The mandate for multichannel retail

Evaluating supply chain models
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Executive summary

Retailing has entered a new age in which consumers are demanding and expecting all store owners to offer a multichannel shopping experience, delivered seamlessly across mobile, online, and in-store merchandising platforms. Virtually all of the growth in retail sales over the next few years will come from multichannel venues, driven primarily by the impact of digitization — the changes in people’s lives as smartphones, tablets, and high-bandwidth connections become prevalent.

Retailers can choose among six different supply chain models to operationally support seamless multichannel shopping experiences. In making this choice, each retailer will have to decide between independent and shared supply chains, and whether to build them internally or through outsourcing. These choices will depend on the retailer’s overall value creation proposition. Each retailer has a distinctive “way to play” that combines a business model, customer expectations, and distinctive capabilities to set a strategy for driving growth, profitability, and long-term success.
The multichannel consumer

There’s no denying anymore that an increasing number of shoppers are demanding far richer retail environments than ever before, anchored by multiple digital channels for browsing, evaluating, comparing, and purchasing products. The prevalence of smartphones, tablets, and “always-on” broadband connections is transforming consumer behavior. Faced with the impact of this digitization, virtually every retailer — no matter how strong its physical stores are or, indeed, whether it has any physical stores at all — must now respond to this sizable and restless digital consumer base. It must offer a seamless mobile and online strategy that integrates the shopping experience across portals, apps, and retail channels.

The statistics highlight the importance for retailers of fulfilling these consumer expectations: Although overall retail sales are stagnant, online sales are expected to increase at a compound annual growth rate of about 10 percent in the next five years (see Exhibit 1, next page); some categories — food and beverage, jewelry, and health and beauty, among others — will likely expand by as much as 15 percent year-over-year online. Moreover, cross-channel annual spending levels of multichannel shoppers are often double those of retail-only customers. All of this means that retailers that fail to put in place effective multichannel operations will lose out on 15 to 30 percent of their category sales by 2015, and much more in the following years.

Retailers that offer a more robust and integrated shopping experience will primarily capture these double-digit online gains. According to a 2010 Strategy& survey, 68 percent of Web users like to do side-by-side (and site-by-site) product comparisons on the Internet before making purchases, and 49 percent feel that it is important to be able to order online and pick up the items in a store. These features just hint at what consumers increasingly expect from retailers through multiple channels, a wish list that includes access to a wide swath of products online and the option to review in-store inventory via the Web (see Exhibit 2, next page).

Not surprisingly, considering how innovative and entrepreneurial the Internet channel is, the winners of the online retail wars, now and in the future, will be the most creative companies that can deftly provide a shopping experience compatible with the expanding expectations of
Exhibit 1
Across retail categories, online growth is shifting sales online

U.S. online share of overall retail sales
2010–2015 forecast

Key takeaways
- While overall retail sales are stagnant, online sales will grow at a CAGR of 10%
- Some categories like food and beverages, jewelry, and health and beauty are growing about 15% year-over-year online
- Multichannel customers have significantly higher lifetime values than bricks-and-mortar or online-only customers
- In addition to online sales, digital channels influence an even larger percentage of retail sales (for example, through online research, mobile couponing, or location-based offers)
- Retailers that fail to put in place effective multichannel capabilities will lose out on 15% to 30% of revenue in their category by 2015, and struggle to compete effectively for digitally influenced revenues in retail

Source: Forrester Research; Morgan Stanley; Strategy& analysis

Exhibit 2
What customers want from multichannel retailers

Virtuous cycle of customer experience
Stages and potential breakdowns

How the customer experience can founder
1. Store shoppers don’t have access to reviews and ratings; sales reps don’t use product information that can be found online
2. Store does not offer online long tail of assortment
3. No option to review in-store inventory online
4. Item out of stock in store can’t be ordered for home delivery from store
5. Inconsistent online and offline pricing
6. Channel-specific promotions can cause buyer’s remorse if discovered only after a purchase
7. No option to reserve and pick up in store and order from store for home delivery
8. Online returns cannot be returned to store or can only be returned to store

Source: Strategy&
consumers. But it is virtually impossible to deliver this desirable shopping experience without first implementing an optimal multichannel supply chain — one that is efficient and scalable — designed to best support the company’s overall channel strategy and the distinctive characteristics of its customer requirements and economic trade-offs.

