Operating Strategies
by Tim Laseter & Team

The Last Mile to Somewhere

Once considered the domain of tacticians, operations now resides at the forefront of business strategy. Consider the saga of Web-based delivery services.

In the not-too-distant past, many executives considered *operations strategy* an oxymoron. *Strategy* covered lofty concepts like competitive dynamics and brand positioning, while *operations* implied tactical stuff like supply-chain management and customer service centers — mere afterthoughts for a visionary leader. New Economy executives were particularly prone to this perspective, outsourcing operating activities in order to focus single-mindedly on capturing "eyeballs."

But not anymore.

The New Economy has entered a new phase — a shift from value creation for customers as the sole focus, to value capture by companies and shareholders. Operations strategy now resides at the forefront of business strategy for dot-com startups and traditional companies alike.

Eyeballs alone can no longer sustain once high-flying dot-coms; market pressures now demand continued growth as well as improved profitability to revive their market valuations. Take a look at what happened to e-tailers during the 1999 holiday season: They faced shortages of popular goods, overstock of undesirable merchandise, and an inability to get the right items to the right customers on time. Their experience underscores the importance of capacity planning to a company's very identity. After all, Brand Management 101 defines a *brand* as a promise *delivered*. So truly managing a brand requires more than developing clever commercials and spending millions on Super Bowl advertisements. This past holiday, a traditional operations metric — on-time delivery performance — decided the fate of e-tailers.

There has also been an increasing focus on operations strategy among traditional companies trying to adapt to the Internet economy. Consider B2B exchanges. More than 100 have been announced to date, representing billions of dollars in investment, making these exchanges perhaps the most critical Internet-related investment on the agenda of bricks-and-mortar CEOs. The focus of these high-technology investments? Traditional operations processes, such as purchasing, supply-chain management, and collaborative design. With Internet technology, these traditional processes can deliver hundreds of billions in bottom-line improvement.

In short, every major company

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faces a growing need to evolve operating strategies to harvest the enormous value potential sown by the Internet. Only the foolhardy will ignore the strategic implications of operations.

The evolving story of the last-mile delivery industry — e-tailers offering same-day home delivery — offers an excellent example of the transition from value creation to value capture, and the critical role played by operations strategy. Last August, in a widely quoted report, we analyzed the operating models underlying a host of such startups and concluded, "We believe the last mile may lead to the gallows rather than to the promised land" (see "The Last Mile to Nowhere: Flaws and Fallacies in Internet Home-Delivery Schemes," *s+b*, Third Quarter 2000). Digging into the fundamental economics faced by companies such as Kozmo, Urbanfetch, and Webvan, we found same-day delivery e-tailers hobbled, perhaps critically, by four fundamental challenges: limited online sales potential; high cost of delivery; a speed/variety trade-off; and existing, entrenched competition. The market apparently agreed. Between August and November, HomeGrocer.com Inc. sold out to Webvan Group Inc., Kozmo.com Inc. canceled its plans for an initial public offering, and Urbanfetch.com Inc., after discussing a merger with Kozmo, closed its original consumer-focused business.

Are we gloating over our prescience? Not at all. We believe these moves reflect a new focus on operations strategies that we hope will lead to a workable business model, a last mile to *somewhere*.

The Last Mile Revisited

Our report drew upon hard numbers to cast a dark shadow over the existing same-day delivery schemes. Not surprisingly, it triggered extensive reader feedback — not all of which was positive. Ronald Facchinetti, founder of a European last-mile startup, challenged our analysis:

"Your article does not contain the kind of arguments I would expect from a consulting firm that prides itself on sound strategic analysis. The popular press has until now been unable to understand the strategic value of the instant-delivery model, and your paper was no exception. As founder of Expry, an instant-delivery firm starting up in Europe in October, I feel compelled to address the fallacy of the arguments in your paper…."

Mr. Facchinetti questioned our understanding of delivery economics, citing his knowledge of Kozmo and Urbanfetch. He also highlighted the superior value proposition of same-day delivery and asserted the strategic necessity of controlling last-mile delivery. Although articulate and logically structured, his argument flowed from a flawed understanding of delivery economics. As supported by our discussions with a number of last-mile players, high — and widely variable — delivery costs coupled with limited delivery density across the day prove to be critical challenges for these companies. Although we concede his point that the last mile will prove strategically critical in e-tailing, we nonetheless continue to question whether same-day delivery companies can control it.

