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MCM STATE OF OPERATIONS 2020:

Seismic Shifts Bringing a New Normal to Ecommerce Operations and Fulfillment

By **Tim Parry**

What will the world of ecommerce operations and fulfillment look like after the World Health Organization declares an end to the COVID-19 pandemic?

The answer, as well as a prediction of when the pandemic will end, is uncertain. However, industry experts firmly believe that the seismic shifts that began in mid-March will create a new normal for the ecommerce channel.

Self-quarantines, shelter at home orders and government-ordered closures of nonessential businesses have caused a major change in consumer behavior. The grocery sector, which according to McKinsey Group had 2019 ecommerce sales in the 3%-4% range, saw a gigantic online bump as consumers bunkered in. Essentials like paper goods and disinfectants flew off soon-empty shelves as panicked buyers hoarded.

Most categories have suffered, though, especially apparel and luxury goods, as discretionary spending dried up while unemployment soared. While consumers stocked up in store and online with necessities like CPG products, they eschewed spring and summer fashions from department stores and specialty sellers.

"Retailers are looking for extended payments, asking for discounts, negotiating with landlords on rent," said Robert Escobar, who runs supply chain operations for apparel rental firm Le Tote. "Everything is being re-evaluated, trying to preserve cash in general. We're all doing that while we don't know where the bottom is."

Some retailers reinvented themselves on the fly to be classified as "essential businesses." For example, Best Buy repositioned itself as a competitor to Staples and touted curbside pickup for home office equipment and distance learning essentials for students.

Here's a look at how ecommerce companies are adjusting to make it through the pandemic, and what the new normal may be like by the holidays.

Help Wanted in Fulfillment Centers

Perry Belcastro VP of fulfillment services for Saddle Creek Logistics Services, said flexibility and scalability are a top priority for ecommerce merchants in the current market.

"Going forward, fulfillment operations must be more flexible than ever before to accommodate unpredictable order volume," Belcastro said. "To be responsive to fluctuations in demand, merchants need scalable resources, including space, staffing and technology."

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While demand spiked for essential items at big-box sellers like Costco, Walmart and Target in February and March 2020, most of the rest of retail saw a steep falloff as stores shuttered. Even ecommerce didn't prove a safe haven as that spend failed to make up the shortfall for retailers. And the big boxes began to see foot traffic decline in early April.

Amazon changed its logistics, transportation, supply chain, purchasing and third-party seller processes to prioritize essential items, while putting a temporary moratorium on all other categories through FBA. It also sought to hire 100,000 hourly workers and raised their wage to $17 per hour. Walmart provided bonus pay and announced plans to hire 150,000 new associates in stores and fulfillment centers.

Volume is Key for Major Parcel Carriers

As ecommerce continues to grow, the three major carriers will benefit from package volume, said Tim Sailor, principal of Navigo Consulting Group.

Even if Amazon eventually takes all its shipping business away from the major carriers, as some have speculated, Sailor said there will still be plenty of ecommerce packages in the stream. "If you look at their trajectory, Amazon is going to continue to try to build its own network," Sailor says. "They are building more robust supply chains, and their customers' expectation is 'I want it now.'"

But for the carriers, will there really be life after Amazon? If you look at FedEx, there certainly is. After FedEx ended its air and ground contracts with Amazon in 2019, the divorce got bitter over the holidays when Amazon forbade third-party sellers from using FedEx, citing costly delays.

But FedEx has moved on. In its third-quarter earnings call in March 2020, CEO Fred Smith said the company is "in the midst of the ecommerce revolution," looking to make it ground service into the most cost-effective option.

Since the FedEx breakup, Sailor says Amazon transitioned a lot of its ground business to UPS. In its fourth-quarter earnings report in January 2020, UPS said Amazon's percentage of total company revenue rose to 11.6%. The carrier said it was able to increase its business with Amazon through competitive wins and the structural shift to next-day delivery.

"UPS made it clear in its report that the relationship with Amazon was deeper than UPS had led us to believe previously," Sailor says. "It really evolved over time."

Sailor says the U.S. Postal Service continues to benefit from ecommerce growth. It still has a very extensive relationship with Amazon, even if volume has been reduced. Also, FedEx in 2019 diverted about 2 million packages per year from the USPS into its ground network to build density and shave costs.

In March 2020, the USPS said continued growth in ecommerce coupled with a 4.7% increase should generate an additional $800 million in parcel revenue in 2020. However, lawmakers warned that plummeting mail volumes could force the USPS to shut down by June without immediate financial help. It did receive $10 billion as part of the federal stimulus package, which its union called "woefully inadequate."

As of April 2, 259 USPS employees had tested positive for COVID-19, and about 2,800 workers were in quarantine. Drivers and warehouse associates for UPS, FedEx and Amazon have as well, in some cases leading to temporary facility closures.

Density will Drive the Last Mile

Seven-day delivery will have a major impact during the 2020 holiday season, said R.W. Baird analyst Ben Hartford, thanks to Amazon once again raising the expectations bar. Even weekend Prime orders are expected asap, he said.

How the quickly the country recovers economically from the pandemic will determine how much density there will be for last-mile carriers, Hartford said. Last-mile carriers need to build route density, he said, to make sure their independent contractors have access to volume they need to grow their individual businesses.

"Density is important as it relates to improving last-mile economics," Hartford said. "If they increase the

(delivery contractor) volume, they may not increase the number of packages per stop, but they can improve the number of packages they deliver in each day. All that helps the economics for that provider."

FedEx consolidating Express packages into ground narrows the gap in the service requirements between the two services, which previously had very little overlap.

