

Contract or Public Warehousing? The Wrong Question!!

Prior to 1980, almost all of the third-party warehousing in the United States was performed under 30-day agreements. How, and why, did this change?

Contract warehousing is the term used to describe a warehousing agreement having a term longer than 30 days. Public warehousing is used to describe the performance of short-term warehousing services, usually 30 days or less.

Why ask the question of which to use? The investment banking community has had an unprecedented interest in warehousing during the past decade. For those unfamiliar with the warehousing industry, the emphasis on contracts is natural. Contracts represent stability; therefore, a businessman who operates without one must at best be a speculator, and, worst on par with a river boat gambler!

The Historical Perspective

Contract warehousing was relatively rare in the United States prior to 1980. Early adopters were users of warehouse services having unusual requirements. For example, E. I. duPont de Nemours, one of America's oldest and largest producers of chemicals, was a leader in the outsourcing of logistics services during the 1960s and 1970s. The nature of its operations created a need for large warehouses in small communities, where its production facilities were located. Recognizing the unreasonable investment risk of developing big buildings in small towns, duPont offered its warehousing suppliers long-term contracts, in order to allow the construction to be financed. As duPont's business evolved from the manufacture of gunpowder to include consumer products, such as nylon and house paints, its need for outside warehousing increased. With that increase came an even greater use of contract warehousing than ever before.

Two events during the 1980s changed the supply chain management situation. First was the de-regulation of transport, which lowered the cost of moving goods, and allowed common carriers flexibility in their pricing and service offerings. This, in turn, increased awareness among senior managers of the advantages of outsourcing logistics services, including warehousing. For the first time, manufacturers and retailers were seeking to outsource giant distribution centers, not the small inventories in traditional public warehouses.

The second event was the scarcity of mortgage money. Major banks had taken serious losses in funding Latin American ventures, so the Federal Reserve tightened the money supply. The 1980s saw the worst real estate down-turn since the Great Depression of the 1930s. Management in lending institutions was pessimistic about real estate loans. The result was substantial nervousness, even timidity, in financing new warehouse construction.

With these events happening almost simultaneously, the only solution for both the warehouse operator and the customer was the development of long-term contracts that would provide the security that lending institutions required. Not only duPont, but a growing number of manufacturers and chain retailers, were seeking to outsource warehousing in a big way, requiring the construction of expensive mega-centers that could not be financed without a contract. The result was a rapid expansion of contract warehousing services, and a new generation of warehouse operators who were engaged exclusively in contract warehousing.

The Lodging Analogy

Everyone knows the difference between a hotel and an apartment. Apartment dwellers sign leases which can be long-term agreements. In contrast, few users of hotel services want the space for more than a few days, and contracts for hotel rooms are rare enough to be virtually non-existent.

Perhaps because they have been around since ancient times, hotel operators are not considered to be speculators. The risk that every customer can leave without notice is balanced by the fact that new guests will arrive at the well-managed hotel as fast as old ones vacate the premises. Furthermore, few hotel users would consider renting an apartment, because the space is needed only for a short time. As a result, hotels and apartments are not ever in competition with each other.

Public warehousing is like a hotel for merchandise. Its natural customer cannot commit to a long-term contract because of seasonality, or the need for maximum flexibility in space usage. Consider the producer of gift wrap, whose changing need for warehouse space corresponds to major holidays that include the highest volume of gift giving. Or, think about the packer of tomato products, who

builds inventory during the seasonal harvest each year.

How is it that the same investment banker who judges “the warehousing space” by the number of client contracts, readily will finance the construction of a hotel, which loses customers on a daily basis?

A Contract Written In Disappearing Ink

Many of the financial analysts who study the logistics service industry either ignore, or fail to recognize, the fact that nearly every contract existing between the warehouse operator and the customer can be canceled on short notice for operations failure. Nearly all contracts contain clauses enabling prompt separation in the event of unacceptable performance. They include a listing of *key performance indicators*, abbreviated as KPIs. Failure to maintain these KPIs, or to cure a defect after receiving notice, is grounds for termination of the contract.

One cynic described the typical warehousing service contract as a creative device used to fool the bankers.

Surveying The Market

Recognizing that trends toward public or contract warehousing are best discovered in the marketplace, we commissioned two surveys, one by each of the trade associations representing warehousing service providers, the International Association of Refrigerated Warehouses (IARW), and the International Warehouse Logistics Association (IWLA).

The methodology varied for each. IARW solicited opinions from ten of its more active members, and received responses from eight. IWLA sent an e-mail survey to 553 member executives, and received 112 responses. Although the methodology differed, responses from both surveys were strikingly similar.

The results indicated a mix of long- and short-term agreements. Only one IARW respondent reported that more than 50% of revenue was from three to five year contracts, and three of the eight indicated that more than half of their revenue came from 30-day agreements, or other contracts of less than 12 months. A substantial plurality of IWLA respondents, (44%), responded that 75% of their business was public, rather than contract warehousing. Only 38% reported that public warehousing was less than half of their revenue.

