THE DISTRIBUTION EXPERTS™
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Forget Everything You Know About Distribution Network Strategy

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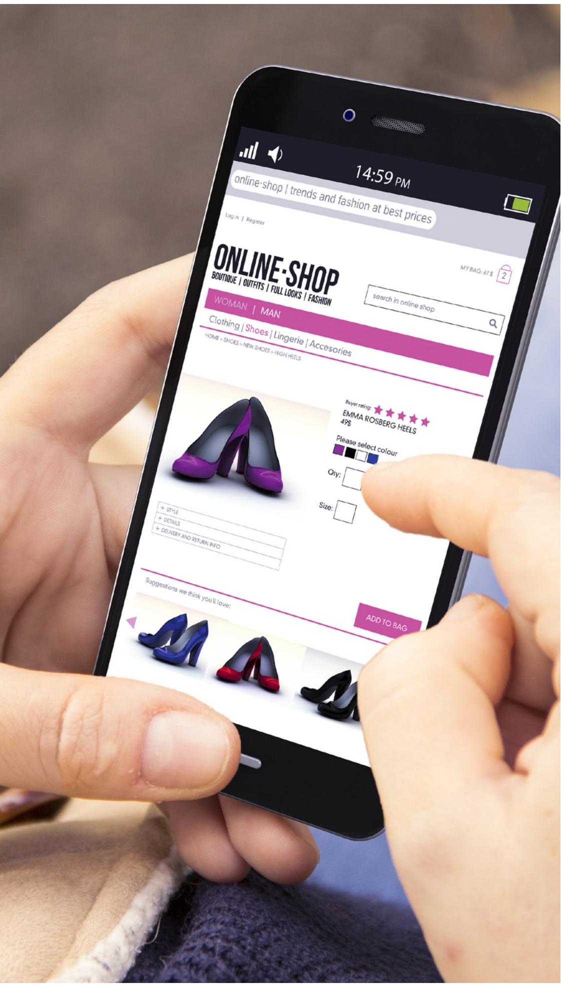


With so many disruptive changes driving business today, it might be time to take a fresh look at your distribution network strategy. But with so much uncertainty, and greater Board accountability for results, the stakes are higher than ever before. This means the process of developing and implementing a distribution strategy must change as well.

Distribution network strategy is no longer just about optimizing traditional costs (transportation, operating expense, fixed costs and capital). Today, when evaluating different network strategies, you have to take into consideration the total supply chain cost, including real estate occupancy costs, labor costs, inventory working capital costs and possible cost offset by available economic incentives as well as service level improvements that drive revenue growth. Availability of labor and real estate construction costs are more significant factors in the post-Amazon era than they were in the past. The network capabilities needed to support eCommerce and new channel growth are very different and demand innovation enabled by emerging technologies unavailable even a few years ago. The impact of service levels on sales may drive different decisions today than they did even just a few years ago.

Because every decision has a ripple effect that crosses functional silos, network strategy discussions must include a broader set of stakeholders, including the Board of Directors, C-suite, Sales, Operations, Finance, Merchandising and others.

Finally, the pace of change and disruption demands that leaders revisit strategy every couple of years to maintain competitive advantage. In this article, we identify 7 ways that distribution network strategy development has changed and how you need to think differently about it.

1. The way people buy has changed for good.

It's highly likely that your current distribution network was not built for the explosive eCommerce growth and service expectations we see today. These disruptive changes demand a fresh look at your network strategy. eCommerce may have significantly changed your order profiles with smaller, more frequent orders. Customers now expect fast, free shipping. Three to five days is no longer fast enough. Two-day delivery is the norm, with next day, same day and even same hour expectations increasing as Amazon relentlessly builds out a network that can deliver on that promise. Returns are on the rise as customers bracket purchases by buying multiple sizes or styles and returning the ones they don't like. This creates inventory headaches across your network. And in some cases, eCommerce may be cannibalizing other channels, including stores, causing many companies to re-evaluate and downsize store networks.

