

# Drop Shipping Done Right

## Three Key Priorities for Success



**Allowing vendors to** ship merchandise directly to a retailer's customer, called drop shipping, can be an attractive option for expanding the selection of merchandise available for purchase on a retailer's website. When used correctly, a drop-shipping strategy can reduce distribution and fulfillment costs and even improve service levels within the supply chain. However, if the rules of engagement between the retailer and vendor are not clear, drop shipping can hurt profitability and jeopardize the customer's overall experience and loyalty.

Based on our client work, Kurt Salmon has identified three priorities every retailer must consider if they plan to include drop shipping as part of their business model.

**PRIORITY ONE:**

**Understand when drop shipping makes sense—and when it doesn't**

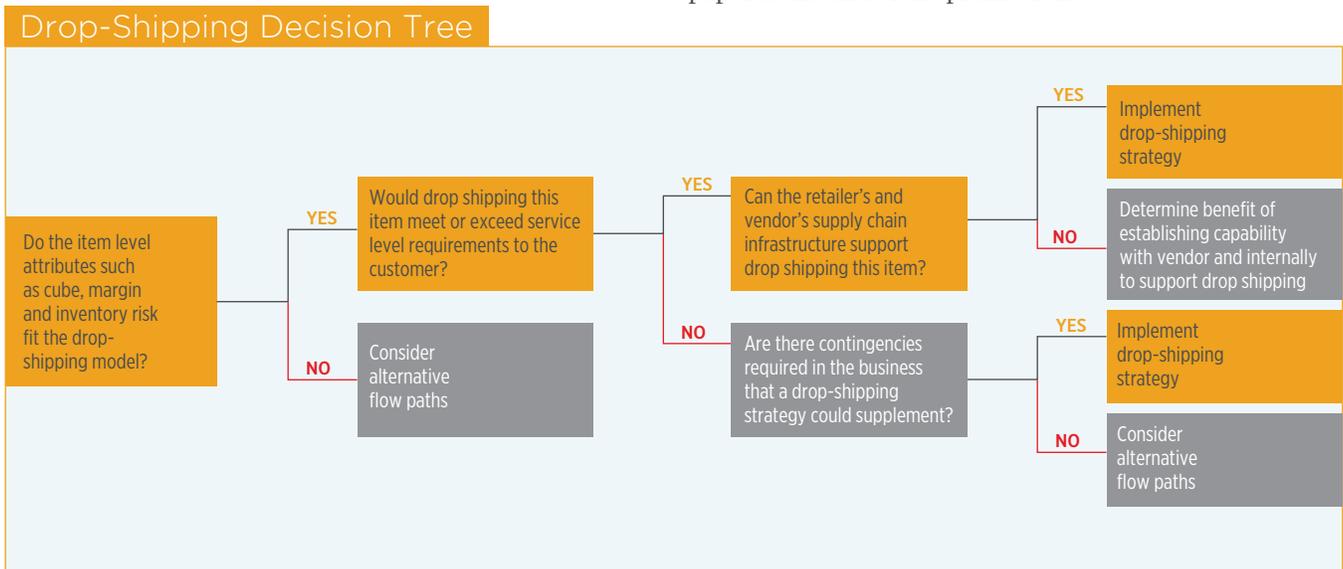
One of the benefits of a drop-shipping strategy is enabling a wider assortment of merchandise without incurring the associated cost and risk of carrying the inventory in-house. Further, a drop-ship agreement with a vendor can improve service levels to customers. For example, the vendor may be able to fulfill a backorder on the retailer's behalf rather than having to wait for the replenishment back into the retailer's network. Ultimately, the decision to implement a drop-shipping program will come down to the analytics and implications between the comparative cost and service of a drop-shipping inventory model versus the associated margin and inventory risks.

Often, drop shipping is a natural fit for large or heavy items, which typically ship alone. The shipping and handling are relatively straightforward, and often it is logical to break this particular order line out from other, smaller items purchased by the customer. However, drop shipping can be applied profitably to many other types of products.