We also received more supportive feedback, including an e-mail exchange with Robert Waller, chief operating officer of Urbanfetch. Mr. Waller's first letter indicated that Urbanfetch fully understood the economic challenges:

"Frankly, we concur with many of the basic observations of the authors. We are in particular agreement with their closing comment, 'Eventually, someone will find a value proposition that works — but many others will fail along the way.' "

His note explained the actions under way at Urbanfetch to build a "positive delta between costs per delivery and gross profit dollars per delivery." The Urbanfetch COO listed a half-dozen actions — equally balanced between improving margin dollars per delivery and lowering costs per delivery — that demonstrated a recognition of the challenges and a determination to address them. Unfortunately, even though on the right path, Urbanfetch ran out of time and disbanded its consumer business in favor of its growing and profitable Urbanfetch Express courier service for business customers.

Whether our analysis was misguided, as Mr. Facchinetti implied, or perceptive, as Mr. Waller indicated, there's no denying an evolution in the fledgling e-tail delivery industry. The shifts fall into five broad categories, all driven by critical operations strategies — essential components of any successful e-business in an environment directed (finally!) toward profitability. They are:

• **A focus on cost structures.** Like the dot-com startups before them, most last-mile deliverers originally focused on the land grab for market share, ignoring the cost side of the business. Impatient investors and companies' dawning realization that delivery economics don't behave like the information economics of a Yahoo (with minimal marginal cost for each additional transaction) forced a shift in focus among the players. Kozmo has laid off 300 people since last June. The smaller Urbanfetch eliminated 2 percent of its work force in August, even before it abandoned its consumer business. After Webvan signed its deal with HomeGrocer in early September, it delayed expanding into the New Jersey and Baltimore/Washington markets to sort out differences between its highly automated operations and the lower-cost approach of its new acquisition.

These efforts haven't gone unrewarded. Webvan's third-quarter results highlighted solid progress: 50 percent growth in revenues over the combined second-quarter results of Webvan and HomeGrocer. The company also showed improved gross margins, and inventory turns now approach 20 per year. Although it wouldn't provide details, the company explained that it continues to experiment with delivery models to manage capacity and improve the number of deliveries per hour. By controlling delivery options and tightening staffing levels based upon experience, Webvan, we suspect, has wrung out most of the startup waste on the delivery side and can now turn its attention to optimizing the distribution operations.

• **Refinement of the product mix.** The we-deliver-anything-anywhere-anytime models built by the delivery dot-coms were about as sustainable as a pizza in a freshman dormitory. Although an extreme case, Urbanfetch uncovered one regular customer who had placed orders totaling nearly $1,000 over a year. Unfortunately, the $1,000 in revenue — mostly from video rentals — required more than 100 deliveries, plus numerous "free" pickups. This customer, supposedly desirable because of his loyalty, actually *cost* Urbanfetch several thousand dollars.

The surviving deliverers have eliminated such loss-making incidents. Keeping a close eye on profit potential, Kozmo in the fall trimmed its offerings from 25,000 items to 15,000. Before it pulled out of the consumer business, Urbanfetch had taken prudent steps to get rid of video rentals and other money-losers. It had also added a wine product line that was immediately profitable, because the company astutely selected medium- to high-priced vintages and instituted a two-bottle minimum from the start. Going forward, Kozmo would do well to take things up where its former rival left off.

• **Fine-tuning of service offerings.** Most last-mile companies believe they can achieve savings by moving away from immediate gratification and relaxing current delivery standards — but none is confident about how this will affect demand. Webvan, for example, stopped hyping same-day delivery and now hopes to attract consumers by allowing them to specify a 30-minute delivery window. That value proposition is proving attractive to customers in Oakland, Calif., where on a typical day, 30 percent of Webvan's deliveries were ordered two days earlier. Such advance notice enables the company to improve planning and lower costs, even with the 30-minute guarantee.

Webvan's grocery delivery rivals offer one-hour delivery windows and hope the company sticks with its precision offering, convinced that it equals

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financial suicide. Though we believe Webvan's unique scheduling software and hub-and-spoke network design could allow it to offer such superior service without a cost disadvantage, it announced a shift to a one-hour window in all of its markets in December. Though a drop in convenience for customers in San Francisco, Atlanta, and Chicago, the change is a service improvement in Webvan's other markets, formerly served by HomeGrocer.

• **Expansion into business-to-business.** The vast majority of consumers schedule deliveries for the evening or early morning, leaving delivery resources underutilized during the business day. Because of this, most last-mile players have programs under way to capture business customers to improve overall utilization. Kozmo now delivers prepared meals to the less price-sensitive business consumer. Webvan has introduced "Webvan at Work," a program that lets time-pressed employees order groceries while they're at work and pick them up in their company's parking lot on the way home. Additionally, some of Webvan's most valued customers are small Silicon Valley companies that order snacks, soda, and office supplies for employees.

