KENCO

THE IN-DEPTH GUIDE TO 3PL PRICING

and how to estimate your logistics costs

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1. Introduction to the In-Depth Guide

Whether you've decided to do some research on your own or your C-suite has asked you to report on current or projected costs, you're in a place where you need to know exactly what's written on your logistics price tag. You've likely crunched a few numbers and taken a good, long look at operational costs, but you're wondering if you're really getting the whole picture.

A common issue with estimate projects like these is even skilled logistics professionals are often too close to in-house processes to be accurate.

> If you're used to more holistic strategy when it comes to operations, you might accidentally overlook or combine costs where they shouldn't be combine.

When you approach anyone in any business and ask about their pricing model, the number one response you will get is, "Well, our industry is complicated. We can't get into the minutiae of how we price until we see your proposal."

Now I won't say everyone is wrong, but the bigger issue is, yes it is complicated––but every industry has consistent guidelines that can be discussed and mentioned. The following document is not intended to be a "how-to" document to create the cost structure for a warehouse operation. The information that follows includes guidelines and rules of thumb to be considered when pricing an account.

For the most accurate picture of what your logistic costs should be and how much it would cost for you to work with a 3PL, you'll need a neutral third party to assess where you're showing success, where you need improvement, and the best ways to make everything happen seamlessly. That's exactly what we've set out to do today.

When you're reviewing your operations and the consideration for outsourcing, there are two important costs that make up 90%+ of your logistics spend:

1. Space

2. Labor

In many aspects of business, prices are easy to pin down––$X amount for X units of a product, $Z cost for a forklift, and so on. The holistic cost of a distribution center is not as straightforward, large in part due to its operational complexity.

You've likely grappled with questions like these throughout your career:

- ✔ What are my true storage costs for product?
- ✔ Am I storing my products efficiently?
- ✔ Is the layout of my current logistics facility the right one for me?
- ✔ Are we paying too much for the space we have?

With estimates and zeros and all the possibilities of room for unexpected costs, pricing your logistics can be overwhelming. **This is exactly why so many companies trust a 3PL to manage their logistics operations.** The 3PL is the expert in process, training, technology, labor management, and cost reduction.

Working with a 3PL will also easily bundle “unseen” financial concerns such as:

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1 Cost of staff and operational readiness

With a 3PL in your corner, you won’t have to wonder if your order volume can be handled properly.

2 Cost of scaling your operation

If your company grows or needs to temporarily scale back their logistics, it won’t throw your in-house operations into a chaotic rebalancing.

3 Cost of determining best methods

While your company might not have accounts with all major carriers, 3PLs typically do, giving both you and your customers more options.

4 Cost of opportunity and discovery

A 3PL has the experience needed to spot room for growth, change, and cost savings without the need for a targeted assessment each time.

5 Cost of recovery in unforeseen situations and markets

From hurricanes to dock worker strikes, logistical nightmares do happen. A 3PL has the agility and know-how to quickly deploy an “Option B” for logistics that your company might not have otherwise considered.