Creating a multichannel supply chain is a complex task due to the starkly different objectives and priorities of traditional and online retail supply chains. For example, in the physical retail environment, supply chains are designed to efficiently keep the products that consumers want most on store shelves, with rapid replenishment from regional distribution centers. For online channels, customer value is driven by the ability to offer a much wider assortment, and even customized products that the retailer ships from a central warehouse or supplier inventory.

Or consider the difference in logistics costs: For retailers, transportation costs are kept relatively low by moving pallets and truckloads of products through a network of regional distribution centers. But in the online channels, logistics costs are substantial, as most products are shipped directly to people’s homes or offices individually or in small groups by parcel carriers (see Exhibit 3).

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**Exhibit 3**

*A comparison of operating models in the traditional retail and online retail environments*

<table>
<thead>
<tr>
<th>Supply chain</th>
<th>Traditional retail</th>
<th>Online retail</th>
</tr>
</thead>
<tbody>
<tr>
<td>Procurement</td>
<td>• Retailer’s job is assortment selection to fill limited shelf space, cut long tail</td>
<td>• Long-tail or virtually unlimited assortment is a key value proposition of online retail</td>
</tr>
<tr>
<td></td>
<td>• Items are procured and negotiated in bulk and will get sold through the channel</td>
<td>• Slow-moving (long tail) items may be procured in very small quantities</td>
</tr>
<tr>
<td>Inventory management</td>
<td>• Inventory exists at up to three levels: distribution center, regional distribution center, and store</td>
<td>• Inventory only exists at one level: distribution center</td>
</tr>
<tr>
<td></td>
<td>• Inventory value is mostly driven by stock levels of SKUs</td>
<td>• Inventory value is mostly driven by scale of assortment</td>
</tr>
<tr>
<td>Warehouse operations</td>
<td>• Lower number of orders, stable throughput</td>
<td>• High number of orders, high throughput growth</td>
</tr>
<tr>
<td></td>
<td>• Limited need for small order size pick/packing</td>
<td>• Significant need for small order size pick/packing</td>
</tr>
<tr>
<td></td>
<td>• Forklift and pallets to trucks</td>
<td>• High degree of manual labor or smart automation (e.g., Kiva)</td>
</tr>
<tr>
<td>Transport &amp; logistics</td>
<td>• Often company-owned fleet that delivers between distribution centers and to stores</td>
<td>• Freight carrier picks up large number of shipments from distribution center</td>
</tr>
<tr>
<td></td>
<td>• Logistics costs per item are low</td>
<td>• Logistics costs per item are high</td>
</tr>
<tr>
<td>Post-sale support</td>
<td>• Return to store can create reverse logistics complexity</td>
<td>• Return by mail (or store for some multichannel players) returns item faster to sellable inventory</td>
</tr>
<tr>
<td></td>
<td>• Return to store creates additional touch point to retain and up-sell</td>
<td>• Often extensive service levels and generous policies</td>
</tr>
</tbody>
</table>

*Source: Strategy&
There are six different supply chain models that retailers can deploy to maximize returns from their multichannel operations. Each of them requires its own capabilities. Depending on a company’s existing strengths, some of them are more difficult to implement than others, but each of these models focuses on different core aspects of supply chain management and on generating distinctive results (see Exhibit 4).

### Exhibit 4
Supply chain strategies for online and multichannel retailers

<table>
<thead>
<tr>
<th>Setup</th>
<th>Scope</th>
<th>Pros</th>
<th>Cons</th>
</tr>
</thead>
<tbody>
<tr>
<td>In-house</td>
<td>Online only</td>
<td>1 Maintains complete control</td>
<td>Large scale required to offset high fixed costs</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Enables operations-based competitive advantage</td>
<td>Long learning curve before advantages may be realized</td>
</tr>
<tr>
<td>Outsourced</td>
<td>Multichannel</td>
<td>2 Keeps investments low and offers service-level options</td>
<td>Typically cannot scale for hypergrowth</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Eliminates distraction from other areas of business</td>
<td>Solutions limited to established categories</td>
</tr>
<tr>
<td></td>
<td></td>
<td>3 Creates potential synergies such as reduced overhead, though difficult to fully realize</td>
<td>Infrastructure and processes typically poorly matched to e-commerce</td>
</tr>
<tr>
<td></td>
<td></td>
<td>4 Maintains complete control</td>
<td>Potential synergies and existing expertise often overstated</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Enables operations-based competitive advantage</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>5 Leverages preexisting relationship with vendor</td>
<td>Cost plus third-party logistics pricing model passes inefficiencies back to retailer</td>
</tr>
<tr>
<td></td>
<td></td>
<td>6 Keeps investments low and offers service-level options</td>
<td>Challenging to create multichannel experience</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Eliminates distraction from other areas of business</td>
<td></td>
</tr>
</tbody>
</table>