Other delivery companies have implemented more dramatic swings toward B2B. Looking much more like a traditional courier service (and obviously no longer a "free delivery" model) Urbanfetch's Manhattan-based business service, Urbanfetch Express, has attracted several premier business accounts, including Condé Nast, Sony, and Cap Gemini Ernst & Young. Sameday.com has completely abandoned its original business model and now offers proprietary software and a nationwide fulfillment network to businesses for a fee.

• **Extension of synergistic partnerships.** The early crowding of the last-mile marketplace was madness, pitting companies in a battle to see who could deliver the least profitable goods to the most people. Consolidation eliminates competitors, ideally increasing delivery density (sales per square mile, a figure critical to profitability) and providing economies of scale in buying and merchandising.

Mergers — like the Webvan and HomeGrocer combination and the near-union of Kozmo and Urbanfetch — represent the most explicit form of partnership. A more subtle harbinger of future last-mile alliances, however, comes from that stalwart of e-tailing, Amazon.com. Its partnership with Toysrus.com (the independently managed Internet subsidiary of Toys "R" Us Inc.) highlights a well-worn core competency concept: Amazon contributes its expertise in Web design and e-tail fulfillment, while Toys "R" Us applies its superior knowledge of toy merchandising. This allows Amazon to continue to sell a huge range of products to its 26 million customers while avoiding the inventory risk that produced a $40 million write-off for the 1999 holiday season.

Stronger partnerships between a category killer like Amazon and last-mile deliverers seem logical, too, especially since Amazon owns a big stake in Kozmo and about 10 percent of the combined Webvan/HomeGrocer. Amazon currently employs Kozmo to deliver books in select cities in response to BarnesandNoble.com's same-day service. A more substantial partnership might offer Webvan delivery services to Amazon customers — which would be faster and less expensive than normal mail service. The combination would offer a new, potentially superior offering in the speed versus variety trade-off.

The Next Mile

For the last-mile deliverers, the road forward appears anything but straight. Disruptive technologies and business models may still blindside them. The wireless Internet represents the most obvious disruption on the horizon. Should impulse purchases shift to handheld Web devices, the same-day specialists will face significant risk that their target customer, on the move with a cell phone or PDA in hand, will find nearly immediate curbside pickup as convenient as one-hour delivery. But mobile commerce, despite being a cultural phenomenon in Japan and Scandinavia, is a threat that's surfacing relatively slowly in the U.S. — at least by Internet standards. No "killer app" has yet emerged to drive global adoption, and key wireless hardware and software vendors in the U.S. suggest a near-term focus on B2B applications.

Another potential disruption could come from alternative delivery models that attempt to solve the problems of delivery density and attended delivery. New competitors — and complementary businesses — now offer options such as office-centered delivery points and mobile lockbox delivery containers. To address the delivery density challenge, the startup Shipoint.com has formed partnerships with building owners to offer secure, and even refrigerated, pickup points for building tenants, concentrating deliveries at single locations, thus providing more convenient service for some consumers. As one of its founders notes, "Why try to deliver to the home when 68 percent of the online consumers are at work all day?"

Inplex, a Toronto-based startup, entered the office-centered business several years ago by accepting contracts for centralized mailroom services in select office buildings. From that base, it began offering a multitude of services to tenant companies — and this year Web-enabled the services and further expanded its offerings. It now plans to roll out the model across all major North American cities.

One company approached us with a plan to use returnable lockbox containers that would eliminate the need for attended delivery. The company envisioned a business built on managing a circulating inventory of insulated, secure containers for use by any last-mile deliverer. The players we met with were uninterested in changing their current models to adopt a new lockbox system. However, tests of a similar idea currently under way in San Francisco — that hotbed of experimentation — suggest that the concept is far from dead.

Which company will win? As consultants, not oddsmakers, we'll pass on the chance to make specific predictions. The results will depend on the willingness and ability of company management to implement change — and investors' patience to let them try. Our recent visits to last-mile e-tailers show many (but not all) scrambling to address the fundamental economic challenges we identified last summer — with an aggressiveness we hoped for but would not have predicted.

Investors are another story. They continue to show impatience with business models awash in red ink — so the ability of companies to stretch their existing cash becomes paramount. Recognizing the great consumer value proposition of the last mile, we remain hopeful that some company will evolve rapidly enough to survive the treacherous terrain.

Closing Thoughts

Of course, there's far more to operating strategies than just delivery. We value feedback from our readers as we do from our clients — collaborative interactions expand our point of view and help us refine our thinking. We hope you will join us — and help us — as we explore the strategic operations issues facing companies today.

To help us set priorities (or simply to read us the riot act), you can send us your thoughts in an e-mail (laseter_timothy@bah.com). Alternatively, you can contribute formally to our ongoing survey on Internet-enabled operations innovations, conducted in conjunction with the Darden Graduate School of Business at the University of Virginia, by visiting our Web site at www.strategy-business.com/survey.htm. We look forward to learning from you. +

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