

EXECUTIVE SUMMARY

Much has been written recently about the so-called “Amazon Effect” on today’s retail landscape. As sales continue to shift from traditional brick and mortar stores to online, ecommerce based transactions, the impact to the transactional relationship between manufacturer and retailer has been significant.

This paper will focus on specific impacts to the returns or reverse logistics portion of that transaction that the explosive growth in ecommerce sales is already causing in the supply chain. Going beyond today’s headlines of store closures and drone deliveries, you will be provided with an understanding of how your items are showing up on sites like Amazon Marketplace via independent 3rd party resellers, the risks associated with this activity, and what you can do to mitigate this risk moving forward.

With the growth in ecommerce sales expected to continue, now is the time for manufacturers and retailers to react by putting a greater emphasis on their reverse logistics capabilities. This paper will demonstrate to the reader that the “Amazon Effect” on returns related costs is real and left unchecked, will have an increasingly negative impact on your company’s bottom line for years to come.

INTRODUCTION – The “Pendulum” in Reverse Logistics is On the Move

Reverse logistics has seen relatively few changes over the past 25-30 years but from time to time there are forces that enter the manufacturer – retailer transactional relationship that have had an impact on these processes and costs. As is often the case, a pendulum has been used to illustrate the “swings” that have occurred:

In 1990 when the processing of returns needed to move out of the back room of stores to a centralized location, return centers sprung up. Many would say that in this instance the pendulum, swung in the favor of the retailer

Later that same decade, manufacturers like P&G and General Mills were at the leading edge of an alternative program that was developed to eliminate the need for manufacturers to physically and financially accept returns at the end of a product’s life cycle. These adjustable rate policies or “ARP’s” paid retailers an allowance based on how that product was expected to perform in the supply chain tied to rates of damage and expiration collected during an auditing process of the supply chain. As adoption expanded steadily from the late 90’s and into the 2000’s, the feeling was that the pendulum swung back in favor of the manufacturer

Throughout this evolution in returns policies, the processing of, and financial reconciling of the costs associated with processing returns remained a constant source of discord in the industry. At the root of this discord are these two main factors:

- Allowance based programs being based on the concept of “shared responsibility” – determined by where and when in the supply chain an item and its condition at time of the audit (i.e. damaged in manufacturer’s DC, expired in retailer’s DC or damaged at shelf) a level of responsibility is assigned to the manufacturer, retailer or both, impacting the amount of the allowance calculated and ultimately provided to the retailer
- Final disposition of the product – regardless of the program (accepting returns, not accepting returns in lieu of an allowance) the exact disposition of the product and who would cover certain costs (i.e. handling, transportation and disposal), who should determine disposition, and who should potentially benefit from any recovering of value tied to liquidation have all contributed to, at times, what many in the industry would refer to as a less than optimal arrangement

From time to time, there have been various factors that have impacted returns that would warrant some sort of reaction from either the manufacturer, retailer or both, to reign reverse logistics costs back in. Sustainability, store level hazardous processing, mergers in both the manufacturer and retailer industries, and consolidations with reclaim service providers have all had some impact on returns related costs. Remember the example of the pendulum? Even with these factors coming into play, there really hasn't been any significant change with the position of the pendulum lately. That is until now.

The pendulum has started to move again and this time there is a force behind it unlike anything the industry has experienced up to this point in time impacting reverse logistics. That force is the growth of online sales, also known as the "Amazon Effect". This effect that Amazon specifically, and ecommerce in general, is having on reverse logistics is real, complex, and becoming more and more costly to contend with as these specific factors weigh in on the process:

- Sales are continuing to shift from brick and mortar to ecommerce
- Return rates are much higher for ecommerce sales so your blended rate of returns is increasing
- The composition of the makeup of your returns is changing
- Retailers are reacting to preserve profit by controlling the costs of reverse logistics
- Sites like Amazon Marketplace are making it very easy for independent resellers to move your product online

As a result, now is not the time to be passive about managing returns and reverse logistics. This paper will provide you with a greater understanding of the Amazon Effect on reverse logistics and how you can put certain controls and processes in place to better insulate your business from the rising costs of returns and reverse logistics. There is also a Business Case excerpt that uses a real-life example of how controlling the final disposition of your items takes on even greater importance in this ecommerce focused retailer landscape that looks to continue to be dominated by Amazon for years to come.

