UBS Asset Management

Running the last mile

The European logistics industry has seen significant growth over the past 10 to 15 years. The development of new technology and competitive online retailing has dramatically altered consumer behaviour. According to data from Eurostat, the share of the European population making a purchase online in the last three months rose from 28 percent in 2009 to 50 percent in 2018.

Naturally, this exponential growth has had significant knock-on effects on the distribution market. Pre e-commerce, the average consumer in Germany received one to two parcels a year; present day, this figure has shot up to 24. Distributors subsequently intensified their network coverage to accommodate higher parcel volume as well as shorter delivery times. Whereas, previously, a few centrally located regional distribution centres (RDC) were sufficient to serve an entire country, in an e-commerce age, this model is not sufficient to meet the demands of modern e-shoppers. As a result, most operators have now moved to a "hub and spoke" model, whereby a single RDC is connected with several smaller local distribution centres (LDCs) closer to large population centres. This model allows the volume of goods to be deconsolidated before being distributed further, allowing for the more granular nature of business-to-consumer (B2C) logistics.

Challenges to the last mile

As distributors are struggling to deal with capacity and congestion associated with increased parcel volume, this model is coming under increased strain.

The first issue involves the inevitable frictions of the supply chain. According to data from Parcelhub, 5 percent of European e-commerce deliveries fail the first time, costing the industry €1.64 billion a year. In addition, the reverse logistics required to process returns are more intensive than traditional retail distribution, as additional floor space is required to process unwanted items. UBS recently downgraded its price target for ASOS, citing increased investment required to secure customers and flat revenues per head. To further make this point, Amazon's operating margin is largely driven by the higher margin Amazon Web Services (AWS) business.

The cost of leasing assets in urban locations has also gone up significantly. Most major cities — despite the increasing volume of parcel traffic — have seen a net loss of industrial land over the past decade. As a result, competition for remaining sites has intensified, meaning there is a significant increase in rents closer to the city centre. This, in turn, means urban logistics in most major cities now run at estimated recovery value (ERV) multiples of two to three when compared with out-of-town markets. This trend is particularly observable in major European cities, such as London, Paris, Milan and Barcelona.

A further addition to the cost is the growing consumer preference for same-day delivery. According to data from Mckinsey, the cost of providing same-day delivery over next-day adds a further 30 percent to logistics costs. However, the costs of transportation and inventory-carrying already amount to nearly 75 percent of the operating costs of an average distributor. Therefore, should this persist, many distributors will struggle to compete.

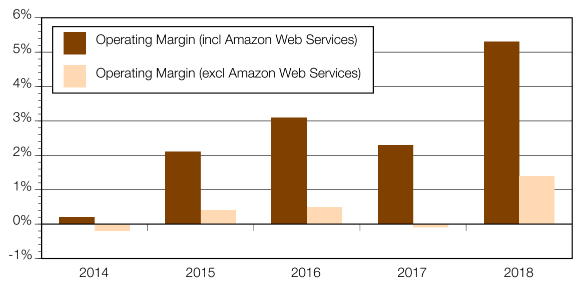
There are also question marks as to whether the industry will have the human capacity to sustain this model. Deutsche Post recently estimated that to meet the demands of expected e-commerce eight years from now, 100,000 additional delivery drivers will be required. In fact, many European companies are already reporting driver shortages. Given the relatively low prestige of the logistics profession and Europe's ageing population, it is highly improbable recruitment will reach these levels putting upward pressure on labour costs.

Finally, the environmental cost of last-mile logistics must be considered. Data from the UK indicates that miles recorded by light commercial vehicles have increased by almost 100 percent over the past 25 years. Several cities have already taken measures to curb the use of polluting vehicles, while the UK government recently declared it would be carbon neutral by 2050. Therefore, a system relying on petrol-operated vehicles is unlikely to be sustainable long term, either from a regulatory or an ecological standpoint.

Is the model defunct?

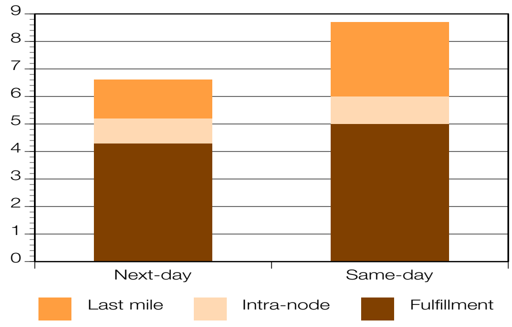
The good news for distributors is that there are solutions to these problems.