At the same time, stores are undergoing a transformation that creates new options to improve the distribution network. Credit Suisse analysts predict 25% of shopping malls will close in the next 5 years[1]. In a slew of recent headlines, a number of retailers have announced they are closing stores by the hundreds as same store sales plummet. This creates an opportunity to leverage highly motivated landlords to secure low cost real estate in prime locations. How might your network be transformed if you could take advantage of the opportunity to create small distribution operations located closer to customers than you've ever been? Favorable rates and flexible lease terms might be the key to an adaptive network that includes centralized DCs, 3PLs, dark stores and/or existing store assets for fulfillment.

When is it Time to Revisit Your Network Strategy?

If you can answer yes to any of these questions, it might be time to take a fresh look at your network strategy.

- Is your business experiencing or projecting high growth?
- Are you nearing 80% capacity or do you currently have storage and throughput challenges?
- Are you starting to see a build-up of off-site inventory?
- Are you having trouble meeting service expectations?
- Do you feel like you've exhausted all options to maximize space and optimize efficiency?
- Have you opened up new channels?
- Are you making changes or adding new store formats?
- Is competition for labor driving up labor costs?
- Are you losing sales to competitors with later order cut-off times, and shorter order-to-delivery cycles?
- Are you closing a significant number of unprofitable stores, potentially necessitating a realignment of your network?

"DSW's newest store format is a hybrid store/ distribution center where associates fill orders from a mezzanine located directly above the store where customers are shopping. Don't see your size on the floor? An associate can send a request to the pickers above to send down the size and style requested. Instantaneous fulfillment with zero shipping cost seems like just the thing to satisfy today's omnichannel shoppers."

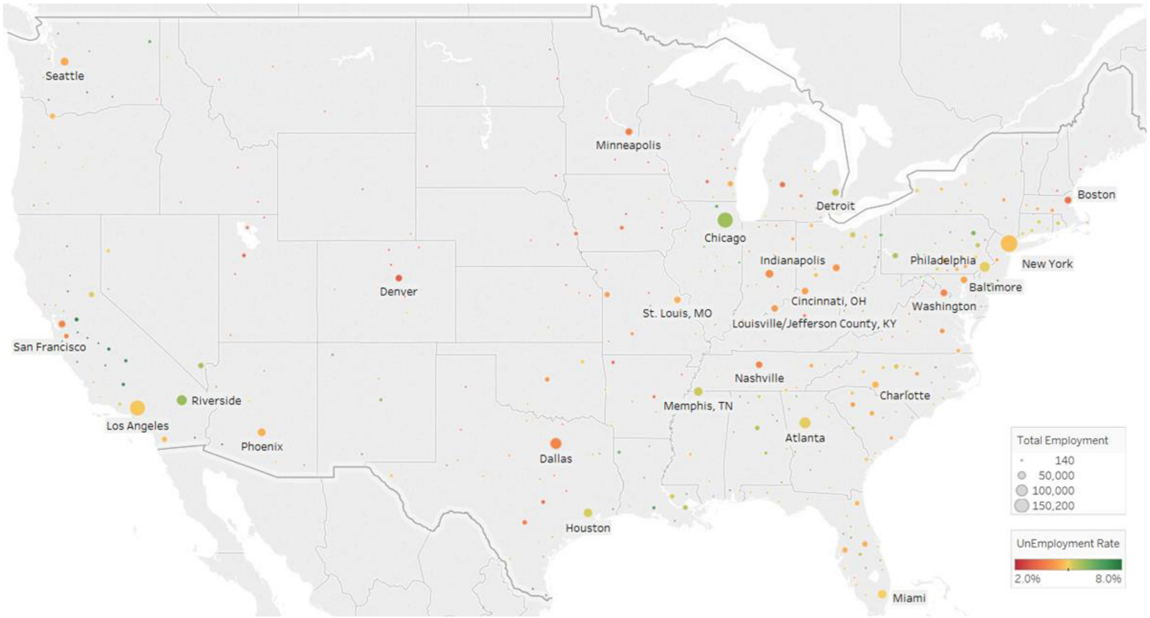
[1] http://fortune.com/2017/05/31/malls-retail-stores-closing/