When asked about trends, the results were mixed. One IARW respondent observed that there is more demand for contracts when the supply of space is tight. Another pointed out that the larger customers are those wanting long-term agreements. IWLA respondents overwhelmingly reported an increase in demand for *both* public and private warehousing, and also predicted that an equal growth opportunity exists for both types of service. There is evidence that respondents recognized the “disappearing ink” feature in long term contracts.

Admittedly, there is a problem in surveying these trade groups. Many of the largest warehouse service providers are not members of either one.

A View From The Top

As a supplement to the two market surveys, we discussed the subject with the chief executives of four multi-city providers of logistics services. Each gave an

opinion about the relative future of public warehousing and contract logistics services.

All considered contract business to be the faster growing of the two options. Most recognized that public warehousing is in decline but definitely not dead. One told us that the larger users preferred contract arrangements, but the public warehouse model fits small and mid-range companies up to \$600 million in sales. Furthermore, believing that the smaller companies are more loyal customers than the larger, he prefers a 50/50 mix of public and contract services. Others prefer a ratio that favors contract warehousing, ranging from 70/30 to 90/10.

Higher margins are necessary for public warehousing because of the increased risk. One respondent observed that the smaller operators are better able to provide the personal attention that the smaller customer deserves. As his company has grown in size, it has become increasingly difficult for his managers to offer that level of service; therefore, his marketing is directed toward the larger users who want contracts.

Another executive described a shared environment in which contract and public warehouse customers are all kept under the same roof. He believes that the shared environment inherently is more practical than the use of a dedicated building for a single customer.

Another respondent described the continuing need for public warehousing in port cities, where many users cannot justify a long-term commitment for space. At the same time, the warehouse operator frequently is in competition with a municipal port authority that offers free storage for a short period of time.

Some respondents pointed out that public warehousing is best used to fill unused space in buildings that are under long-term lease or ownership. In contrast, the best dedicated warehouse contracts feature a lease that expires at the same time as the contract, enabling the logistics service provider to remain asset light. One executive responded that he would do as little public warehousing as necessary. None of them believed that public warehousing will disappear.

So What Is The Right Question?

If the question of whether to use public or contract warehousing is wrong, what is the right question? Longevity of customer relationships is a far better measure of stability than longevity or quantity of contracts. Therefore, the most important question that a prospective warehouse services buyer should ask his supplier is this:

How long has each of your top 25 clients been doing business with your company?

Which company is stronger: A public warehouse operator who has never lost a major account in the past thirty years, or a contract operator whose oldest client has been with him for less than three years?

Conclusion

While it is clear that contract logistics services have captured the attention of large companies, as well as the trade press, we found no evidence that public warehousing will disappear.

(Continued on page 3)

KEN'S COMMENTS

"We Have Nothing To Fear But..."



All of us know that we are living in a difficult time, and most of us are frustrated by the bad news we receive daily. We need the hopeful outlook of cheerleaders, exemplified by the letter written by Charles Kantner with AIP Logistics, that is reproduced below. If you like what you read, spread the word!

Dear Fellow Business Leaders:

As we reflect over the past three months, we've seen an unbelievable and unpredictable business climate. Future generations will study these turbulent times and learn from the collapse of commodity prices, stock prices, and the pending economic slowdown. As we move forward, we will eventually see business return to a new normal. The new normal undoubtedly will include a shift in consumer spending, causing some businesses to fail and some to prosper.

Our economy needs confidence, our employees need confidence, and we need to be confident. I believe that the American economy will persevere and eventually rebound. As business leaders we must look at our business life as a roller coaster ride and remember that the roller coaster never ends at the bottom of the hill.

As we progress into 2009, the successful businesses will lead, maneuver, rebuild, innovate, and charge into the storm. I believe that these are other important ingredients in this return to stability: communicating with and supporting our political leaders, continued business and personal spending, exhibiting a positive presence in our communities, and understanding what is ahead.

When thinking about what 2009 holds I often reflect on this quote by Henry Ford II: "Nobody can really guarantee the future. The best we can do is size up the chances, calculate the risks involved, estimate our ability to deal with them, and then make our plans with confidence."

Wishing all a prosperous and innovative 2009.



The Origins Of Commercial Warehousing

According to popular history, Joseph is the inventor of commercial warehousing. The Old Testament describes how this adviser to the Egyptian king interpreted the dreams of the monarch with his predictions of substantial crop surpluses followed by famine. Joseph's recommendation to build and fill food storehouses was applied successfully, and the management consultant from a nearby land became a local hero in Egypt.

Other evidence exists about warehousing in Neolithic times, around 8000 BC. Tom Standage, author of *A History of the World in Six Glasses*, described storage of surplus food in temples. Deposits of surplus food came to be seen as offerings to the gods, a practice that survives in Taoist temples today.

WAREHOUSING TIPS

A Declaration of Professionalism

Our thanks to Carlo Graffeo, of Colonial Electric Supply in suburban Philadelphia, for permission to publish this inspiring document.