Understanding the "Amazon Effect" on Reverse Logistics

Just as the sun rises in the east, returns will continue to be a function of sales. Historically, from a pure brick and mortar perspective, manufacturers with a well-run reverse logistics program can keep the costs of returns as a percentage of sales to around 2%. Some of the best-in-class examples can get this closer to 1% of sales. From the retailer's perspective, it is not uncommon for the cost of reverse logistics to erode their profits by 10% or more.

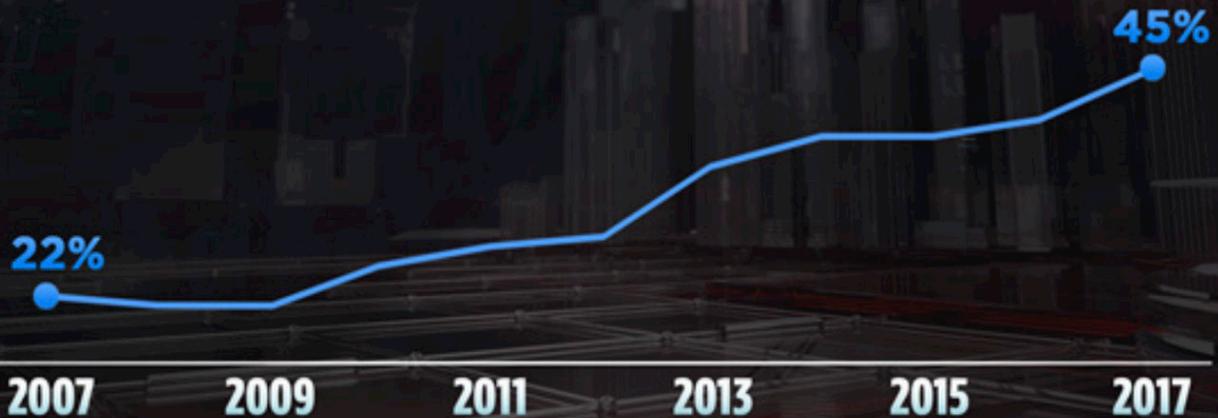
As many manufacturers and retailers are starting to realize, they are no longer managing these costs from the historical brick and mortar aspect as sales continue to dramatically shift away from brick and mortar to ecommerce.

The Shift in Sales from Brick and Mortar to Ecommerce

According to the U.S. Commerce department, ecommerce sales in Q3 of 2017 jumped 15.5% from a year ago to a new record of \$115 billion. Online sales now make up 9.1% of all retail sales, up from 8.2% a year ago. (Richter)

With this year's holiday season still top of mind, here is an interesting graphic that illustrates not only how prevalent online shopping has become this time of year but how it has doubled in only 10 years. (Reagan)

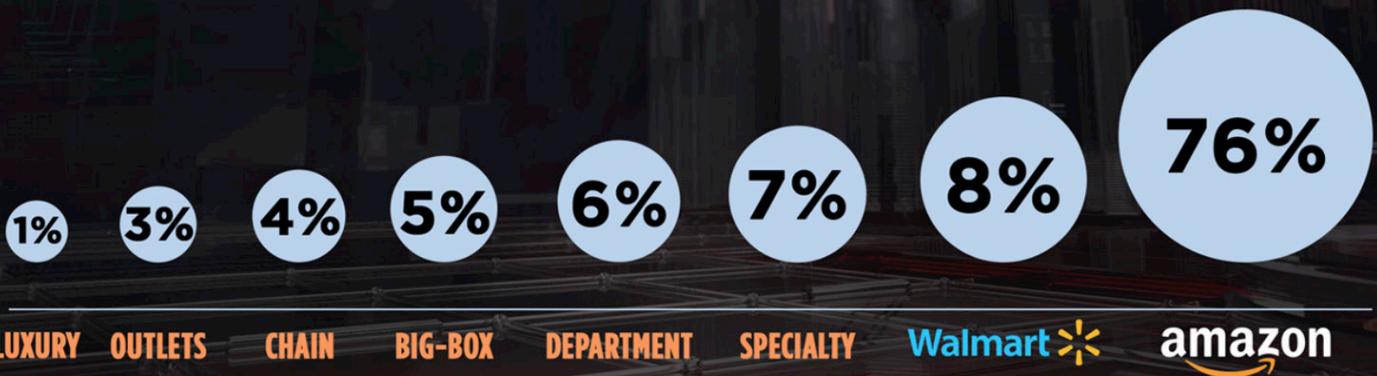
WILL DO MOST HOLIDAY SHOPPING ONLINE



In referencing the CNBC All-America Economic Survey, this same article also went on to show just how dominate Amazon is in this space with this next graphic below.