In February 2020, Amazon ended delivery contracts with partners not hitting its SLAs. Many had just been formed in 2018, when Amazon began inviting entrepreneurs to support its demand by starting their own delivery businesses. The program quickly grew to 800 businesses using 75,000 drivers. Several of these companies said they'd have to close, although some of the drivers may have been rehired when Amazon said it needed 100,000 new workers.

The gig economy is also having an impact on last mile delivery, with thousands of independent contractors keeping the ecommerce engine humming, even though working without benefits. In California, the passage of AB5 meant 70,000 drivers were eligible for health and retirement benefits and a $12 minimum wage by being reclassified as employees.

Parcel consultant Jerry Hempstead noted how AB5 could impact FedEx Ground and Home Delivery as both use contract drivers for local parcel deliveries.

"Granted they have arms' length agreements and the contractors are responsible for withholding taxes, social security and unemployment," Hempstead said. "I think they are in the clear, but there has been much litigation on whether the contractors are employees or not."

E-Grocery Speeds Up

E-grocery is projected to grow from 4% of the grocery sector to 15% by 2027, according to Neil Stern, a senior partner with consultancy McMillonDoolittle. In March 2020, Seattle shoppers put e-grocery fulfillment to the test via an explosion in shopping apps like Instacart and Shipt, as an early COVID-19 hotspot.

If the e-grocery customer experience is generally a good one, it will move beyond its status as temporary necessity to driving a major shift in buying habits.

Before the coronavirus outbreak, several grocery chains began to step up e-grocery fulfillment plans. Instead of associates as order pickers, several major chains began moving to the micro fulfillment center (MFC) model. Grocers that had already made the switch are likely weathering the panic-buying storm better than others, Stern said.

An MFC is a highly automated system that can fit in a small space in the rear area of a grocery store, away from the sales floor, or in an adjacent or nearby building. It taps the power of robotics to grab items for online orders in a matter of a minute or two.

Though MFCs can be considered a "shiny object," Stern said they are also "battle tested." They are excellent for fulfilling about 70% of a store's SKUs and are more popular in densely populated areas. MFCs also reduce the number of out-of-stocks because inventory is kept separated from the store channel.

With the speed of an MFC, Stern says the cost per fulfillment can rise from about $1.50 per order to about $6 per order, which is important in a sector with razor-thin margins.

"Stores [without MFCs] get crowded with pickers, and that can annoy and distract shoppers," Stern says. "At some point, when that business model maxes out, grocery chains look for other solutions."

An MFC could cost a grocery chain between $2 to $3 million per location, compared to $100 million for a fully automated offsite grocery fulfillment center. Stern says the affordability of MFCs can help grocery chains like Wakefern and HyVee keep up with giants like FreshDirect, Peapod and Amazon Fresh.

Just before the pandemic, Amazon had partnered with Dematic to create an MFC in its new Los Angeles-area supermarket. Since other retailers follow Amazon's lead, Stern says this should make Dematic a provider to keep an eye on.

In addition to Dematic, other MFCs to watch include Takeoff Technologies, which has partnered with Wakefern; Alert, which has been working with Walmart; Israeli automation startup Fabric and AutoStore, a robotic system owned by Swisslog.

Robotic Demand to Grow Post-Coronavirus Pandemic

Several factors related to the pandemic could alter the state of fulfillment center robotics, said Blue Horseshoe Consulting manager Chris Elliott.

First, a likely major pandemic-driven recession could lead to acquisitions and consolidation. Also, Elliott said, retailers and 3PLs could add more robots to the mix, at the expense of humans.

As happened with other sectors after 9/11 and the 2008 recession, Elliott believes the more established players will probably expand by adding the right components. For example, Locus, which provides robots for 3PL provider DHL, may want to acquire companies that could help it add intelligence to its products.

"Robot are not smart on their own," Elliott says. "They need to be programmed with artificial intelligence and machine learning, and most robotics firms outsource that. Companies like Locus and Fetch Robotics may try to acquire those companies to bring their engineers and technology in house."

Of course, Elliott adds, we could also see an even bigger robotics fish like Toyota swoop in and buy the likes of a Locus or Fetch. Also, a private equity firm could decide to form a new holding company and acquire all the pieces it needs to create an all-in-one robotics firm.

One thing the industry learned when the coronavirus outbreak exploded: Fulfillment firms were unprepared with workforce flexibility, Elliott said. 3PLs and retailers who do their own fulfillment will look to automation and robotics either for greater flexibility or to start trimming the workforce.

"We're having massive disruptions to the labor force," he said. "When companies come out of this, they're going to be looking and asking, 'what are we to do the next time this happens?'"

Steve Johnson SVP consulting for Johnson Stephens, a unit of Hy-Tek Material Handling, agreed with Elliott that robotics adoption is bound to grow substantially post-COVID-19, given labor shortages and higher wages, among several other factors. Amazon's implementation of a $15 minimum wage across the country, and now offering $17 per hour in the crisis, is putting pressure on all other fulfilment employers.

"We have a client that's an $80 million wholesale footwear brand, selling to Macy's and JC Penney, with not a huge fulfillment business but growing it," he said. "Do you put in conveyors or robotics? I think robots make a whole lot more sense, especially if they can lease them. They'll only need 7 bots to start, and maybe in five years it'll expand to 30. They're facing challenges as an SMB that can't deal with the capital outlay of a three-level pick module. They'll get as good or better production rates and it's cheaper to rent."

If robots are going to further replace human workers, there are other things to consider. For example, Elliott says, will the spike in ecommerce continue after the pandemic, and will 3PLs and retailers with their own FCs have a large enough workforce?

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