It Pays To Know Your Cost to Serve

A WHITEPAPER BY VISKU

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Retailers tend to be fragmented in their approach to determining their Costs-To-Serve. But new thinking suggests Cost-to-Serve analysis should be a core, business-critical initiative for informing future decisions and direction.

Do you know your Cost-To-Serve your customers? Of course you do – your management accounts have line after line detailing your expenditure on warehouse facilities, pick and pack operations, transport, postage, couriers and the like, along with the charges from any third party logistics partners.

But put the question another way. Pick a customer order at random. Do you know what it will cost to fulfil that particular order? More acutely, do you know what margin you are making? In fact, are you actually making any profit at all?
For many retailers these questions can be difficult to answer.

It's quite obvious that some orders cost more to serve than others.

Picking and packing a mixed order of items costs more than a full carton or pallet-load. Shipping to Shetland is more expensive than delivering to Derby.

Some lines pack a lot of value into a small warehouse footprint and turn over rapidly - others gather dust on acres of floor space.

However, there are more fundamental issues. The cost base for selling through a physical store may be very different from that of an on-line operation, and even in eCommerce, there are significant differences in Cost-To-Serve between home delivery, click and collect, or using a third party such as Amazon.

Of course, different service levels attract different costs. And not all Costs-To-Serve show up under ‘Transport and Logistics’ – different policies and strategies impact areas from the finance cost of inventory to the resource used in resolving customer issues, and of course there are returns to consider too.

Somewhat scarily, in a great many businesses Costs-To-Serve are treated as though they are a fixed overhead and allocated evenly across orders,when in reality they vary by the individual characteristics of each order – channel, geography, the nature of the goods, the behaviour of the customer, and so on. They also, of course, change over time, and not necessarily uniformly.

So whether determining channels to market, or setting up or revising fulfilment and distribution strategies, the company needs a deep understanding of where the Cost-To-Serve are generated, how these vary across orders, and what actions can be taken to improve profitability on every order.

In addressing Cost-To-Serve there is only so much that can be achieved by nibbling away at transport charges or warehouse efficiency, necessary though such efforts are. Major elements of Cost-To-Serve are determined by business models and strategies set at the highest level.

Understanding Cost-To-Serve at a granular level across the broad gambit of products and services a business offers should inform the wider strategy and should give clear visibility of margin and how to maximise it or protect it.

Channel thinking

The retailer may trade solely through physical stores, or as a pure eCommerce/home delivery player. If the latter the business may perform its own fulfilment, or outsource to a third-party-logistics (3PL), or drop-ship – or perhaps, all of the above. Click and collect may also be in the mix. Each of these has a different cost profile, and even within a channel, the costs may vary dramatically according to the type of goods.

Home delivery of a laptop may merely require a trusted courier; a 75" TV screen is probably a two-person delivery.

The choice of channel(s) affects the **architecture** of distribution resources and networks, which in an ideal world could be located to optimise both customer service/response, and the costs of warehousing, transport and the rest. There are choices to be made: does eCommerce fulfilment occur in the store replenishment warehouse, or in separate facilities, or perhaps, from the physical stores themselves?

In the real world, of course, few businesses have the luxury of starting with a blank sheet and suitable warehousing is not always easy to find in the optimal locations.

The retailer's logistics specialists may have significant input to conversations on channels and networks; perhaps less so on the **Service Offer**, which is unfortunate as this sets the day-to-day targets for the operation and thus determines a lot of variable cost.

At its most fundamental, does the business make the same service offer regardless of product type, order value, customer location, or are these differentiated?

What does a standard offer of, say, 48-hour delivery cost to fulfil? What premium would a 'same day' service have to charge to at least cover its extra costs?

Differentiated Service Levels

The acceptability of differentiated Service Levels, and by implication, prices, may vary across product groups and customer sectors.

Consumers, for example, are curiously willing to accept that prices may be higher, or there may be fewer offers, in a retailer's 'local' format store than in the big supermarket. However, they are not necessarily so accepting of a differential between the physical shop and the online offer.

Geography poses other issues. The inhabitants of the Highlands and Islands accept that same day delivery is not going to be a reality, but aren't prepared to be 'gouged' on price, even though they are well aware of the extra Cost-To-Serve. Retailers have the option of abandoning this market segment, of accepting the loss, or of sharing the additional costs over the wider customer base – but of course they need to understand their Cost-To-Serve before they can make that choice.

An **over-ambitious service** promise can raise unbudgeted costs

Meeting demand for items that are in critically short supply can generate unbudgeted transfers between warehouses, fulfilment centres and stores, and last-mile delivery by taxi is not unheard of!

The Hidden Cost

The Service Offer can affect Cost-To-Serve in other, more subtle ways. For example, offers on warranties and guarantees, above and beyond the requirements of consumer law, of course have costs, and these are quite often concentrated in particular product categories. The numbers don't show up on a logistics budget but they are a real Cost-To-Serve nonetheless.

Another element determined by the Service Offer and which has very obvious, if often poorly understood, costs is the problem of Returns. There is of course the cost of return transport, of extra warehouse space both to store goods and to process them, the process costs of inspection, rectification, repacking and labelling and returning to stock or of disposal.