6 Cost of experience when branching to new regions or countries

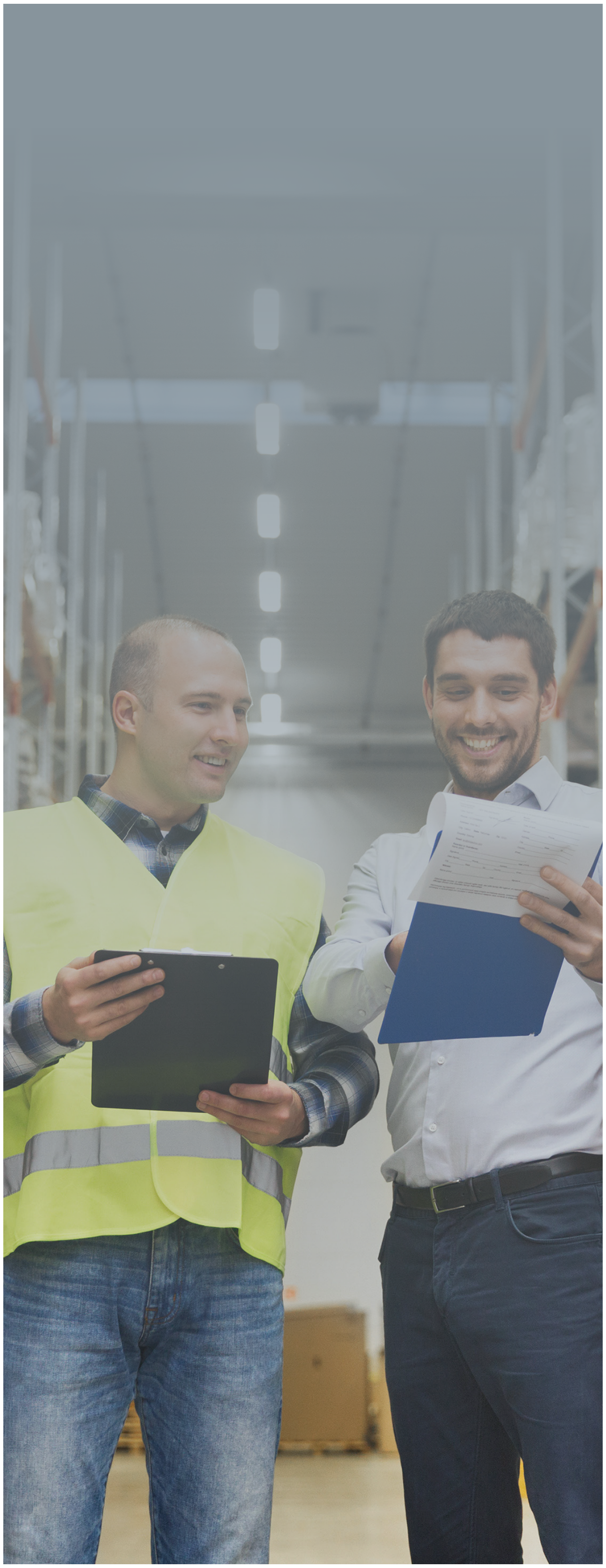
Whether it’s the next state over or going global, expansion shouldn’t be a solo effort.

7 Cost of professionalism

When your in-house logistics struggles to keep up consistently with demand, that damages your brand. Relying on a 3PL to keep things running smoothly means you provide better service to your customers, which in turn means repeat orders and recommendations.

While these aren't the type of benefits that come with a concrete price tag, they're still costs which can make or break a business in any market. Shoring these up in your favor by teaming up with a 3PL should be considered insurance for success.

> With the right 3PL, you're gaining a partner who not only understands your goals and needs but one who can grow your operations faster and more efficiently than you could ever do on your own. They know the ins and outs of the business, areas of wasted cash flow you can eliminate, how to best spend your resources, and let your team focus on the products that fuel your operation.



2. Costing of 3PL Operations:

Pricing starts with the customers' operational information. The more accurate that information is, the more accurate the 3PL's costing solution will be. It is in the interest of all parties to ensure the data provided to the 3PL makes sense. In creating an effective pricing for any operation, the primary activities are data gathering and process flow.

First and foremost, the goals must be determined. What are your goals and goals of the 3PL for the operation for which the pricing is created––efficiency of storage or workforce? A key consideration to effective pricing is the relationship between handling and storage requirements. These two warehouse functions have opposing requirements.

Configurations that maximize the space utilization can make it more complicated and inefficient to pick orders. Large storage areas increase the travel distance and reduce picking efficiency. Also, ideal case or each picking calls for small amounts of inventory in dedicated pick locations, which increases the space required. This is contrary to efficient storage density. The pricing must reflect these characteristics.

So, there are three choices:

1. Minimize space

2. Minimize Labor

3. Minimize total cost

Unless specified, the 3PLs pricing process should create a model that is a blend to minimize the total cost of the operation. The questions your 3PL should asked are:

- **Does this layout need to emphasize storage density or productivity?** You cannot maximize both; almost every improvement in storage density increases labor requirements and vice-versa.

- **Do all stakeholders want the lowest overall cost?** The easiest way to determine the lowest overall cost is to use the pricing model for what-if scenarios. This process can model the business considering overall costs. It takes into consideration the cost of money to finance rack and equipment, the cost of the space-related expenses, the labor to run the warehouse, the cost of working capital on that labor, etc.