Source: Strategy&
Model 1: Online-only/in-house supply chain

Amazon.com is the best-known proponent of this approach, which relies on extensive product sales forecasting and inventory management systems to fulfill orders quickly at a high rate of accuracy while optimizing shipping times to customers. Indeed, because of its aggressively innovative, internally developed e-commerce supply chain, Amazon can offer a vibrant and attractive customer experience that includes recommendation tools, a variety of shipping options, and excellent post-sale communications through its website. Managing supply chain and logistics in-house makes sense for Amazon, which uses these operations to build, leverage, and differentiate itself through scale and customer service. Moreover, maintaining internal control of the supply chain also allows Amazon to collect vast quantities of data, which can in turn be mined to improve all aspects of the supply chain and the website.

Other prominent pure e-tailers have also chosen an in-house supply chain management model that facilitates high-touch customer service. Shoe seller Zappos designed a proprietary supply chain that could provide a best-in-class returns policy and quickly place returned items back into inventory. Zappos based this approach on the notion that shoes are anything but an impulse buy; customers want to try them on and see how they feel and look before buying them. By offering free, fast, and convenient returns — customers send back as many as 35 percent of the shoes — Zappos made the at-home trial period uncomplicated and overcame consumer resistance to making shoe purchases online. As a result, rather than competing on price, Zappos provides great service, enabled through its supply chain — its differentiating advantage. And because Zappos has such high volume concentrated in a single product category, by managing distribution in-house the e-tailer can develop and control specialized infrastructure for this product line and command good transportation rates.

Quidsi, which owns Diapers.com, Soap.com, and other personal goods sites, has among the most sophisticated in-house supply chains of all e-tailers. For Quidsi, as for Zappos, in-house supply chain management is economical because large volumes of very similar products warrant and support investments in highly specialized infrastructure and processes. To reduce warehousing costs, an inventory management system determines the minimum amount of product that needs to be on hand in the company’s three regional distribution centers by assessing customer life cycle and order frequency trends, which are highly predictable for Quidsi’s products. To minimize shipping expenses and waste, proprietary packaging algorithms select the optimal box size for each order. While shopping, consumers are offered additional items that, if purchased, could help optimize logistics costs. Productivity is
improved by intelligent pod-enabled picking systems that find shelved items quickly and efficiently.

The combination of these supply chain innovations enables Quidsi to offer same-day fulfillment, free two-day shipping at a modest threshold, and a 365-day return policy, while maintaining competitive pricing — critical requirements for success in the consumer goods category. Not surprisingly, Amazon acquired Zappos in 2009 and Quidsi a year later in part for their efficient, innovative, and scalable in-house operating systems. In March 2012, Amazon announced the acquisition of distribution center pioneer Kiva Systems, which specializes in building warehousing systems for online and multichannel retailers. This acquisition will help Amazon substantially improve its own fulfillment capabilities; in the process, Amazon will be able to better control its fulfillment costs as a percentage of revenue and also quickly build highly effective distribution centers in many additional locations. (To avoid having to charge sales tax, Amazon has not established a physical presence in many states, a situation that will likely change soon as state legislatures exempt online retailers from this requirement.)

**Model 2: Online-only/outsourced supply chain**

By turning over supply chain management to a third-party logistics firm, young online companies with rapidly growing but still subscale operations can focus their limited management bandwidth and capital on their most distinctive and important capabilities. This model has been adopted prominently by Gilt Groupe.

An online retailer of luxury clothing and other high-end items, Gilt’s greatest value and skill sets are in merchandising, an activity that depends on strong marketing and promotion of Gilt’s site as well as providing a compelling product line. In addition, procurement is considered a differentiating capability at the e-tailer, which scours suppliers for high-end products that it can offer at low prices in online “warehouse” sales. With this approach, Gilt has expanded into other luxury areas such as gourmet food and travel.

