GRAY GROWTH
LOGISTICS

Finding a 3PL for Your Direct to Consumer Frozen Product

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WHITE PAPER

Introduction

The direct to consumer (DTC) food channel has shown growth for several decades. Companies sell through this channel for multiple reasons. Consumer acceptance of the channel grows year over year. Technology made the channel increasingly dependable and IT friendly for companies. The temperature-controlled DTC supply chain, from co-manufacturers (co-mans) to **3rd party logistics** (**3PL**) facilities to delivery companies enjoyed predictable growth for many years.

Then came the COVID-19 pandemic in early 2020. The entire food distribution system changed almost overnight. Existing trends either came to an abrupt halt or accelerated at an astonishing rate. Consider three primary sectors of the temperature-controlled food industry and how they fared in the pandemic.

- **Supermarkets and other brick and mortar grocery outlets** – supply disruptions, huge increase in delivery demand, increased demand for frozen foods.
- **Restaurants and food service** – weeks of shutdown followed by limited service capacity, work from home disrupted existing sales patterns, major increase in delivery demand, large scale demand dislocations for distributors (Sysco, US Foods, etc.), local farm to table farmers, restaurant operators and staffs, other direct to restaurant (DTR) food vendors.
- **Direct to Consumer food companies** – large demand increase, huge growth in supply as DTR companies seek to add a DTC channel.

For companies seeking to enter the DTC marketplace with a frozen or long-life refrigerated food product, the process of attracting a 3PL has become considerably more difficult.

This paper will explain how the process has changed, what it means for the DTC frozen food business, how to go about acquiring a 3PL, and what Gray Growth Strategies believes will happen once the pandemic ends.

> *In March [2020] food retail revenue soared over 25% from February,* ***"collapsing more than eight years of dollar growth into a few tumultuous weeks,"*** *FMI said in the report. As of April, food retail revenue remained more than 10% higher than pre-pandemic levels.*

The Market for 3PL Services

Before delving into the supply and demand aspects of the 3PL market, a definition is in order. **A 3PL is a storage and fulfillment center**. The 3PL receives items in bulk, stores them, and picks the stored products for ship out based on a customer order. Most 3PLs are public, that is, they are open to service the needs of multiple manufacturers/importers. In the smaller company, temperature-controlled DTC 3PL market, almost none are private.

Demand

In the temperature-controlled food market, three types of producers represented the lion's share of demand for DTC 3PL services in the pre-COVID-19 era.

- Large CPG companies who typically sell via retailers entering the DTC market.
- Existing DTC sellers seeking to grow their businesses from regional to national.
- Start-ups and small producers

86%

respondents have purchased frozen food

A fourth segment, overseas companies seeking to build their brands and establish a following in the USA, represented a small percentage of the pre-COVID-19 demand.

The COVID-19 pandemic generated increased consumer demand for frozen foods.

Consumers, with supply chain concerns heightened due to a nationwide shortage of paper goods and other products, began stockpiling freezers with food. This exacerbated the challenges facing many stretched-thin supply chains.

As a result of the coronavirus crisis, 78% of shoppers surveyed said they made a change in where they shop for food. Forty percent shopped at fewer stores, and 28% shop more online.

Seven in 10 frozen food shoppers stepped up the amount of frozen foods bought since the beginning of the Coronavirus pandemic, according to the American Frozen Food Institute (AFFI).

*Of more than 1,200 U.S. adults polled online from April 10-14, **86% have purchased frozen food** — such as frozen pizza, vegetables, or entrées — since early March, when the COVID-19 outbreak began to escalate.*

On top of 70% buying more frozen fare than usual, 68% of survey respondents said their purchases included different items than usual and 72% picked up different brands than usual because of unavailability.

Grocery suppliers are not likely to reach pre-COVID-19 stock levels again until the fall, according to United Natural Foods (UNFI).

The pandemic accelerated several trends already in effect concerning 3PL demand.

- Supply chain disruptions in the retail channel and the near destruction of demand in the restaurant and food service channel convinced CPG companies to review their relationship with the DTC channel. Many CPG food companies established DTC operations in the past decade. The channel offers an additional revenue stream, greater brand loyalty, better feedback and relationships with customers, and a measure of independence from retailers.