To model whether or not drop shipping is the right option for a particular SKU or category, rigorous analysis comparing cost, service and other factors between in-house and vendor fulfillment is necessary. In fact, the rigor of this analysis is where Kurt Salmon has found many

retailers fall short. Cost comparisons include obvious factors such as the cost of holding and shipping inventory in-house versus the total cost of drop shipping from the vendor. Not so obvious factors include costs of splitting order lines, SKU affinities, regional SKU and service level profiles, etc. Above all, remember that the customer is still going to pay the same competitive price regardless of fulfillment source. Kurt Salmon has seen more than one client's eyes pop when they were shown the real cost of their drop-ship program. But when applied correctly, drop shipping can be an exceptionally powerful tool: One big-box client found tremendous gains from increasing their drop-shipment footprint—improving both margin and service to customers.

Outside of pure cost and margin analytics, it is also important to factor promotions into the drop-ship equation. One mass retailer that drop shipped about 40% of its assortment from different vendors was already feeling pressured by razor-thin margins. Their customers paid only one shipping charge per order, but the retailer was actually paying two or three separate shipping charges from different fulfillment sources for each order. Adding a free shipping promotion on top of this destroyed whatever margin remained and created a very red result on paper at the end of the promotion.



## PRIORITY TWO:

### Develop a rigorous vendor training and management process

As retailers build an expansive online assortment, it is not uncommon for them to have thousands of vendors. Some may never be suited for drop shipping, while others may be a good fit. To protect the customer experience, it is absolutely critical that a retailer implements a vendor certification and management program. Vendor certification and management does not necessarily mean vendor compliance. Rather, vendor compliance should assess a vendor's capability to support a retailer's drop-shipment model and ability to deliver outstanding customer service.

When assessing a vendor's ability to be a drop-ship partner, it is important to understand their capabilities, including ability for technology integration, maturity of their business, flexibility in their supply chain network and capacity. Leading retailers will often group their vendors based on their abilities, service level offerings and history of working together. Regardless of level, all vendors must be held to the same documented performance expectations, exception rules and compliance criteria.

- » A-level vendors are those who are ready at a moment's notice to sign up for a certain volume of products and be able to deliver 100% of them on time and to the retailer's service standards.
- » B-level vendors have had some success fulfilling orders to the retailer's standards, but the relationship has not been flawless. Selectively drop ship from these vendors.
- » C- and D-level vendors are either brand new or have a history of underperforming. Drop shipping small volumes from these vendors is acceptable, whereas large volumes may require in-house fulfillment.

Depending on a vendor's capabilities, some retailers may feel more comfortable keeping a small reserve of the drop-shipped product in-house to minimize risk. One of Kurt Salmon's department store clients holds two weeks of safety stock for its highest-volume drop-shipped products, but for low-volume drop-shipped products, they determined that it was not worth the inventory holding costs to keep any stock on hand.

Certifying vendors that are allowed to drop ship is only the first step; maintaining and managing the vendor program is just as critical. Keys to success include thoroughly documenting expectations, regular communication, and establishing easy to understand metrics and feedback loops.

The most successful vendor management documentation is long enough to clearly set expectations, but short enough that a vendor is able to be a profitable complying partner without needing a Ph.D. to understand the requirements. This document should include:

- » Payment terms and invoicing
- » Legal requirements
- » Packaging and merchandise label/ticketing requirements
- » Systems requirements
- » Purchase order and ASN requirements and exceptions
- » Testing and exception management processes
- » Shipping and routing
- » Compliance management and escalation

But having clear, detailed documentation is not enough to manage a vendor program. The way in which a retailer establishes their relationship with the vendor will also heavily influence outcomes. Some retailers choose to be a "coach," rewarding positive behavior and working collaboratively toward the same customer experience goals. Others choose to be a "hammer," enforcing rules and penalties for not complying. Often, the coach approach leads to greater success, but every now and then, the coach needs to be a hammer.