Another factor in the process is risk.

How much risk are you or the 3PL willing take on? The chart below explains the different pricing approaches and the level of risk or shared risk involved in each. The level of risk will dictate the level of management fee used in the proforma. Higher risk relates to a higher management fee charged by the 3PL.

Cost Model Options			
Attribute	**Management Fee**	**Unit Rate**	**Fixed/Variable Hybrid**
Gainshare Program	Yes; Savings split mutually agreed upon by the parties and defined in contact	No	Project Dependant - Projects affecting "fixed" labor resources and/or pass through expenses eligible for gainshare program
Risk Level (for 3PL)	Low; 3PL accepts lower profit via fixed management fee in exchange for less risk that may be associated with volume swings and/or business changes	High; unit rates are fixed and therefore volume swings can significantly impact 3PL profitability in either direction. In exchange for higher risk level, 3PL typically expects a higher profit	Medium; risk is limited primarily to variable resources, which can be more easily reacted to than fixed resources
Risk Level (for Customer)	Medium; some customers feel that this pricing alternative does not drive spirit of improvement with 3PL since the return, albeit low, is guaranteed; risk is often offset by gainshare programs	Medium; unit rates are fixed and customer can anticipate expenses based on volume; unit rates are dependant upon order profile and volume assumptions; changes typically trigger re-pricing	Low; customer and 3PL jointly agree upon staffing level for fixed resources; expenses for variable expenses can be easily anticipated based upon volume
Continuous Improvement Savings	After gainshare agreement time limit is exceeded, all savings go directly to the customer	All labor related savings go directly to the 3PL; supplies and other pass through cost savings go to customer	Project Dependant; after gainshare agreement time limit is exceeded, savings associated with variable labor and/or pass through expenses go directly to the customer
Fixed Fees	Management fee and G&A would be fixed for the five year term	Unit rates guaranteed as long as order profile and volume assumptions are within tolerance; business changes trigger pricing review	Management fee and G&A associated with fixed expenses are fixed for the five year term; unit rates guaranteed as long as order profile and volume assumptions are within tolerance
Price Increases	Typically apply to labor COL adjustments, benefits, and any other pass through expenses only	Increases tied to profile and volume changes	Increases are passed through on fixed expenses; increases related to unit rates are tied to profile and volume changes
Price Caps	Management fee and G&A are capped; labor rates can be jointly assessed and agreed upon; market driven pass through expense caps cannot be anticipated	Caps are tied to business profile	Management fee and G&A for fixed expenses are capped; labor rates for fixed expenses jointly agreed upon; unit rate caps tied to business profile

Ultimately, you and the 3PL are tasked, either separately or jointly, with determining the pricing method (cost plus, fixed-variable, unit rates, gain-share, etc.) and the level of risk that exists in the operation.

3. Understanding Space Costs for Logistics

Breaking Down the Costs of Your Space

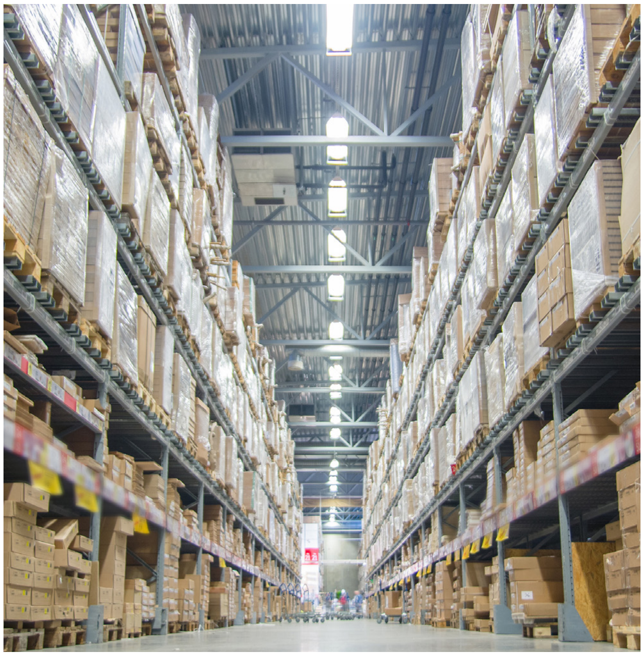
When your logistics partner calculates the cost for storage of your inventory, to determine that cost, the 3PL must first know how much space is needed. The square footage could be given if the operation is an existing operation. If not, the 3PL must calculate the amount of space required to run the operation.