  The combination of retailer supply chain issues, competition, and significant increases in consumer DTC demand accelerated CPG focus on the DTC channel.
- Start-ups and smaller producers of frozen foods have long been challenged to sell through retailers. As the pandemic created increased demand for frozen foods, few retailers had the ability to increase their freezer capacity. Retailers had even less need to identify new products as they faced capacity challenges with their existing mixes of frozen products. This made the goal of selling via retailers that much more challenging.
- Many DTC food companies consider Amazon for their marketing mix. Amazon does not provide storage and fulfillment for temperature-controlled products. Amazon is happy to provide a sales platform, but fulfillment is the responsibility of the seller. Cost limits the delivery area of a fulfillment center (3PL) to two days. There is no cost-effective means to ensure that a frozen product shipped to many areas of the country in the heat of summer will remain frozen beyond two days.

$17 billion lost

*CPG giants have **lost $17 billion** to innovative newcomers in the last seven years. CPG brands received investment of more than $5.5 billion from 2015-2019. During that time, the number of brands receiving investment tripled, while the amount of money invested in new companies quadrupled.*

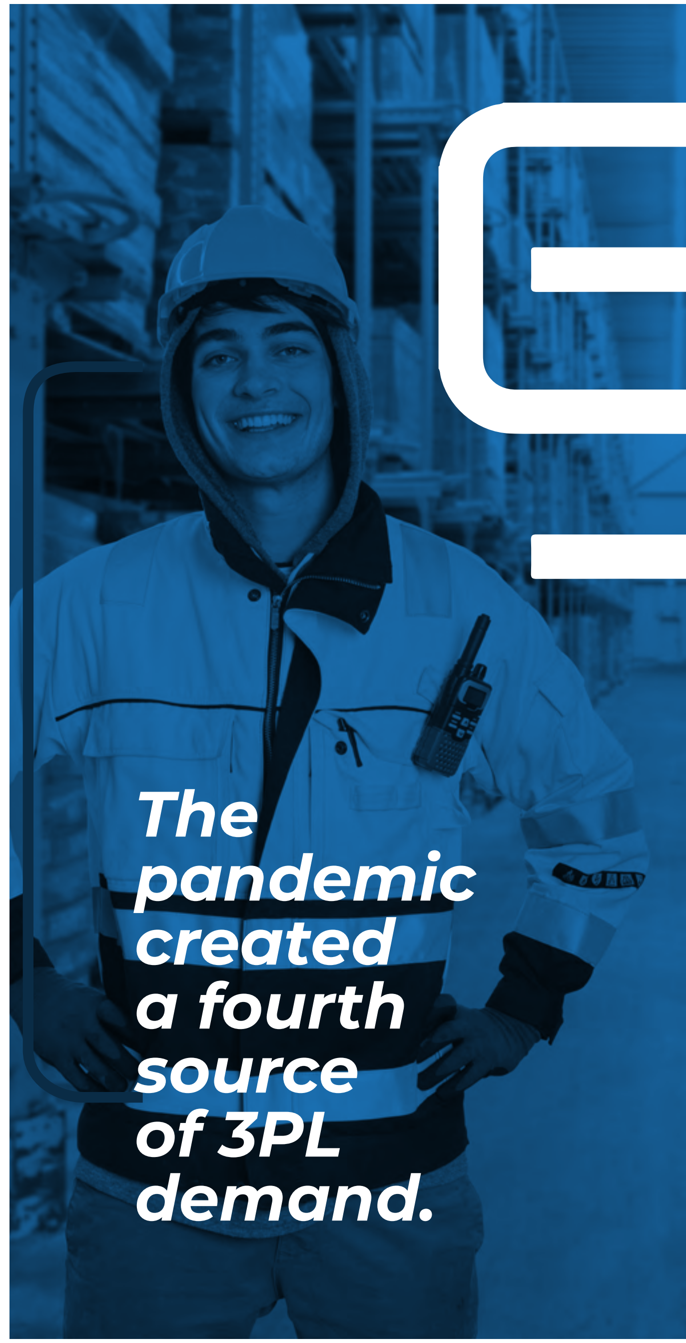
As consumers increasingly turning to DTC brands, CPG companies lacking DTC channels or those offering products undifferentiated from those available at the local retailer have lost market share.