The Hidden Cost

A high level of returns also means that the level of inventory in the system, with carrying and finance costs, may be much higher than the inventory that is apparent in the warehouse. Some lines of merchandise, such as apparel, may be much more liable to be returned than others, and policies that allow or encourage consumers to over-order and return – beyond their consumer rights – need to be considered in the light of a true understanding of the costs involved.

It can also be the case that ‘legitimate’ returns are increased by measures taken to reduce Cost-To-Serve – cheaper packaging, or low-cost couriers, may increase the incidence of breakages.

These costs and trade-offs need to be understood and allocated, not just accepted as a fixed cost of doing business.

Accounting policies also mean that there are other charges that are treated as fixed overheads when in reality they are variable and attributable Costs-To-Serve. The administration costs of an order may be much the same for a £10 order or a £1,000 order and it may be reasonable to spread such costs evenly. But other ‘overheads’ may be quite specific to particular product lines, channels, or other differentiators.

Wastage/spoilage rate in a physical store where customers are handling the merchandise may be higher than in an on-line channel. Some goods take much more storage resource (absolutely or in relation to value) than others, not just space but for example the need for environmental control – those costs need to be known, even if how to recover them is a different argument.

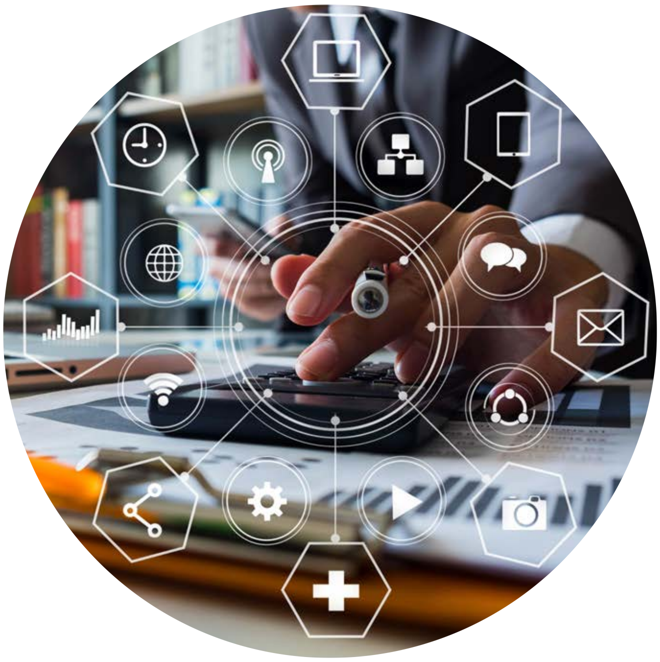
Some classes of goods may, even in small amounts, greatly increase insurance premiums – again, that needs to be visible. The list goes on.

01

Firstly, very many elements in the total Cost-To-Serve are determined in large measure by high level strategies, policies and business models, some of which do not outwardly have an obvious impact on fulfilment operations.

02

Second, most elements of the Cost-To-Serve are not a type of fixed overhead, but are specific to channels, products, geographies and sometimes consumers.



03

If adequate profitability is to be attained and maintained, the true Costs-To-Serve – and all of them, not just the obvious physical costs of warehousing and transport – need to be understood and accounted for at as fine a level as practicable. The adage 'you can't manage what you don't measure' is a little overused but is certainly applicable here.

The Exceptions

That doesn't mean that every order, or category of orders, must fully recover all its costs at all times. There may be entirely valid reasons why certain items may be treated as 'loss leaders', or a very low margin accepted in a campaign to boost market share, or even why consumers in 'easy to serve' locations should pay a few pennies more so that customers in more remote areas can get any service at all.

But you cannot sensibly make those calls if you don't know what your costs and margins really are.

Nor, obviously, can you appropriately target cost reductions and other actions if you don't know your costs. Much more importantly, you can't properly plan for significant projects, such as the location of new DCs, business model changes or commercial contracts – selecting a new 3PL - without this information.

More than a one-off exercise

But it should also be evident that this isn't a one-off exercise. The balance of Costs-To-Serve is constantly changing as fuel costs, labour costs, rents, the affordability or otherwise of warehouse automation and so on vary, but also with changing customer behaviours.

Particular channels may become more or less popular, for instance, as people drift back to the office, home delivery may decline relative to click and collect, or the nature of demand 'peaks' may change with recession. Also, the balance between branded and white label goods may change with economic hardship and that may affect how much margin is available to cover the Cost-To-Serve.

Cost-To-Serve needs continual revisiting in order to inform and respond to higher-level business decisions, and is an essential tool for protecting margin and ensuring profitability.

In Conclusion

Real value can be gained from doing the Cost-To-Serve analysis in pockets, perhaps starting with products, channels or geographies where you know you have challenges.

In the process you and your advisors will gain a deeper understanding of how your Costs-To-Serve are made up, where the ‘hidden’ costs are buried, which costs are truly fixed overhead and which are order-related.

From that you can begin to make better-informed and more profitable policy decisions, across the board, from channels to market to investment decisions and service level promises.

If some of these topics have resonated with you – our team of supply chain experts can help you to talk through in the context of your own business challenges and together understand how best to support your future success.

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