2. Labor has reached a tipping point.

Labor availability and wages play a bigger role in network strategy than ever. Across the U.S., blue collar labor is in short supply and high demand. The tight labor market and changes in minimum wage laws are contributing to rising labor costs. In certain markets, competition is so fierce that for as little as an additional 50 cents per hour, competitors can poach your best talent and an arms race ensues, driving wages up for everyone in the market. When unemployment declines to around 3-4%, labor markets are virtually tapped out because the remaining workers in the pool are likely lacking requisite skills, or are unemployable. Primary markets (inland empire, Chicago, New Jersey, etc.) are approaching crisis level labor shortages and secondary markets (Nashville/ Memphis, Indiana, etc.) are seeing a boom in demand that could create problems in the near future. You must consider labor availability and wages as well as competitive pressures as you evaluate locations.

A tight labor market can drive a solid business case for automation, where emerging technologies like autonomous vehicles, robots and wearables are financially justified. The right solution will enable flexibility and scalability, while balancing operating cost against long-term capital investment.

LABOR POOL SIZE AND UNEMPLOYMENT RATE IN KEY MARKETS



3. Shifting demographics undermine traditional thinking about real estate.

Tight labor markets have contributed to rising construction costs and the inability for industrial contractors to keep pace with demand over the last several years. This is pushing rental rates higher. Additionally, locations near emerging distribution markets (those with a strong last mile delivery proposition) are starting to demand a premium for that valuable land. This is why economic incentives play a bigger role in the business case than ever before. States and cities are competing fiercely for jobs. They are more willing than ever to negotiate incentives, such as real estate tax abatements, infrastructure grants, sales tax exemptions, job training grants, job retention and growth incentives, low interest loans and loan forgiveness programs. Often transportation cost will allow for flexibility of up to 100-mile radius within a particular geographic target. That could place you within range of a second or even third market, just across state lines, where you can seek competitive opportunities, such is the case in the Mideast, Carolinas, New Jersey/New York Metro, and Chicagoland/Milwaukee regions.

The internal competition for obtaining capital is fierce in most companies. Distribution center investments often tie up capital that is badly needed to fund other areas of the business. Where capital is tight or already ear-marked for other investments to support growth, you might consider lease-back options. Consider partnering with a property trust company on a build-to-suit, lease-back agreement that could allow you to shift significant capital cost to operating expense and enable you to make the desired network strategy improvements.

A growing retailer used this strategy, leveraging an existing DC asset it owned to access $50 million in cash that was used to fund new store growth. They were able to do this just by entering into a lease-back agreement with a real estate property trust.

You may find that there are other ways to squeeze more life out of existing assets. As you review your strategy, the first thing to ask is whether you can get more capacity out of the existing network. Can you take advantage of emerging technologies in automation and robotics to optimize your DCs and gain capacity? Have you looked at outsourcing some portion of your fulfillment to a third party logistics provider to free up capacity elsewhere? What about your store assets? A hybrid solution with the proper mix of these alternatives could be your best option. Underutilized assets may also be candidates for shared operations with vendors and/or customers.

4. Inventory echelons are not all the same.

Inventory carrying cost requires greater consideration than ever as part of a network strategy. You can't compare inventory turns for your eCommerce channel to those of the Retail channel, unless you factor in store inventory turns as well. Otherwise you run the risk of underestimating inventory carrying cost as part of your business case. eCommerce inventory typically turns an average of three to six times per year. In the DC, retail inventory turns are often much higher, but when you factor in the store turns, you get a number that is closer to an apples to apples comparison with eCommerce inventory. Don't make the mistake of

"Where capital is tight or already ear-marked forother investments to support growth, you might consider lease-back options."

penalizing one type of inventory over the other in your business case. And consider the potential for sharing inventory across channels to reduce overall investment.