The two-day limit means that shippers either need to work with multiple 3PLs or they need to ship packages beyond the two day ground delivery region of their fulfillment center by 2nd day air. 2nd day air can add $30 or more to a freight bill. Amazon requires the Prime shippers provide delivery within a two-day window. As frozen and refrigerated food product companies seek to add Amazon to their marketing mix, the trade-off between air freight and additional 3PLs favors contracting more 3PLs. Amazon's enormous size and market reach is a significant driver of temperature-controlled DTC 3PL demand.

- Existing DTC sellers found themselves in a sweet spot. Growing consumer demand accelerated their growth. Growth, experience, and often strong financial backing made this group even more attractive to 3PLs when considering expansion options.

The pandemic created a fourth source of 3PL demand. Many companies that previously focused on the restaurant and/or food service marketplace found their demand slashed in a matter of weeks. Long on food and short of customers, these companies turned to the DTC channel. Hundreds of food suppliers became potential DTC 3PL customers within a matter of weeks of the pandemic shutdowns.

Temperature-controlled DTC 3PLs realized more service inquiries in a few months than they enjoyed in the previous 4 to 5 years combined. An already growing temperature-controlled DTC 3PL industry was overwhelmed with companies seeking their services.



Supply

The temperature-controlled DTC 3PL sector represents a modest fraction of the estimated $1 trillion 3PL market.

Within this sector, Gray Growth Strategies recognizes three primary market segments.

- **Large cold storage facilities dedicating a fraction of their capacity to DTC fulfillment.**
- **Existing smaller company DTC 3PLs**
- **New market entrants.**

Small and very large providers dominate the DTC frozen-food 3PL marketplace. The large providers measure revenues in the $billions and storage space in the tens of millions of square feet of floor space. These firms devote a small fraction of their capacity to DTC services. The majority of their capacity is bulk storage.

$925 billion

*In 2016, Grand View Research projected the **global 3PL market to reach $925 billion** by 2020.*

But, a more recent report shows the 3PL market to reach $1,789.94 billion by 2027, registering a CAGR of 7.1% from 2020 to 2027.

The typical existing smaller company DTC 3PL may recognize $6 to $15 million in annual sales. New market entrants may gross $500K to just a few $million annually. There is no appreciable middle sized DTC 3PL segment. There are, however, several multi-location operators of smaller 3PLs including one operator with 10 locations nationwide.

The reasons for this segmentation are as follows:

- **Frozen food DTC demand represents a modest fraction of all retail food sales.** This segment was a much smaller percentage even 10 years ago. The temperature-controlled logistics industry cannot justify constructing large facilities dedicated to DTC services. Some supermarkets are beginning to build these types of facilities, but at present, they are not intended for shared use.
- **Location is a major determinant of a DTC 3PL's value to a food producer.** Consumers are accustomed to next day or same day delivery. One cannot cost effectively meet consumer demand for rapid delivery from a 3PL located hundreds of miles from a metropolitan area. When electric delivery vehicles and then electric self-driving vehicles become available, proximity will be even more critical. Large facilities allow for lower costs and more internal technology. Multiple smaller facilities enjoy greater proximity to a large target market. Delivery costs are almost always greater than 3PL costs thereby favoring multiple smaller fulfillment facilities.

***Enter micro-fulfillment**, the concept of placing small-scale warehouse facilities in accessible urban locations close to the end-consumer. Micro-fulfillment centers act as a middle ground between manufacturers and grocery retailers.*