Amazon profit margins (%)



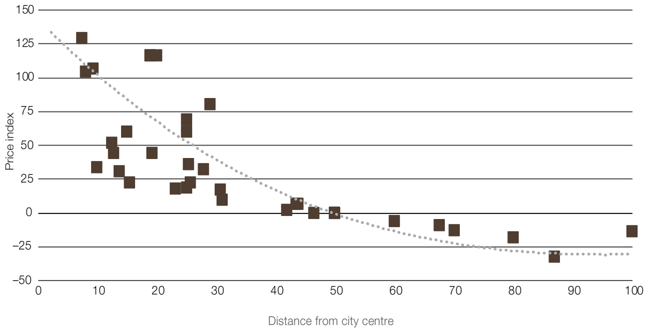
Sources: Amazon company accounts; PMA, June 2019

Cost of delivery (euros per delivery)



Source: Mckinsey, 2019

E-commerce growth in Europe



Source: Prologis, 2019

Firstly, it is inaccurate to say that the typical modern consumer needs "everything, now". According to a survey conducted by Postnord, most European consumers are happy to wait three to five days for a package to arrive, whereas only a minority required it to arrive within one to two days. Moreover, the expected delivery time varies massively according to product. Whereas grocery shopping must be fulfilled quickly, very few people would expect a sofa to be delivered within such a narrow timeframe — particularly as they will need to dispose of the old one first! Evidence also suggests that consumers are not willing pay for super-fast delivery, so providing a range of options (such as collect in store) will most likely nudge shoppers towards an equilibrium point between convenience and cost.

Many of these issues can also be solved by central and local government by ensuring there is a cohesive industrial plan that protects urban logistics zones. More creative solutions are needed; for instance, if roads are congested, why not use rivers or rail? This would make sense in European cities, which historically have been built around major rivers and have extensive rail infrastructure. A lack of urban logistics space can also be offset by mixed-use residential/industrial developments — so-called beds and sheds — as well as multi-storey warehouses.

Also, the issue of failed deliveries can be reduced by greater use of "in absentia" solutions. Delivery lockers have been very successfully used in several European countries, and locating them in shopping centres can boost sales in bricks-and-mortar stores, as well. Less developed, but equally powerful, are "behind-the-door" solutions, such as Smartlocks. Smartlocks are a mechanism by which customers can give delivery drivers temporary access to the house to leave items. Trials have shown that while consumers were sceptical at first, approval ratings increased significantly after the first few deliveries. Leaving items in car boots is a less intrusive alternative and suitable for rural locations where most people drive.

ESG considerations are a huge challenge, but the impact of the supply chain can be lessened by using green vehicles, such as electric cars and bikes. While electric vehicles have high upfront costs, they should prove economical in the long term due to reduced fuel costs. Technology can also play a role in making a route more efficient; a good example of this is a UPS scheme, wherein drivers are only allowed to turn with the direction of traffic. This minimises braking and acceleration and reduces fuel consumption.

Finally, the expected shortfall in human drivers may be offset by the use of robots and driverless cars. Most operators believe drones are unlikely to feature in the short-to-medium term; however, there are already several companies experimenting with delivery robots. Deutsche Post, for instance, is already using a "follow me" delivery robot, which allows older delivery drivers (especially relevant with fewer younger drivers entering the profession) to carry much greater capacity.

Evolution, not revolution

There is not the space here to exhaustively consider all the innovative approaches to reforming the last mile. However, it is clear that the current format of last-mile logistics is not sustainable long term due to environmental, financial, regulatory and human constraints. However, e-commerce is here to stay, and logistics companies will need to find more efficient ways of making smaller value, more frequent deliveries. Fortunately distributors are generally very innovative, having always had to deal with wafer-thin margins. There is already a lot of progress in addressing the major issues, particularly in the areas of smart data use and automation. The last mile of the future will be greener, more automated and more tech-enabled than the first generation; but it is unlikely to undergo a sea-change from its present form.

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