investment into a traditional operation may achieve these goals, but such moves are usually inefficient and cost-prohibitive in the end.

Scaling up requires automation, wave planning, and other expertise that most traditional retailers—and even newer online-only ones—lack. Weathering the ebb and flow of fluctuating sales can make purchasing pricey material-handling equipment (MHE) and other systems risky, as Amazon so famously found when it invested heavily in its own distribution model for years before seeing a profit.

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2 HRC Advisory, 2016, How E-Commerce Is Eroding Retail Earnings
Outsourcing e-commerce, on the other hand, gives retailers several advantages:

1. An optimized footprint by leveraging existing 3PL networks
2. Deep expertise in warehouse operations, MHE design, and systems integration
3. Economies of scale, reduced overall costs, and minimized capex investment

When it comes to labor, 3PL providers tend to achieve more cost-effective terms, including pay and benefits, than individual companies can. Managing a contract-bound 3PL can be easier than managing one’s own employees. Regarding scale, 3PL providers can spread the cost of building automated e-commerce facilities across clients if the facility is shared. Should a company want to have its own facility, it still may reach a point where 3PL management of that asset makes more sense due to the provider’s competitive labor rates.

Five Keys to the Perfect 3PL Match

Here are the five crucial areas for traditional and newer online retailers to focus on when outsourcing an e-commerce operation.

1. **Define and align service levels and their cost to meet the customer promise.** What does the customer care about across channels and order types and what will it cost the business? Fast delivery and free returns processing, including shipping costs, are two examples that top most customer expectation lists. While shoppers ordering from a big-box store may be fine with a 10-day lead time from the order to the warehouse to the store, online customers expect delivery within two days or even four hours in urban areas. Yet if it is a replenishment order online, they may relax their expectations for delivery, which lets the distribution center be more flexible.

Big-box store shoppers may be fine with a 10-day lead time but online urban customers want delivery within **two days or even four hours**.

Understand how seasonality and other forecasting patterns relate to the business as well. A 2015 survey of 200 retailers across the United States and the United Kingdom revealed that 34 percent of retailers identify fulfilling orders on time as their biggest challenge during the holidays. If holiday demand causes online orders to spike three to 10 times higher than normal, consider two choices based on your customers’ desires: double down to fulfill your promise during those periods or relax the delivery promise if customers are more lenient. It is important to guide the 3PL on actual requirements to avoid overbuilding or underbuilding the e-commerce solution for critical times of the year.

A $2 billion retailer we work with took this course of action when it hired a 3PL provider to handle e-commerce orders during peak demand. It outsourced a portion of its operation that

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*4 “Holiday Promotions Are Here As E-Retailers Aim To Hit Their Sales Targets,” 2017, Digital Commerce 360*
had been performing poorly. Its tight working space and picking process worked for the brick-and-mortar business but was inadequate for e-commerce. The 3PL not only handled peak demand well, but also bulky items that had not flowed easily through the existing warehouse. The retailer is now considering outsourcing all of its brick-and-mortar and e-commerce operations to the 3PL.

2. **Define your omnichannel strategy.** Consumers expect multiple delivery methods (such as same-day or next-day shipping) along with network channel integration (including click-and-collect and ship-to-store), all of which require a nimble and flexible supply chain. Define the road map and the impact that an omnichannel strategy will have on the broader supply chain. What will product type and mix, along with choice of channels, look like in the future? Will the business develop them organically or through acquisitions? What are you providing via e-commerce: many product types such as Amazon or a single category such as the Gap?

Next, determine the level of 3PL sourcing needed across the network—e-commerce, brick-and-mortar, and co-packaging. Does the business want to invest in logistics and warehousing or focus entirely on being a manufacturing and branding expert? A rapidly growing company will probably want to completely outsource to a 3PL. A smaller or slower growing company may decide to outsource selectively.

In evaluating its options for insourcing and outsourcing, a global wine and spirits company we work with recently decided that it was most efficient to consolidate a number of domestic functions, including co-packaging and several 3PL warehouse locations, under a single roof. It built a North American distribution center and outsourced to a 3PL to perform both customer-fulfillment shipping and marketing-driven co-packing, which allowed it to realize more efficiencies through truckload and multiproduct shipments to customers.

3. **Provide transparency into warehouse operations.** Retailers tend to focus on sources of supply and manufacturing, while 3PL warehouses remain an afterthought. Yet it is important to understand what the company is doing upstream that could impact effective management of a 3PL warehouse. These facilities are best viewed as an extension to the existing internal supply chain that will engage with procurement and analytics. In a 2014 chief supply chain officer survey, 65 percent of respondents reported that big data analytics is the most disruptive and important trend in supply chain strategy. The right level of visibility for decision-making becomes crucial, so select a partner with sophisticated B2B integration and reporting capabilities.

Beyond technical transparency, 3PL providers should be prepared to develop a comprehensive concept-of-services document. It could include operating parameters such as footprint, number of orders, and peak versus average order volume. End-to-end services to be performed—such as kitting and returns processing—along with the client’s responsibilities in enabling them, are more factors to define.