Given these priorities, Gilt views its less distinctive fulfillment capabilities as a pure support function that is better outsourced, while the company works on building better relationships with suppliers and on fostering a sense of exclusivity among its customers through an attractive website with a wide assortment of products. Moreover, viewed purely from an economic standpoint, the investments required for in-house distribution operations are difficult to justify when, as is the case with Gilt, products sold vary widely in geographic origin, available quantity, size, and weight. As Gilt’s sales profile shifts with
changing market opportunities, outsourcing provides the flexibility to scale distribution operations up (or down) rapidly in response to requirements.

For bulky or perishable products, such as furniture and food, Gilt goes beyond outsourcing supply chain operations while owning the inventory. Instead, the e-tailer utilizes drop shipping, in which the products are sent out by the manufacturers from their own warehouses. In so doing, Gilt never physically touches or owns unsold inventory in these product categories and reduces the number of stops that items make between manufacturer and consumer.

**Model 3: Multichannel/shared in-house supply chain**

Because traditional and online retail make different demands on their supply chains, combined fulfillment and distribution operations serving both channels are generally not optimal for either. But there are cases when a shared, in-house supply chain is, in fact, the best and only option — for example, when online orders account for a very small share of sales.

That was the situation at one large supermarket chain, which set up a system in which online orders are routed to one of a select set of stores based on customers’ locations. At these sites, inventory for online and retail purchases is shared. Employees filling online orders pick from the same shelves as retail customers, and the supermarket’s trucks deliver orders to consumer homes. Across the small number of online orders from each geographic location, demand for specific SKUs is highly variable. So the supermarket includes online purchases in the sales reports that are used for determining in-store inventory to make sure that the shelves are stocked with sufficient items for both online and physical store orders.

Building a dedicated distribution network for its minimal online business would have been an expensive undertaking for the supermarket with very little return. Because many grocery products are perishable and are expected to be delivered relatively quickly, the supermarket would have had to set up a large network of fulfillment points as close as possible to customers just for online sales, and it would have had to maintain separate inventory for this channel; both are costly ventures.

The adaptations required to pick online orders from stores designed for customers’ use are minimal. Customers’ baskets — the number and value of items they buy — are substantially the same online and in-store. Despite charging a fee for delivering orders under a minimum
value, the supermarket still is willing to swallow a net loss on online fulfillment. (This loss is the rule, not the exception, for physical supermarkets with online businesses.) Were its online business to grow larger, the company might attempt greater scale economies in picking. Were it to grow much larger, these economies would require dedicated facilities. For the online business’s current stage of development — where the density of online orders from any one geography is low — a shared model is cost-effective and not disruptive to the store’s primary business.

**Model 4: Multichannel/dedicated in-house supply chain**

With this approach, the supply chains that serve the online and physical parts of the business are maintained separately to meet the distinct operational requirements of each channel. Separate networks and inventories involve incremental costs, so the results must be weighed carefully to determine whether the benefits are worth these costs. One luxury apparel retailer tried this strategy by establishing two distinct distribution centers in the same region of the United States. The results were not quite what a discount e-tailer would like, but they were satisfactory in comparison to those of competitors in the high-end/luxury category: Order processing took about 48 hours, and the free shipping threshold was upward of $200. Although these numbers are not best in class when it comes to fulfillment efficiency and pricing, they were more than offset by the benefits gained by customizing the supply chain to each channel’s unique operational needs. The two dedicated supply chains ensured that luxury service-level requirements were met in the stores, where stockouts of such high-margin products are very costly, while the e-commerce sites had the wide and varied assortment of products that customers have come to expect from e-tailers for goods at any price.

Separate, dedicated supply chains are preferable when a capability like customer service is more important for some channels than others. However, this approach makes economic sense only if both the physical and online sides of the business are sizable enough to operate at an efficient scale and if the savings from combining the channels would not be significant.

