Contract or Public Warehousing? The Wrong Question!

By Ken Ackerman

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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, at 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 deregulation 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 downturn 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 that 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 nonexistent.

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 for only 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, will readily 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 10 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 percent 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 percent) responded that 75 percent of their business was public, rather than contract warehousing. Only 38 percent 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 with 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

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by Oslo (US$192/$m^2$/pa), Moscow (US$137/m^2/pa) and Stockholm (US$131/$m^2$/pa). Contrarily, rents remain the lowest in Antwerp (US$59/$m^2$/pa) and Lyon (US$61/m^2/pa). The continued lack of modern supply is likely to lead to further rental uplifts across selected European markets in 2012. Nevertheless, companies will be sensitive to persisting economic headwinds, and lease negotiations are expected to become tougher going forward. Therefore, a general stabilization of rental levels for class A space across the majority of European logistics markets is expected in 2012 and, in some markets where vacancy levels remain higher, occupiers will still be able to negotiate favorable terms.

■ U.S. Warehouse Rents Up for the First Time in Several Years in 2011

Momentum in occupier activity for "big box" logistics continued throughout the whole recovery cycle (starting at the end of 2009) and, so far, shows no signs of retreating in 2012. As a result, many of the key hub markets, including California and Phoenix (on the west coast), Chicago, St. Louis and Kansas City (in the Midwest), and Philadelphia and New Jersey (on the east coast), are experiencing a tightening in supply of class A space. While development has remained restrained throughout the recovery cycle, speculative development is now underway in several of these markets, as developers act to capitalize on an anticipated need for further logistics space. Meanwhile, the build-to-suit pipeline is heating up significantly as well, in particular led by strong demand from e-tailers. Nevertheless, although development activity is strengthening, it remains on a low level, and continued strong demand for large units might lead to the leasing market temporarily slowing, as tenants might have to postpone requirements until suitable space comes back on the market, or be forced into short-term renewals.

Average warehousing rents for the aggregate United States started to approach their bottom at the end of 2011, while tightening supply levels led to the first rental increase in several years in the 2011 annual comparison, although growth patterns in individual markets remain uneven. At the end of last year, the highest rents for class A space were recorded in San Francisco (US$97/$m^2$/pa), followed by San Diego (US$84/$m^2$/pa), Washington, D.C. (US$77/$m^2$/pa) and the area of New York /Long Island/Westchester-Connecticut (US$75/$m^2$/pa), while the lowest rents were seen in Atlanta, Cincinnati, Columbus and Memphis, ranging from US$26 to $34/$m^2$/pa. On an annual basis, rental levels rose an exceptional 38 percent in Denver; elsewhere, rents grew strongest in San Francisco, Miami-Dade and Seattle. Meanwhile, continued rental declines ranged from around 11 percent in Sacramento to a limited -0.3 percent in northern New Jersey. Rental growth is expected to continue in 2012 across the main hub markets, while occupiers seeking space outside these hubs will still find ample opportunities to negotiate favorable terms.

On a global level, demand for warehousing space is likely to remain healthy over the medium term, as companies continue to seek supply chain optimization and achieve greater flexibility. At the start of 2012, warehousing property markets across the world show very similar patterns in terms of availability and movements in pricing. Continued limited speculative development, which is driving down available supply, will, therefore, create a pinch point for occupiers. Overall, they will be faced with hardening conditions, as decreasing choice for class A space is heating up competition and rents will experience upward pressure across many markets in 2012. Being smart in understanding the different property warehousing conditions will be crucial to locate the best opportunities for individual solutions.

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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.

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Finding a Business Purpose

A company's purpose starts with its leaders and works its way through the organization. It shows up in products, services, and employee and customer experiences. An inspirational purpose often lies hidden, so review the following:

1. Revisit your organization's heritage (past history).
2. Review successes. At what does the business excel?
3. Start asking "why?"
4. What won't your organization do? Review false starts and failures.
5. Talk to employees.
6. Talk to top leaders.
7. Talk to high performers.
8. Talk to customers.
9. Follow your heart.

A purpose is informed by the world's needs. When you build an organization with a concrete purpose in mind – one that fills a real need in the marketplace – performance will follow.

Ask the following questions:

- Why does your organization do what it does?
- Why is this important to the people you serve?
- Why does your organization's existence matter?
- What is its functional benefit to customers and constituents?
- What is the emotional benefit to them?
- What is the ultimate value to your customer?
- What are you deeply passionate about?
- At what can you excel?
- What drives your economic engine?

Mission statements used to have a purpose. The purpose was to force management to make hard decisions about what the company stood for. A hard decision means giving up one thing to get another. — Seth Godin, marketing expert

When a mission statement is well written, it serves as a declaration of purpose. But corporate mission statements are often little more than a descriptive sentence about products, aspirations or desired public perceptions. They're more powerful when they clearly and specifically articulate the difference your business strives to make in the world.

Leaders who want to succeed should straightforwardly communicate what they believe in and why they're so passionate about their cause, according to business consultant Simon Sinek, author of *Start with Why: How Great Leaders Inspire Everyone to Take Action* (Portfolio, 2010).

Most people know *what* they do and *how* they do it, Sinek says, but few communicate *why* they're doing it. "People don't buy *what* you do; they buy into *why* you do it," he emphasizes.

The Bridge to What Matters

Great leaders like Martin Luther King Jr. and Walt Disney always communicated their "why" – the reasons they acted, why they cared and their future hopes. Great business leaders follow suit. Apple's Steve Wozniak thought everyone should have a computer and, along with Steve Jobs, set out to challenge established corporations' status quo. Starbucks' Howard Schultz wanted to create social experiences in cafés resembling those in Italy.

It's up to you to build a bridge between the business's purpose and your own values:

- In what way can you make a difference through company products and services?
- How can you express what truly matters in the work you do?
- In what ways can you make a difference in the world through the people you work for and with?

When you share your greater cause and higher purpose, listeners filter the message and decide to trust you (or not). When listeners' values and purpose resonate with your own, they are primed to become followers who will favorably perceive subsequent messages.

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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 30 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.

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