### PRIORITY THREE:

#### Close the loop around customer service

The ultimate risk of drop shipping is that a vendor will be unable to deliver quality and customer service that meet a retailer's standards, leaving the brand vulnerable.

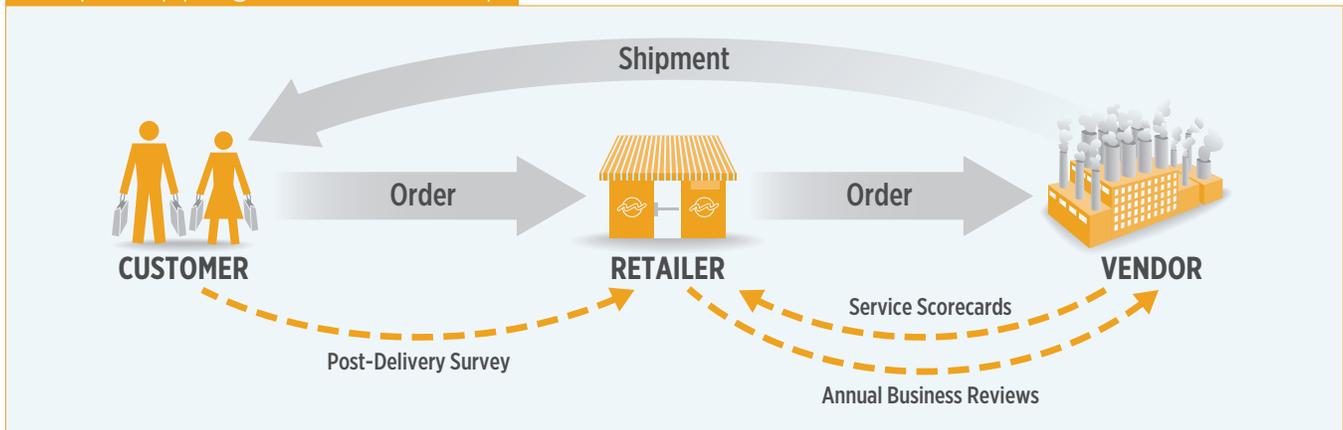
To combat a poor customer experience, leading online retailers strive to control as much as possible the process that is visible to the customer. For example, the retailer will control the timing, frequency and messaging of all customer communications; require a vendor to use certain packaging; and, above all, ship within the service levels promised to the customer.

Delivery speed is imperative. It may be difficult for some vendors to meet certain service levels with their own supply chain network, especially because their distribution infrastructure is often set up to support a wholesale business. However, many larger vendors are investing heavily in DC technology to support their business, and as they do so, service risks may decrease. In fact, a recent Kurt Salmon survey of retailers' online fulfillment found several cases in which a drop-shipped product arrived days before a product that came directly from the retailer, despite ordering the same items at the same time.

Regardless of what a vendor promises in terms of service level, it is of course essential to make sure they are actually delivering against that promise. To accomplish this, many retailers create feedback loops with their vendors to create commitment and follow-through on all service expectations. To this end, one approach is creating a service scorecard and review process, which includes customer follow-up and post-shipment surveys. Kurt Salmon also encourages retailers to test the vendors firsthand by ordering products to be delivered to their own homes. These random checks can help illuminate any service issues from the standpoint of a retailer's pickiest customers—its own staff. In the end, continually providing feedback and coaching to vendors will ensure a retailer's coveted customer experience is not sacrificed.

As retailers look to expand assortment, improve service and cut costs, the trend of vendor drop shipping will continue to grow. By understanding when drop shipping makes sense and coaching vendors toward excellent service, retailers can make sure their drop-shipping strategy is paying off. ♦

#### Drop-Shipping Feedback Loop



#### AUTHORS

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