**Model 5: Multichannel/shared outsourced supply chain**

Dell tried this model and learned that it should be adopted only if the retail and online sides of the business share many of the same characteristics relating to meeting customer needs and logistics requirements. In Dell’s case, the demands of its online and store-based sales components couldn’t have been much more different.
Dell made its name and fortune on selling custom-built computers directly to consumers over the Internet. At first with an in-house supply chain and later relying on third-party manufacturing and operations, Dell had become extremely adept at customizing individual products for consumers and shipping them efficiently and rapidly to people’s homes and offices. Using this model, the computer maker was very profitable and earned a well-deserved reputation for being one of the most innovative e-commerce companies in the world. Its online supply chain was especially admired for its demand shaping capabilities, its ability to manage complexity, and its excellent working capital metrics. But by 2007, competition and price wars in the PC industry had intensified and margins had tightened. Dell was compelled to widen its distribution model by selling its computers through retail channels. In making that decision, Dell also made another difficult choice: to use the existing direct-to-consumer supply chain to produce and ship products for retailers.

That turned out to be problematic. For one thing, Dell made most of its computers in Asia, delivering them directly to consumers around the world by plane and burying the shipping costs in the price of the machine. Dell’s supply chain was optimized for flexibility in manufacturing, inventory, and transportation, as the custom model required, but did not have the demand forecasting capabilities that would allow the company to build in the extra time needed for the more economical ocean shipping required by retail’s razor-thin profit margins for PCs. Moreover, when Dell tried to rejigger its supply chain to satisfy high-volume retail orders, production in the direct-to-consumer side of the business slowed considerably and customers were forced to endure delays before their computers arrived. More recently, the company has made significant efforts to increase the efficiency of its retail-facing supply chain operations by expanding ocean shipping and improving product planning and forecasting. These moves toward dedicated supply chains for each channel illustrate that a shared multichannel supply chain capability is suitable when business requirements are similar across channels but not when they differ dramatically, as they do in Dell’s case.

**Model 6: Multichannel/dedicated outsourced supply chain**

Companies that are adept at traditional retail supply chains may not have the innate capabilities already in place to put together a successful e-commerce supply chain. The differences between the two channels are quite stark; in particular, the online component requires the rigid order processing, picking, and parcel shipping accuracy aligned with first-class customer service, while physical stores require strong inventory management, consumer demand forecasting, and order planning capabilities to keep costs low while ensuring that products are available on shelves when customers want to buy them. For these reasons, having separate supply chains for each channel — in-house for the stores and
outsourced for the new e-commerce function — can make sense, particularly if the company is unfamiliar with the nuances of online retailing and dares not risk compromising a well-functioning retail supply chain with the additional complexity of fulfilling the online channel through it.

Walmart, the undisputed supply chain king in the retail sector, came to this conclusion, and has benefited greatly from it. While still using its massive clout as a purchaser to drive advantageous procurement programs throughout the organization — both in the retail channel and online — Walmart chose to outsource much of the inventory management and logistics aspect of its e-commerce business. When implementing this choice, the company emphasized that it wanted a fulfillment and distribution partner that could keep costs low while meeting the service requirements — prompt fulfillment, expedited shipping options, and package tracking — that customers have come to expect of online retail. Ultimately, Walmart found a third-party provider that has a wide warehousing and distribution footprint. The provider has been able to work with the retailer to set up programs that offer customers convenient options such as being able to pick up or return items ordered online at Walmart stores. Walmart’s case illustrates that third-party fulfillment firms can offer both the advantages of outsourcing — such as flexible capacity for use during the busy holiday season — and many of the services associated with managing distribution in-house. Although Walmart’s distribution capabilities are world-renowned and Walmart.com attained the scale to justify in-house distribution quite quickly, it has little reason to rush to bring distribution in-house.

Frequently, companies choose one of these six models by default or without careful consideration of whether the approach they pick will fit well with their current supply chain setup or the particular types of customers they are serving — often without knowing whether it will benefit their companies or not. That’s a shortsighted approach that can cost a retailer market share and, for the largest companies, billions of dollars in lost profits. Although there isn’t a single right multichannel approach for all retailers, there is a correct one for each retailer depending on its business model, value proposition with consumers, and existing set of operational capabilities.
Picking the right multichannel approach

For many retailers, the decision about which multichannel strategy to choose can be difficult, because they lack a clear set of rules to follow to determine the best path forward. To mitigate this hardship, Strategy& has created a diagnostic program that can identify the capability gaps that retailers need to address in order to succeed in multichannel environments with the most effective supply chain strategy.

The diagnostic begins with a soft launch during which executives and others in the company are interviewed in an effort to (a) understand corporate strategy and the company’s desired customer value proposition, (b) design a working plan for the operational requirements needed to deliver that customer experience, and (c) launch data gathering for the diagnostic and market analysis.