ON WHICH WEBSITES WHERE WILL YOU DO MOST OF YOUR ONLINE HOLIDAY SHOPPING?

UP TO TWO CHOICES PERMITTED



As you can clearly see, no other retailer comes anywhere near Amazon in the results of this survey. Technology continues to be a significant driver behind this growth as many consumers today access ecommerce sites from their smart phones and other portable devices. The convenience of no longer having to go into stores to shop has evolved from the PC to the laptop and now to these highly mobile devices. Behaviors online are also changing as more and more online shoppers utilize sites like Amazon and other marketplace sites as resources to research product information, pricing and reviews more so today than traditional search engines prior to making a purchase online.

The Impact This Shift to Ecommerce Sales Has on Returns and Reverse Logistics

As so often is the case, convenience comes with a price and in this instance, that price is in the form of higher return rates. Generally, return rates for online purchases are 2-3 times higher than in store and for certain categories, return rates can be up to 10 times higher online. As retailers continue to look for ways to stand out from their competition with the online consumer, the area of returns processing continues to evolve. For example, the concept of “buy online, return in store” continues to take hold with the consumer as ecommerce continues to grow and evolve. According to the United Parcel Service of America, Inc. 2016 report titled “UPS Pulse of the Online Shopper”:

Although 68% of online returners have shipped items back to the retailer, 60% prefer to return items to a physical store when given a choice. The reason for the difference may be based on the efficiency of the online return process. What used to be an intrusive process is now flawless among many of the best retailers.

As more of your sales are comprised of online sales, your overall returns will therefore increase. As more units are returned through existing store locations, many retailers are now faced with processing these additional units through their existing reverse supply chain.

The Overall Makeup of Returns is Also Changing Because of Online Transactions

In addition to an overall increase in the volume of units being returned, another dramatic change occurring in the reverse supply chain is with the mix of the different types of returns that retailers are now required to process. What we see happening is that “consumer returns” now comprises a larger portion of all returns when compared to the other types of returns historically processed in the brick and mortar space (recalled, damaged, out of date or end of life). Consumer returns tend to be more of the nature of “didn’t fit”, “didn’t work”, “color didn’t match photo online”, etc. Most times these items are still intact and therefore would make sense to return to stock to be resold at full price.

As retailers make it easier to return product via improvements to their websites, enhancements to apps, the ability to buy online and return in store, etc. and more consumers turn to ecommerce to make their purchases, what we are seeing is a convergence of factors that are putting pressure on retailers and manufacturers to better manage reverse logistics related costs and recoup value wherever possible to help offset these higher costs.

Retailer’s Reaction to Control Costs

Companies like Wal-Mart (acquiring Jet.com), Target (acquiring Shipt) and CVS (merging with Aetna) are deploying different strategies to answer the threat that has become competing with Amazon in the ecommerce space. Amazon is not standing pat either as they continue to evolve and implement strategies of their own to help maintain their leadership position. Their acquisition of Whole Foods is looked upon as a way for Amazon to leverage that physical footprint as an extension of both their forward and reverse supply chains.

But beyond these headlines grabbing moves, other, more subtle reactions tied to returns and reverse logistics are being implemented by many retailers including:

- Changes to returns policies that limit the manufacturer’s disposition options
- Erosion in return to vendor compliance (i.e. retailers returning to the vendor / manufacturer or their 3rd party processor less than what they claimed)
- Being faced with more returned units, retailers are becoming more reliant on a disposition of liquidate to extract as much value as possible to help offset their increase costs associated with higher returns

As more traditional brick and mortar retailers continue to evolve towards more of an omni-channel model to better compete in today's marketplace, reverse logistics is a natural place to look for cost savings.

To recap, here is what we have covered so far:

- More consumers are making purchases online
- Retailers are competing for these online consumers by making the returns experience easier, seamless and a competitive advantage
- More units are being returned as a result (2-3x more in general, some categories up to 10x more than brick and mortar sales)
- Some retailers are making it more difficult for manufacturers to get their returned products back
- More units returned in general and less of these going back to the manufacturer means more units liquidated into the secondary market

So, if you are a manufacturer in any of these categories (Apparel, Books, Electronics, Health and Beauty, Home, Toys, and Sports) there is a very good chance that more of your product is in the secondary, or even worse, the tertiary markets today because of the effects of ecommerce on the reverse supply chain.