To do so, there are some options to be considered. A few of the considerations are:

- ✔ **How does the product store?**
  - **Rack storage**
  - **Floor-storage**
- ✔ **Elements that play into the decision on racking versus floor stackage are:**
  - **Outbound order flow**
    - Velocity analysis on inventory (ABC velocity by SKU)
  - **Stackability**
  - **Inventory turns**
  - **Number of SKUs**
    - The greater the SKU count, the higher you can expect the honeycomb will be, and the greater consideration should be placed on racking.
    - How wide does your aisle need to be, which is determined, in part, by the type of equipment you need to use on the handling side of the costing.

Additional to these decisions, the capacity planning needs to be reviewed. If the building gets beyond 85% full, then this starts to impact the productivity. And the building must be big enough to handle the peak inventory with consideration for seasonality. Bottom-line, allow your warehouse to become too full, your operation suffers; too empty, and you can't afford to pay your rent.

> You must decide how full is truly "full" and how profitable space is while still being as efficient as possible.



Thankfully, 3PLs bring a measure of predictability to the mix and an understanding of the elements that go into the costing of a logistics requirement.

Once these characteristics are understood, and space is known, the cost of operating in that square footage can be calculated. Along with the cost of the space itself for storage, other costs included the indirect space (space not used as storage, such as the front dock), aisles, pallet rack, building-related costs (such as building maintenance, utilities, sanitation, waste disposal, etc.), insurance, taxes, and landlord expenses like common area maintenance and building upkeep. All of these costs are in your operation and would be in the 3PL cost structure.

> For enterprise and large-scale operations, this could mean estimating figures in the hundreds of thousands of dollars per month.

4. Understanding Labor Costs for Your Logistics

Labor is a raw material you must consider as part of your supply chain costs. Some questions that will help you determine the ultimate cost of your supply chain labor include:

- **How much does it cost, approximately, to serve a potential customer with my goods or services?**
  - While this won't affect your labor cost proactively, it's important information to have for determining what you can––or should––pay for your labor costs. Ideally, you should be striking a balance between offering fair wages and expecting superior service.

- **What level of efficiency can I expect as my labor cost increases or decreases?**
  - Is your company willing to accept lower output for higher cost savings? How will that impact your brand reputation, if so?

- **Are my expectations for labor versus what I can pay realistic, industry-wise?**
  - As with opportunity costs, the unseen costs of underpaying or overpaying for labor can have detrimental effects on your overall logistic efficiency.

One of the most immediately beneficial ways a 3PL can help both determine and reduce or stabilize your logistics costs is best explained in a single word: standardization.

Much of the wasted time, effort, and budget that slips through your company's operational fingers is found in the gap between your current state and the desired one. The 3PL will provide expertise to determine what is wrong, what needs to be done to correct it effectively, and communicating the results of solutions to ensure there is not a repeat of the issue.

Consider the basic processes performed on product handled in your warehouses:

- How much does having access to those processes cost your company?
- You'll also need to account for indirect time at the start and end of each shift. For instance, performing a pre-shift inspection of the forklift, battery change, or attending a start-up meeting.
- Additionally, it is not reasonable to assume every person is capable of working at the same speed throughout the day, or at the same speed of every other person.
- What about the ramp-up time allowed for new associates to get up to speed while training? How do you account for this labor cost?

It is wise to look at all of the costs on your general ledger to see which costs can be allocated to space, and which can be allocated to labor. Those that cannot be allocated to either should become "overhead" and allocated to your bid as a known percentage.

From the 3PL's perspective, for them to accurately determine what staffing is needed to support your operation, they will need to know information such as:

- ✔ What does the inbound product coming into the facility look like.
- ✔ Picking and order configuration.
- ✔ Process, materials, and information flows.
- ✔ Inventory and storage strategies.