After this step, the first phase is devoted to a capabilities assessment and market-back analysis in order to evaluate the following:

- Current capabilities
- Structural options and economics
- Customer segments
- Key processes, systems, and customer experience break points
- Competitive landscape
- Service levels
- Capability gaps
- Size of multichannel opportunities

Phase two of the diagnostic is devoted to developing recommendations, as follows:

- Operations vision and strategic priorities are defined.
- A long list of opportunities and differentiating capabilities is created.
- Priorities are set for which capabilities need to be addressed first, based on ease of implementation and potential impact.
- Priority items are translated into recommendations for strategic initiatives that deliver the operations vision.
- A business case is developed for the strategic initiatives.
- A draft road map for multichannel supply chain strategy is produced that includes implications for capabilities, organizational structure, decision rights, systems, processes, and investments.

Phase three of the diagnostic is reserved for finalizing the multichannel supply chain road map. This stage includes the following:

- Iterating the road map and incorporating stakeholder feedback
- Finalizing the case for change with an emphasis on the business case
- Outlining key success factors and implementation risks
- Drafting the governance structure and high-level implementation plan to execute initiatives
- Writing and presenting the final report

This diagnostic and strategic development program is a targeted and stepwise approach that can provide a unique perspective on the direction a retailer needs to take to succeed in the multichannel environment. More than anything, it provides a road map for quickly identifying the capability gaps that must be closed and the operational strategies that should be embraced.
As the multichannel landscape continues to evolve and as online revenue becomes an increasingly large share of a retailer's revenue stream, retailers will have to not only choose and execute their supply chain strategies well but also respond to new trends and economic conditions. In our view, over the next few years, three critical trends will play essential roles in determining the contours of multichannel supply chains:

**Shorter delivery times:** Led by Amazon and its remarkably efficient overnight and two-day shipping programs, online customers are expecting quicker processing and faster deliveries. Even luxury retailers, which traditionally haven’t had to meet these rapid-fire standards, are not going to be able to ignore the need for speed in Internet retailing while offering this service virtually for free. To remain competitive, retailers will have to implement forecasting systems that provide a high level of accuracy to minimize stockouts and keep inventory at a reasonable level and simultaneously embrace innovation in picking, packing, and shipping so that packages can rapidly depart an increasingly dense network of distribution centers, which must be appropriately located near major cities.

**Greater emphasis on drop shipping:** Retailers have generally used drop shipping to provide products that were out of their traditional orbit (that is, bulky or requiring refrigeration). But as retailers widen their sales channels and, in the process, increasingly turn to third-party logistics providers to handle fulfillment, drop shipping will become more popular because it achieves three valuable results: It expands product assortment virtually instantaneously, allowing retailers to reach longer- and longer-tail customers without increasing inventory carrying costs; it transfers errors and omissions risk to the third-party logistics firm, which is especially beneficial with expensive and perishable inventory; and it reduces inventory holding cost and obsolescence risk for the retailer. To successfully execute a drop shipping program, retailers will need sophisticated vendor management systems that help ensure strong oversight of suppliers and logistics firms and a consistent customer experience across all brands and product lines. In addition, well-
functioning electronic links between retailers and suppliers for sharing sales and financial forecasts are necessary to decrease stockouts and failures in order processing and shipping. The trend toward drop shipping makes aspects of their supply chain operations easier for retailers, while it gives product manufacturers an opportunity to differentiate themselves as first-rate shipping and logistics partners for retail/e-tail outfits.

**Hyper-local distribution centers:** Shipping time is one of the biggest challenges for e-commerce companies. Consumers want instant gratification, or as instant as possible. And the thought of waiting even three days for a delivery can turn a would-be customer into a no-show — as does the thought of having to pay for two-day shipping. While Amazon and others have perfected free two-day shipments, same-day delivery is the next frontier in online fulfillment and will create a huge competitive advantage for retailers that can meet that promise before others. To do this, hyper-local distribution centers are a possible answer. But these are extremely difficult and expensive to establish. Hard questions must be addressed: How can distribution centers be located close enough to the lion's share of customers to effectuate same-day delivery? Is demand forecasting sophisticated enough to enable a company to have on hand locally the products that customers want, while not creating excessive inventory carrying cost across the supply chain? Can the higher costs of operating a hyper-local distribution center be passed on to customers? And can the order deadline be flexible enough to attract consumers?