When modeling cash flows for business justification, there are different ways to handle the increase in inventory that occurs when you add a new distribution center or node. Some companies prefer to model the cash flow impact to correspond with the actual timing of the inventory changes. Others choose to model it as a longer-term cash outflow that gets absorbed over time, usually 2-3 years. There are pros and cons to each approach and you must decide which is right for you based on your organization's philosophy and the Board of Directors' and leaders' desired payback horizon.

5. Transportation opportunities are important but getting more difficult to find.

While transportation cost is still a big factor in network strategy, the days of achieving 15-20% savings in transportation alone are gone. Adoption of TMS and ERP systems have helped many companies wring most of the transportation savings out of existing networks. But there are still a number of ways you can look for opportunities to save:

- Consider a central purchasing agreement for transportation across your organization that allows for economies of scale while maintaining local controls for performance accountability
- Look for places where carriers are repositioning empty/underutilized trailers
- Seek opportunities to collaborate with carriers to reduce their cost to serve in exchange for offering you improved service and rates
- Look for ways to reduce trucks and reduce miles (network changes, hub and spoke operations, multi-stops, etc.)

Today, additional savings from transportation are often on an order of magnitude that is less than a couple of percentage points of total cost. But combine that with small savings from the other cost factors, and you arrive at a justifiable business case.

6. Today's increased risk calls for more resilient networks.

More than ever risk to the business is a factor in a network strategy. What seemed like an acceptable level of risk a few years ago may no longer serve the company's interests. How has the market changed since your last network strategy? What are competitors doing that might allow them to leap frog your position in the market? Is your industry experiencing significant merger and acquisition activity? Determining how to stave off the competition and/or secure a leadership position for the future is often part of network strategy in today's volatile environment.

Be sure to identify and obtain stakeholder buy-in for the level of risk acceptable for the company today. Look at the current market and identify any new or emerging risk factors since you last evaluated your network. Where possible, try to identify the amount of revenue at risk if you do nothing. When measured against the potential investments this can sometimes provide you with your best case for change.

7. The business case is comprised of both quantitative and qualitative factors.

The business case is no longer justified by big gains in any one component of total cost, but instead investment is justified by carving out incremental savings across several components that add up to something larger. From the very early stages of your network strategy, Finance must be involved to ensure that the business case is developed to conform to the standards and language of your company, especially when it comes to the more contentious decisions such as how to model growth, cash flows and the appetite for risk. For some companies, a 5-year payback is acceptable, while others prefer a shorter horizon. There are times when even the C-suite and Board will view certain items through different lenses, so you must be prepared to address those possibilities by performing sensitivity analysis to understand the "what if" questions that may, and should, be asked.

Potential revenue lift from service improvements are often a component of the business case as well. It's as important to document the qualitative decision criteria as it is to show the quantitative evaluation. For example, how do the various members of your team weigh and value qualitative factors like service level improvements, flexibility, risk, and new

"A market-leading industrial distributor knew they had to make changes to their network to ensure their closest competitor didn't surpass them in providing superior service levels to customers. They were able to justify a $25 million investment by tying it to the potential revenue at risk if the business didn't keep pace with service expectations of its customers."