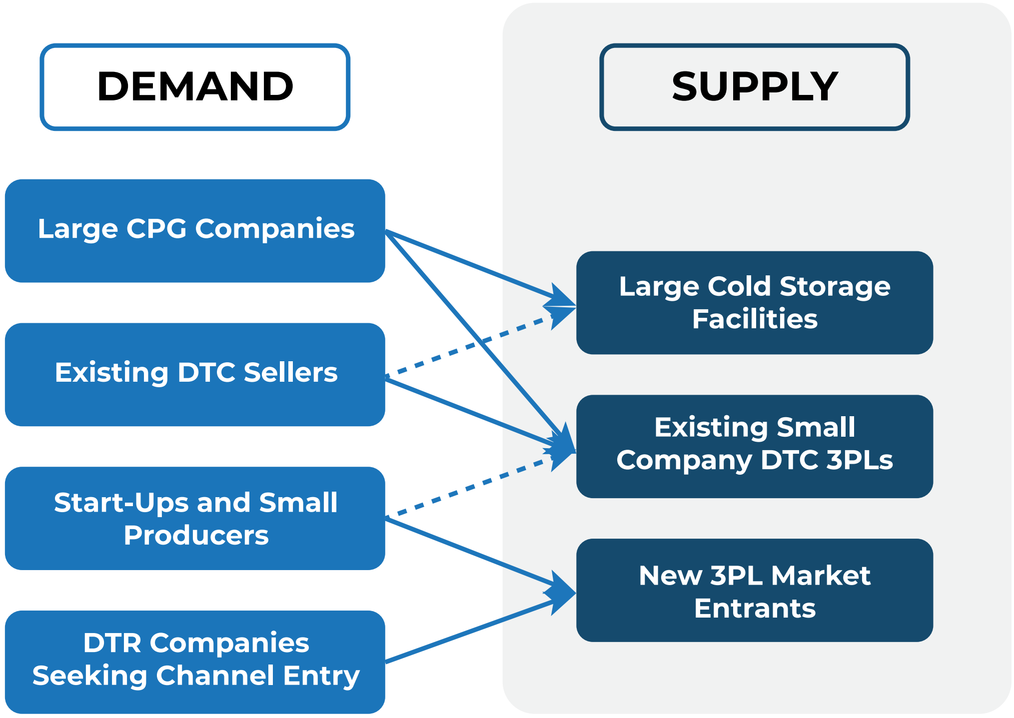
In the last months, several grocers such as Walmart, Kroger, Albertsons and more have been partnering with technology startups such as Takeoff Technologies and Fabric to explore micro-fulfillment centers as an effective solution to grocery e-commerce.

The smaller company DTC 3PLs are too small to attract widescale investor attention. Collectively, these smaller companies represent an industry segment that may not represent even $500 million in annual revenue. Existing players add facilities incrementally. They are often self-financed. Alternatively, these operators will lease space from an existing large cold storage provider.

New market entrants generally fall into one of two categories: companies who lease space from existing cold storage facilities or cold storage operators opportunistically seeking additional revenues. In either case, these companies are typically unsophisticated, employ minimal DTC technology, and they can be hard to find.

The following chart matches the demand and the supply segments. Solid arrows indicate routine pairings while dashed arrows indicate limited opportunities for upgraded facilities.