All this information will allow you to determine what constraints you should consider, and ultimately drive you to a proper product flow.

Once you understand how the operation functions, the next step is to develop the feasible alternatives to satisfy the projected business requirements.

These alternatives would take into consideration the:

1. **Holding requirements:**

   The size of the inventory on-hand. Unless the inventory is 100% stable, the operation must be designed for high, if not peak, inventory level.

2. **Workflow requirements:**

   Everything from how product arrives, to how it leaves the facility and everything in between. The objectives of this aspect of planning are to minimize product handling, to reduce travel distance as much as possible, and to minimize the resource requirements.

3. **Future requirements:**

   Accommodating growth in the form of a higher volume of existing SKUs, increase in the number of new SKUs, more orders, more customers.

4. **Other requirements:**

   The availability of capital, existing information systems resources and limitations, risk management, flexibility, and the level of uncertainty about projections.

Using all of this information, the most appropriate solution can be determined/evaluated to satisfy the account requirements.

Potential considerations for storage and operational types are:

Low Pick / Low Storage:	Low Pick / High Storage:
A simple warehouse with floor-stacked pallets or basic pallet rack.	High-density storage and a manual or semi-manual picking process.
High Pick / Low Storage:	**High Pick / High Storage:**
The picking area should be the primary focus, with possible picking automation. Storage would be a simple configuration.	A large active warehouse, with consideration for automated picking combined with high-density storage.

All this information creates the best operational configuration for the activity type and flow of the facility. This flow directs the determination of what staffing and material handling equipment are needed.

This is where your 3PL should truly shine; a balanced, customized warehouse management system (WMS) along with the customized layout flow, and the right material handling equipment would help you automate best-case, efficient placement of your items based on sales volume and frequency, for example, and options like moving overflow to an auxiliary shared warehousing solution can free up valuable space in your in-house facility, too.

5. How Can a 3PL Help with These Costs?

Partnering with a 3PL gives your business a simple, straightforward number that's as close to an all-inclusive service as a complex supply chain can get. This number can then be used to find the per-item cost, giving you the same data flexibility without the risk of missing key financial information.

To put it another way, some businesses still believe the price of a service is comprised of the cost to serve the customer plus the profit you desire. Unfortunately, there's a fatal flaw in this formula.

(cost + profit = price)

Customers aren't typically willing to pay for inefficiency, waste, or non-value-added activities, yet it treats the price as the variable. A more successful way to think of the profit model would look like this:

(price - cost = profit)

This flipped formula considers price as something being driven by the market, while cost is being driven by the effectiveness of the company. This is the mindset that works best in operations. It does so because rather than passing the near-limitless financial blame onto the customer in the form of an inflated price attempting to justify itself, it takes ownership of setting the cost as the variable.

3PLs ascribe to this more accurate mindset by driving value through cost reduction, working with customers like your company to find the best way to achieve goals within the constraints of a mutually-established budget.

6. To Sum It All Up

Your 3PL pricing and logistic costs will depend on how you answered the aforementioned questions in Part 1 and 2 of this article:

- **How much space do you need?**
- **How much time (labor) will it take to fulfill orders in your spaces?**
- **What are the other labor costs associated with your work––such as time off, variations in efficiency, training time, and overhead costs?**

Also, you will have the investment of your 3PL partner's expertise. How many people on their team are dedicated to your account? What level of knowledge do they bring to your partnership? How much cost-savings and efficiency do they bring to your relationship?

> When thinking about this part of your costs, it's essential to remember that a positive 3PL partnership should result in positive return on your investment in that team. You should see reductions of costs, waste, and inefficiency that would otherwise continue to drain your resources if you didn't invest in the expertise of your 3PL.

Don’t let your profitability veer off course or slowly drip away: to revolutionize the way you approach logistics, submit an RFP below to our logistics team.

Once you determine the cost for your facilities, you’ll be able to start working at shaving costs and tightening up efficiency with your 3PL’s capabilities, rather than struggling to justify or “band-aid” operational costs after the fact.

Submit your RFP to our logistics team today, contact Kenco at **1-800-758-3289** or visit us at **KencoGroup.com**.

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