Most of these questions and the constraints are more relevant to pure-play online retailers, which have no inherent local presence in consumer communities. In contrast, multichannel retailers are in a more advantageous position; they can use their retail outlets and the logistics infrastructure that feeds these physical stores to serve as local distribution centers. By building neighborhood fulfillment capabilities within existing stores, which includes investing in sophisticated inventory management systems to make sure that stores have sufficient amounts of popular products in stock, multichannel retailers can offer same-day in-store or at-home delivery of products purchased on the Web or on the growing number of mobile channels.

As described in our Model 3 (shared in-house operations), retailers can effectively turn each of their stores into a local distribution center capable of fulfilling e-commerce orders. To facilitate this highly distinctive capability, systems need to be designed to improve inventory accuracy and create product transparency and visibility throughout the supply chain and all retail outlets so items can be moved quickly to where they are most needed. In addition, staff training and incentives encouraging employees to fulfill online orders during in-store downtime
are important. There are a number of tangible gains from this model, including improved margins as better inventory control ensures that less online or in-store merchandise has to be sold on sale. And equally important, the retailer can resell long-tail SKUs returned to stores without the expense of sending these items back to the main distribution center.

Amazon has begun to experiment with its own answer to hyper-local delivery. The e-tailer is putting lockers in some 7-Eleven stores in Seattle and London and Rite Aid pharmacies in New York at which customers can pick up their Amazon orders using a barcode and PIN sent to their smartphones. For people in urban areas, these distribution outlets, generally open late if not 24/7, are a convenient way to get the products they purchased quickly (perhaps even the same day ordered), especially if they are not at home during the day to receive the items from UPS or FedEx. This pilot program illustrates that with innovations surrounding hyper-local distribution, the most scaled online-only retailers may even be able to compete against physical retailers in offering almost immediate gratification for consumers over the last mile without the expense of opening actual stores. The precise financial arrangement that Amazon is setting up with 7-Eleven and Rite Aid outlets has not been disclosed. But since the stores will get additional foot traffic and, hence, possible incremental sales from the presence of the lockers, Amazon will likely be able to persuade retailers to join this program without paying them much or even anything. Once rolled out, it is possible that Amazon will provide this service for a fee to other e-tailers as an enhancement of its business-to-business e-fulfillment offerings, and its acquisition of Kiva Systems could be a smart pathway for scaling up regional operations to service retail locker deliveries.
For multichannel retailers, these models and trends pose important questions that require insightful analysis of the business and its customers.

On the consumer front, companies must understand their customers’ expectations of service levels, channel and shopping dimensions, product offerings, pricing, and convenience, and also anticipate changes in customer behavior. These assessments of consumer attitudes and preferences — and assessments of how they may change — must be weighed against the supply chain and operational requirements and costs to implement a multichannel inventory, logistics, and delivery network.

On the strategic front, companies must understand well the competitive landscape and its dynamics and then chart a course to outrun the competition by creating a better customer experience and a differentiated online or physical retail environment. Armed with this plan, companies can then pinpoint the supply chain and operational capabilities they need to succeed.

To build a good multichannel supply chain, companies must determine which supply chain capabilities are most critical to their customer value proposition for each channel and optimize their supply chains for these capabilities, within cost constraints. Whether the optimal supply chain is in-house or outsourced depends primarily on the company’s scale, existing capabilities, and operations strategy.
Conclusion

Clearly, multichannel retailing is a business model that cannot be ignored by established or new retailers. Indeed, it is the growth area for all of retail. Customers already expect multiple ordering and delivery options. As digitization becomes more ubiquitous in the lives of consumers — as their smartphones and tablets integrate further into their day-to-day existence, offering ways for people to purchase items wherever they are and whenever they like — it will become critical for all retailers to develop winning multichannel business models enabled by sound multichannel supply chain capabilities.

There is no universally right or wrong approach to establishing a multichannel supply chain. Whether dedicated or shared, internal or outsourced, the appropriate supply chain depends on a company’s customers’ expectations, its cost trade-offs, and its existing capabilities. After these three issues are considered — along with how future trends will impact them — a retailer can make a clear-eyed choice about which of the six supply chain models delineated in this report is the right one to adopt.
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