THE MARKET FOR 3PL SERVICES



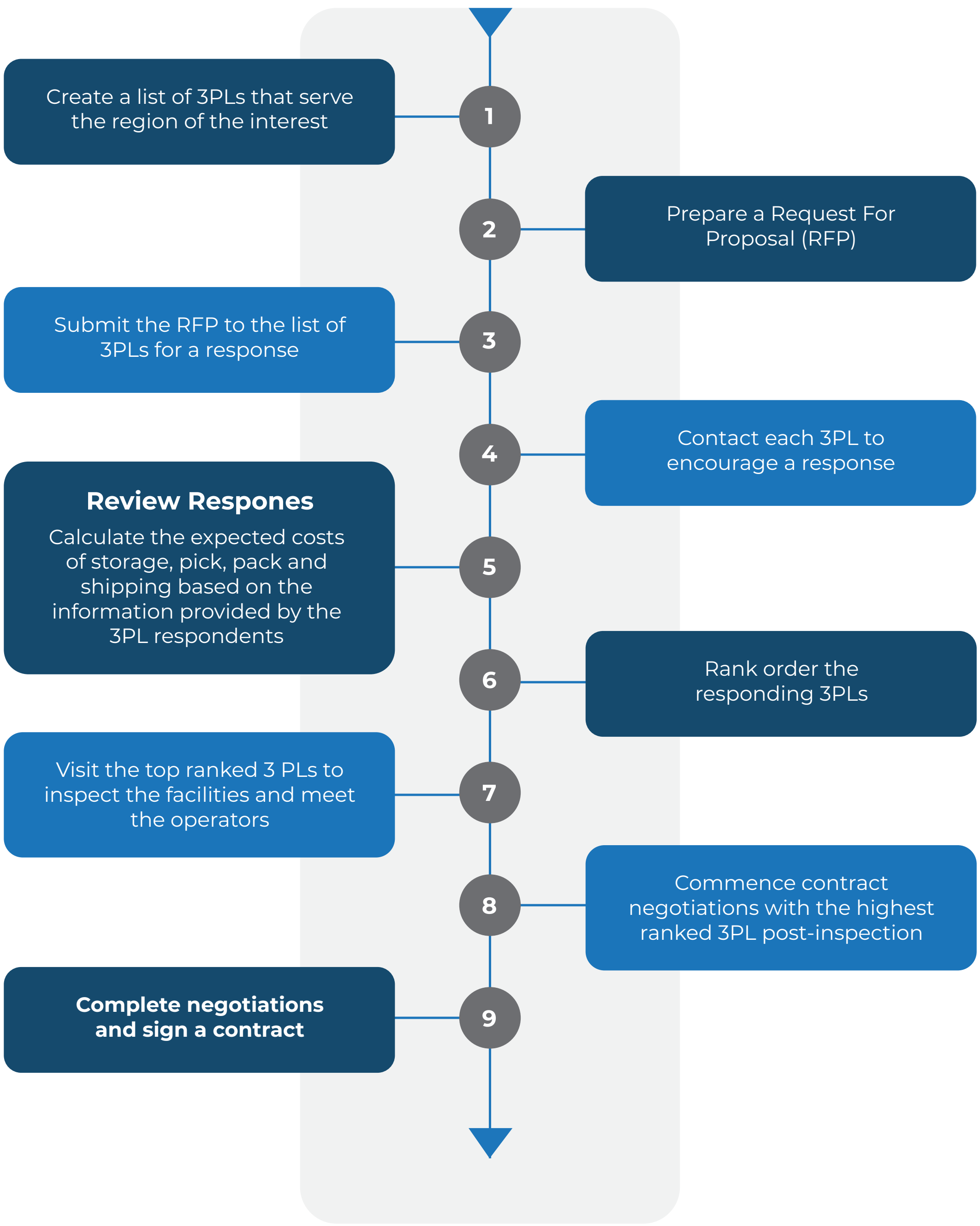
Until the pandemic hit, demand and supply were in equilibrium. The 'DTR Companies Seeking Channel Entry' category barely existed. New 3PL Market Entrants and expansions of Existing Small Company DTC 3PLs were able to satisfy most smaller company growth and start-up demand. Large cold storage companies are increasingly initiating DTC operations to support the needs of their major clients. Some dedicate a percentage of their capacity to promising DTC companies with no previous affiliation to the cold storage companies.

When the pandemic hit, the confluence of increasing consumer demand for DTC products, retailer supply chain issues, and the collapse of the DTR marketplace resulted in a massive increase in demand in a matter of weeks. This allowed existing 3PLs to pick and choose their potential clients.

Finding a 3PL

The following chart identifies the process of contracting a 3PL.

9 STEPS TO FINDING A 3PL



An RFP is a document that, as the name implies, requests that the recipient prepare a proposal to offer their services per the issuer's needs as specified in the RFP. The RFP includes the following:

- **A description of the issuer**, what they do, and their recent business history
- **A description of the products** they offer and what they intend to sell on a direct to consumer basis
- **A description of the services** required by the RFP issuer, especially those beyond the basic receiving, storage, picking, and packing of goods.
- **A description of the systems** used by the issuer. The respondent is asked to confirm that its systems will communicate with the issuer's systems.
- **A 12 to 24 month forecast of shipments** to be picked, packed, and shipped from the target 3PL
- **A request for a price list** of services offered
- **A request that the recipient provide** a description of the business and its history to satisfy any concerns that this 3PL can handle the issuer's requirements for 3PL services.