Like the changes that we are seeing on the supply side of the equation, we are also seeing significant changes to the demand side that should have manufacturers very concerned. Once again, we are pointed in the direction of Amazon.

Amazon Marketplace and Independent 3rd Party Resellers

By now you are probably asking yourself what is happening with this product and where, ultimately is it ending up? Our access to and understanding of the secondary market indicates that the product being processed for reclaim by retailers is being liquidated to independent 3rd party resellers who are then using online marketplaces such as eBay and Amazon Marketplace to resell these items.

What should be of great concern for manufacturers is that the demand for this type of transaction is increasing along with the available supply of your product. This potential circuitous route that your product is taking is what we refer to as the Amazon Effect on Reverse Logistics. As Amazon continues to grow, so does the risk to your sales and brand equity if you are not securing your product. Just how large of an issue is this becoming? According to an article recently published on the website Sellbrite, in 2017:

- 40% of product sales on Amazon Marketplace come from third-party sellers
- In 2016, Amazon made \$23 billion in sales from third-party sellers
- How much do sellers make?
 - Annual sales
 - 49%: Less than \$100,000
 - 36%: \$100,000-\$1 million
 - 13%: \$1 million-\$10 million
 - 2%: More than \$10 million
 - Of that, less than 0.6% sell more than \$50 million

- Primary products sold by third-party sellers
 - 18% Home and Kitchen
 - 11% Toys and Games
 - 9% Books
 - 8% Health
 - 8% Beauty
 - 7% Electronics
 - 7% Clothing
 - 6% Sports and Outdoors (Ugino)

As a manufacturer, if you are not actively managing your reverse supply chain, how many of your items are finding their way into this \$23 billion and growing channel? How do we know that this is just the tip of the iceberg and is only going to continue to get worse? Because Amazon told us so! Earlier this year they stated that one of their strategic imperatives for 2018 was to grow their higher margin business units including Marketplace. (Stevens)

If you need proof that actively managing your reverse supply chain can be an effective deterrent against your items finding their way into the hands of these online resellers, the following business case excerpt reinforces how you can insulate yourself from this.

Conclusion

The reverse supply chain is undergoing tremendous changes because of the “Amazon Effect”. As more units are sold online, retailers are faced with the reality of having to process more returned units. Many of these units are intact and offer the retailer a chance to recover value through liquidation and is an effective source of revenue that can help offset the rising costs associated with the challenges of becoming more omni-channel competitive efficient.

3rd party resellers are then acquiring these items through retailer liquidation efforts at discounts of 80-90% off list cost. This enables the reseller to price your items at prices that are often lower than retail costs in the primary market, including “sold and shipped by Amazon”. Online consumer behaviors are changing as they use sites like Amazon to research items prior to purchasing. As they research price they are often directed to these independent resellers which is fine by Amazon as they have made this high margin business unit a high growth priority of theirs. (Stevens) Revenue growth from 2015 (\$16.1 billion) to 2016 (\$23 billion) for Amazon’s Marketplace was a robust 43%. (Ugino) Combined with the expected annual growth rate for ecommerce over the next 5 years being 9-10%, manufacturers must not be passive in managing their reverse logistics programs.

Therefore, manufacturers who want to avoid the risks (loss of primary and secondary channel sales, diversion, brand equity erosion) associated with their items becoming entangle in this situation must do a better job of securing their reverse logistics supply chains and control the disposition of their items to keep them out of the control of these 3rd party resellers. The below checklist can help you accomplish this:

- Update your returns policy to incorporate ecommerce transactions
- Ensure that you are dictating the disposition of your items
- Where it makes sense to do so, retrieve your returned items to retake possession
- Audit claims for accuracy (quantity, pricing, fees, etc.)
- Validate quantities returned to quantities claimed to ensure that you are securing your reverse supply chain

About DRS Product Returns

Celebrating 27 years in 2018, DRS has been a leading provider of Product Return, Remarketing, Financial and Supply Chain based Reverse Logistics solutions to the CPG industry. We provide our clients with the tools and strategies to secure their reverse supply chains to prevent any unneeded loss of profitability and to mitigate all risk associated with the return of your products.

About the Author

Jim Schumacher joined DRS in 2012. As part of the executive management team, Jim currently leads a team of industry experts who are passionate about helping their clients save millions of dollars each year through more effective oversight of their unsaleables management programs.

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