We believe that professionalism in our company will be developed only as we, the managers, model and live out this example in all that we do. Thus, we will passionately strive to:

- *See our work as service towards others, both internally and externally.*
- *Be responsible and accountable for our speech and actions.*

- *Speak in a manner acceptable to the ears of a child.*
- *Keep agreed-upon deadlines.*
- *Return calls and other communications in a timely fashion.*
- *Treat company resources as though they were our own.*
- *Maintain a proper appearance and attire.*
- *Refuse to participate in, or condone, gossip.*
- *Persevere in the face of difficulty, without complaint.*
- *Seek solutions to problems and challenges.*
- *Treat every situation as a learning experience.*
- *Work harder at listening; seeking to understand, not merely be understood.*
- *Believe in the potential of our coworkers.*
- *Never give up!*

This document is displayed prominently on the company premises.



(Contract or Public Warehousing...Cont. from page 2)

While the contract business will have faster growth and may be more attractive for many users, the need for short-term public warehousing is just as pervasive as ever and it will remain so in the future.

For this reason, the majority of warehouse operators will find it necessary to offer both services. There are distinct and appropriate roles for both contract and public warehousing. The prime question is which approach is the best fit for any particular customer.

Cube Route To Better Slotting

By Peter Bradley, *DC Velocity*, Dec. 2008, pg. 79.

Provided in this article is a useful review of the advantages of using electronic equipment to capture the dimensions of every new product, then using that information to bring about effective use of space. Two sources of dimensioning equipment are referenced: Cubiscan and Mettler-Toledo.

The Role of Transportation In The Supply Chain

By J. K. Hazen & C. F. Lynch, ©2008, 322 pages. Available at www.ctsi-global.com.

This hardcover book is likely to find a place in the literature of education, as well as in business. The role of transportation in the supply chain, and the history of transportation regulation and deregulation are addressed within the book. A chapter is dedicated to each of the transportation modes, including pipelines, domestic water carriers, and special carriers. Other chapters are focused on pricing, management, and information systems, ending with a chapter about shipper/carrier relationships. Included in the appendices is a sample carrier contract. Full-color illustrations are found throughout the book. Each chapter is followed by several questions for the reader.

Positive Results Of Drugs And Alcohol Policy

By John Paterson, *Logistics & Transport Focus*, October 2008, pg. 20.

The author of this article is the human resources director at a British logistics service provider. His company uses an outside resource, Grendonstar, to conduct all drug and alcohol testing. They treat any drug or alcohol problem in the same way that they would treat an illness. Testing for substance abuse is carried out quickly, and in private. Any employee found to be under the influence can be invited to discuss problems either with a line manager or an external advisory service. The company recognizes its obligation to protect all of its employees while they are at work.

Loading Dock 2.0

By Mary Aichlmayr, *Material Handling Management*, September 2008, pg. 22.

Based on interviews with equipment vendors, the focus of this article is on the transformation of loading docks into "material transfer zones" that have critical importance in distribution center operations. Many older buildings have 8 foot by 9 foot dock doors that are not adequate to handle the newer trailers that are 8.5 feet by 13.5 feet. Included in the article is a dock maintenance checklist.

Top 10 Reasons Good Employees Quit

By Dan Charney, *Material Handling Management*, October 2008, pg. 48.

In a U. S. Department of Labor study, it was found that turnover can cost a company 35% of an employee's total compensation. The author, a search consultant, listed the following as the top 10 reasons people leave their jobs:

- ① The job was not as expected.
- ② Work/life imbalance.
- ③ Mismatch between the job and the new hire.
- ④ Management freezes raises and promotions.
- ⑤ Feeling undervalued.
- ⑥ Lack of decision-making power.
- ⑦ Too little coaching and feedback.
- ⑧ Management lacks people skills.
- ⑨ Too few growth opportunities.
- ⑩ Loss of faith and confidence in leaders.

Warehousing Salaries and Wages

Warehousing Education and Research Council, copyright 2008, 155 pages, Details available at www.werc.org.

This report is an update of the 2006 study published by WERC. It covers five hourly wage positions and ten salaried occupations. The 2008 and 2006 results are compared in an executive summary. Surprisingly, three of the salaried positions showed a decrease from 2006, and the wage increases for most of the hourly jobs were modest. In the 2006 study, 42% of the warehouses surveyed had one work shift, but the current study shows that only 32% are on one shift. Wholesaler/distributors accounted for 35% of the responses, and another 33% were from logistics service providers. The details in this study will be of great value to anyone concerned with benchmarking salary and wage compensation.

Employee Motivation

By N. Nohria, B. Groysberg and L. Lee, *Harvard Business Review*, July-August 2008, pg. 78.

The authors developed a powerful new model based on their belief that these four drives underlie motivation:

- The drive to acquire.
- The drive to bond.
- The drive to comprehend.
- The drive to defend.

Management should address these drives with effective reward systems, job design, and performance management processes. Also, the role of the direct manager is of critical importance.