QUANTITATIVE EVALUATION (EXAMPLE FRAMEWORK)

Factors	Details	Scenarios ($ M)							
		2016 Baseline		2021 Baseline		Scenario 1		Scenario 2	
Revenue	Projected Revenue	$1,400		$2,800		$2,800		$2,800	
Customer Service Metrics	Service to Stores / Customer %'s	< 500 Miles	>500 Miles	< 500 Miles	>500 Miles	< 500 Miles	>500 Miles	< 500 Miles	>500 Miles
	% Store Volume	30%	70%	12%	88%	60%	40%	70%	30%
	% e-Commerce Volume	15%	85%	10%	90%	50%	50%	60%	40%
	% B2B Volume	12%	88%	9%	91%	30%	70%	40%	60%
Working Capital Expense	Inventory Carrying Costs	$20		$28		$26		$30	
Operational Expense	Warehouse: Fixed	$10		$17		$15		$16	
	Warehouse: Variable	$24		$42		$38		$40	
	Transportation	$40		$75		$69		$72	
Total Costs	Total Costs	$94		$162		$148		$158	
Capital Expenditure	Real estate, MHS, IT, telecom, office furniture,	-		$80		$105		$110	
Return on Investment	Payback Period	-		-		1.8		6.0	

service opportunities? You must engage a broad set of stakeholders consisting of cross-functional team members and build consensus around these factors and other items as part of the business case development. And don't forget to show the investment required to simply maintain current revenue – the "do nothing" option comes at a cost as well.

THE RIPPLE EFFECT

The problem with trying to optimize a network is that it is never optimal. There are more variables to consider than ever. When you change one variable, whether it's growth estimates or inventory turns, that has impacts across all your other key decision points. For example, lower inventory turns may mean you need more space, which changes real estate cost and potentially increases material handling equipment requirements, ultimately leading to higher capital expense. If growth is actually lower than projected or service expectations change that could lead to a very different answer because of all of the downstream impacts of those decisions. You must weigh and balance each decision against all the other components of the business case to come up with the best answer based on what you know today and what you think will happen. As hockey legend Wayne Gretzky said, "I try to skate to where I think the puck will be." Tipping Point analysis is key to knowing when a change is needed so you can track the puck and make adjustments when it changes course. The best approach to network strategy is one of continuous improvement, where review of the network is a critical component of the business strategy.

SUMMARY

With an accelerated pace of change and disruptive market changes occurring daily, it's probably time to reassess your network strategy. But before you start, be sure to think differently about these 7 key areas, and be aware that every decision you make has ripple effects across your overall strategy. You need a broad look across total supply chain cost. Advanced network modeling software allows you to run scenarios faster and therefore consider a wider array of network options than ever before. Take advantage of these powerful software tools for their ability to help you explore and refine a greater number of scenarios to identify the best strategy to get you to where you think the "puck" will be.

How You Need to Approach Your Next Distribution Network Strategy Differently

- Get Alignment. You need all stakeholders to agree on growth and baseline data so that they can truly buy-in to the solution.
- Where primary market labor is tapped out, look to outlying secondary and tertiary markets.
- Start a bidding war. Economic incentives can offset a sizable component of capital and operating expense.
- Look for ways to squeeze more capacity out of existing assets to delay investment. Optimize, outsource, leverage stores and consider hybrid solutions.
- Compare apples to apples. Don't underestimate inventory carrying cost and working capital tied to your inventory.
- Get creative with financing. Consider sale lease-back and build to suit with lease options to free up CAPEX for other business growth investments.
- Think about and agree upon the acceptable level of risk to the business.

FORTNA CAN HELP

Fortna helps companies assess their operations, develop a strategy and roadmap for competitive advantage and build a business case for investment.

For more information, contact The Distribution Experts at info@fortna.com.

THE DISTRIBUTION EXPERTS™

Fortna partners with the world's leading brands to transform their distribution operations to keep pace with digital disruption and growth objectives. Known world-wide as the Distribution Experts, we design and deliver intelligent solutions, powered by FortnaWES™ software, to optimize fast, accurate and cost-effective order fulfillment. Our people, innovative approach and proprietary algorithms and tools, ensure optimal operations design and material and information flow. We deliver exceptional value every day to our clients with comprehensive services including network strategy, distribution center operations, material handling automation, supply chain systems and warehouse software design and implementation.

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