A typical RFP for most firms in the start-up, small business, or DTR company seeking entry into the DTC channel categories is 3 to 4 pages, plus attachments as necessary.

In pre-COVID-19 times, when 3PL supply and demand were roughly in equilibrium, the company seeking a 3PL could build a list of 3 to 5 3PL prospects, depending on the region of the country. The challenge is that there is no industry association or guide one can turn to that identifies all the temperature-controlled 3PLs.

Now that demand for 3PL services exceeds supply due to the pandemic, most new entrants in the DTC marketplace need to deal with the smallest and youngest 3PLs. Many of these 3PLs spend almost no money for marketing.

They can be very difficult to find requiring the services of an experienced guide. In these COVID-19 times, it is unrealistic for a new market entrant to expect multiple 3PLs to respond. Many are overwhelmed with service requests.

Once identified, and assuming these companies are willing to respond to the RFP, how does one go about evaluating the quality of their services? There is no rating service nor are industry statistics kept to compare one provider to another.

A price-based comparison assumes that service quality is comparable across all industry competitors. This is not a realistic assumption. An experienced industry expert can help to fill in these critical details.

Post Pandemic

A discussion of the post pandemic environment needs to separate the pandemic specific effects from the industry changes due to technology. There cannot be a clear separation as the pandemic has dramatically accelerated many existing trends. The pandemic made clear that consumers want and will pay for variety and convenience. **It has shown that consumers will seek alternative sales channels if the goods they want are not available from their usual sources.**

For food producers, the pandemic has shown that they can no longer work with just one distribution channel. They must diversify. They need to engage all available channels for both offensive (growth, branding) and defensive (revenue security, inventory turnover) purposes. The pandemic highlighted many a food producer's vulnerability in relying on just one distribution channel.

The pandemic encouraged many people to rediscover their kitchens. Bread flour and yeast became as scarce as toilet paper. Meal kits companies, some on the verge of bankruptcy, experienced significant demand increases. Amazon Fresh and Fresh Direct had to limit new customer sign-ups.

As consumers chose not to visit supermarkets, or as supermarket supply chains ran thin, consumers sought goods in the DTC channel. They discovered products unavailable in many local markets. The e-commerce food business opened a world of new food experiences to consumers. It is reasonable to assume that a significant portion of the DTC food growth experienced during the pandemic will continue in a post-pandemic environment.

Supply in the 3PL industry, especially at the low end and highest ends of the business, will likely continue to grow at an accelerated rates. Large CPG companies have existing relationships with major cold storage companies. These firms are increasingly offering DTC services as their clients request.

The current supply and demand situation offers cold storage companies with the opportunity to diversify operations and earn additional income via DTC 3PL services. Many of these new industry participants initiate service as a low tech, higher priced competitor. The new 3PLs establish rates lacking competitor price sheets. 3PLs do not make their rate sheets public information. An industry consultant, with access to the pricing of multiple 3PLs, can negotiate a competitively priced service agreement for a client.

Until and unless investors gain interest in the universe of some 15-20 existing temperature-controlled smaller company 3PLs, their growth will remain modest. Some have added capacity to their existing facilities. Many have begun the process of automating. In doing so, they often substitute fixed costs (automated pick systems, robots, etc.) for variable costs (labor). This substitution exacerbates the need for these firms to target higher volume shippers.

Prospects call for a continued period of demand exceeding the supply of 3PL services, especially at the low end of the business.

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ABOUT US

Experts at Gray Growth Strategies, New York, work closely with your team to understand business objectives and process flows, identify ways to improve your logistics management and suggest steps to cut your time to market and related costs. They bring a unique set of disciplines—from operational to strategic and marketing—to migrate your company's concept or prototype into a full-fledged commerceready service. From DTC meal delivery programs and functional foods to multi-national Fortune 1,000 companies, **Gray Growth Strategies maintains all the ingredients necessary to grow your company's supply chain network**.

Richard Gray is a leading strategist in global direct-to-consumer marketing and business model development. An expert brand marketer across multi-channel environments, he achieves results quickly and within optimized budgets.