Aligning services such as these is an important step in finalizing the working relationship’s design and associated costs. Site visits can provide additional clarity, but perform these only with capable and cost-effective 3PL providers that you have selected after first rounds at the request-for-proposal stage.

4. **Develop a mutually beneficial contract.** Proper contracting is one of the best ways to ensure a fruitful 3PL partnership. A strong contract will hold the 3PL provider accountable for driving

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5 Genpact, 2015, Driving Supply Chain Excellence Through Data-To-Action Analytics
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continuous improvement. We have seen brick-and-mortar and online-only retailers treat these firms as transactional partners, with agreements based on volume and operational key performance indicators (KPIs). While both are valid, we recommend rewarding the provider for removing cost from the network and operating as efficiently as possible. If the 3PL does not deliver, it faces a financial penalty. This can be a delicate balance to strike and not something that retailers often consider, but it lays the groundwork for a successful relationship.

Here are a few more recommendations for effective contracts:

- **Duration.** The average 3PL contract ranges from three to five years. According to a recent Global Supply Chain Institute survey, 16 percent of companies reported having 3PL contracts of two years or less, 51 percent were written for three years, and 33 percent for four years or more.\(^6\) Contracts are driven by a variety of factors including size of investment, real estate solution, and the time period allowed for transition and ramp-up. Consider how these factors impact both parties and include a specific, equitable termination clause.

- **Pricing.** Two pricing structures prevail, depending on operational size and scale. A transactional structure bases price on throughput across fixed storage, handling and picking, co-packing cost per case, and any accessorial costs. In a pass-through structure, all costs are clearly specified and agreed to annually, budgets are set, and a portion of the management fee can be dependent on performance. We recommend a semi-variable contract that makes the 3PL provider whole on its fixed costs but puts its profit at risk if service or costs are not in line with the budget or KPIs.

- **Performance management.** Conduct frequent reviews that hold the 3PL provider and the company’s management team accountable for containing costs and operational performance. In an annual business review, the chief operating officer or vice president discusses long-term strategic plans, the annual renegotiation of rates, and service-level requirements (which may have shifted with major changes to the business model) with the 3PL. On a quarterly basis, directors review performance, financial aspects (if applicable), and partner satisfaction scorecards, among other things. Managers join directors and their 3PL counterparts for monthly reviews of performance trends and share updates on other factors, including business and customer feedback.

A global consumer packaged goods (CPG) company we advise and its 3PL e-commerce provider are an excellent example of the above approach. The CPG owns the facilities and land for its large distribution centers but recognizes it is not a warehousing expert. It monitors and manages the 3PL very closely, putting the provider’s profit margin at risk for underperformance while offering it an upside if it realizes operational improvements. The CPG uses the provider’s tier-one warehouse management solution to unlock all such opportunities. It also holds frequent touch-base meetings to review KPI dashboards.

5. **Lay the groundwork for a sustained strategic partnership.** Be clear about the level of strategic support and thought leadership you expect from your 3PL partner and in what areas you desire input, including systems, operations, or changes in footprint. Potential questions to ask your 3PL include:

- Is there new functionality in warehouse management solutions that would benefit our organization?

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\(^6\) University of Tennessee’s Haslam College of Business Supply Chain Management, 2016, *Selecting And Managing A Third Party Logistics Provider. Innovations In Supply Chain, Knoxville, TN*
To what extent should we adjust our operations to respond to any change in our order profile?

Does our current footprint still make sense, considering any changes in our outbound customer shipments? (Be sure that any recommendation your 3PL offers suits your footprint rather than theirs.)

Then, establish a joint process-improvement program and culture with equitable share to ensure that the 3PL provider helps your company realize maximum improvement in operations, service, and cost. Creating clear incentives, including performance bonuses, volume discounts, and cost-improvement sharing helps keep both parties on track. And forget clauses that allow termination for convenience. Instead, use a material breach or other agreed-to business condition, such as operational underperformance or financial bankruptcy, as the trigger.

Worth it Now and Down the Line

Traditional stores venturing online and new online-only retailers will find that 3PL providers are a point of strength in e-commerce distribution in the short and long term. Within a few months, a 3PL can turn around a struggling operation, performing more cost-effectively while meeting the retailer’s customer promise, the most vital link in the supply chain. The retailer may find a short-term increase in distribution cost is worth it if customers go from being regularly disappointed to consistently thrilled. Working with a 3PL is also one of the fastest ways to access deep experience in managing e-commerce across multiple businesses, along with tier-one WMS systems, which open up opportunities for making advanced warehouse improvements.

For the long term, 3PL providers lend a valuable outside perspective that can constructively challenge internal thinking. They see what has worked and what has not for other companies while also knowing where the overall industry is heading. For growing retailers, they can provide step-change opportunities, required capex, and gain-share where they have skin in the game. So whether you are a long-time retailer adding online to your channel mix, or an online-only company, pairing up with an e-commerce 3PL could be the best solution to some of the most important distribution challenges.

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