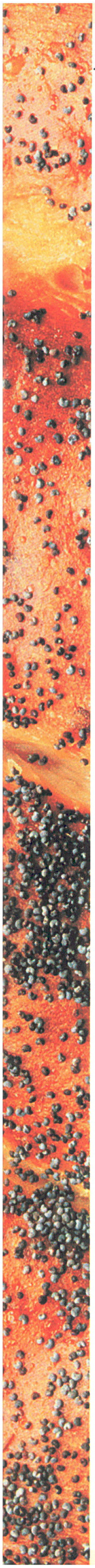
Understanding Supply-side Costs and Strategies for Supermarket Foodservice

BUILDING A MEAL SOLUTION DELIVERY SYSTEM

Executive Summary

A Study Conducted for
the Coca-Cola Retailing Research Council
by The Hale Group, Ltd.



The Coca-Cola Retailing Research Council (CCRRC) is a grocery industry service group established and funded by The Coca-Cola Company through its divisions Coca-Cola USA and The Minute Maid Company. The CCRRC consists of twelve (12) members who are senior executives of their respective organizations. The purpose of the Council is to research strategic issues of industry-wide interest and disseminate information to industry participants so they are in a position to address these issues effectively.

This year the CCRRC selected Supermarket Foodservice as the strategic issue to be addressed—specifically, the development of foodservice departments and their profitable operation. Thus, the CCRRC initiated this study to ***understand supply-side costs and strategies for supermarket foodservice***.

The objectives of the study were to understand the costs associated with delivering "restaurant-quality" meals in a supermarket setting and to identify ways to manage those cost elements to improve overall performance.

APPROACH

Based on extensive in-market and in-store research and data gathering, The Hale Group, Ltd., the consulting firm retained to complete the study, was able to understand:

- the current operational models supermarkets use today to provide "restaurant-quality" meal solutions; and
- the "possibilities" to improve the performance of existing supermarket foodservice operations, as well as create foodservice operations from the ground up that have a better strategic fit with the supermarket's overall market positioning.

The following findings and conclusions have been developed through an analysis of this information.

FINDINGS AND CONCLUSIONS

1. The underlying business philosophy of foodservice operations is markedly different from the business philosophy of grocery retailing.

- *Traditional grocery retailing involves purchasing and reselling products, in essentially the same form, for a profit; the better the* buy, *the larger the profit.*
- *In foodservice, profit is developed to a limited degree on the buy, and to a far greater extent on the development of value at the retail level, assembling ingredients, adding labor and creativity, merchandising and selling at an acceptable price; the greater the customer-perceived* added value, *the greater the profit.*

The recommendation is to view foodservice as a business within the supermarket store, not a department that is operated similarly to all other departments.

2. Having a foodservice offering within the supermarket is widely accepted by supermarket management. However, most supermarkets have yet to develop a foodservice strategy that flows from their overall strategy.

The recommendation is for supermarket management to take a strategic view prior to committing resources. Once a decision has been reached to develop a foodservice strategy, resource commitments will be key. Unless supermarket management is willing to make a commitment to resources—capital and human—and institute new ways of doing business, success will be difficult to realize.

3. The Going-to-Market or execution of the foodservice strategy involves two major building blocks—The Concept and The Enablers; few supermarket managements today have these basic operational pieces in place.

It is recommended that supermarket management clearly define ***the concept*** that will deliver the value proposition/desired customer outcome and put into place the operational system—***the enablers*** necessary to generate consistent execution of the concept. It will be difficult, if not impossible, to succeed without a defined concept and operational tools—the enablers needed to execute the concept in a consistent and profitable manner.

FORMULATING A SUPERMARKET FOODSERVICE STRATEGY

CUSTOMERS

Who is the target audience?
Who are the core customers?
Who will sustain the business?

VALUE PROPOSITION

What is the value proposition that will

- be of value to targeted customers?
- provide a basis for differentiation?
- generate value for both customers and investors?

GOING-TO-MARKET

How will the value proposition be generated in the store?
How will it be managed?
How will the value proposition be branded?
How will the brand be communicated to targeted customers?

EXECUTION OF THE FOODSERVICE STRATEGY

THE CONCEPT

The foodservice concept is, in many ways, the "total product." The concept defines the foodservice positioning, offering, and value equation. The concept is composed of five interactive elements.

- Menu
- Targeted Price Point
- Service Systems
- Ambiance/Image
- Other Special Factors

THE ENABLERS

The foodservice enablers define the operational systems and methods to set the concept in motion in such a way that it provides a consistent experience for customers and a financial return for investors. The foodservice enablers are:

- Product and operation standards and specifications
- A linked supplier network and supply system
- An organizational design including assigned tasks and responsibilities
- On-going training and motivational programs
- Real-time measurement and scheduling systems

Targeted Customers

4. The supermarket industry has not fully understood the cost of sourcing options available nor the implications of the various options in terms of consistency, ease of implementation, and customer satisfaction. While, at first glance, the "cost of goods" shown in the following chart seems counter-intuitive, the study, as well as the experience of the foodservice industry, as understood by The Hale Group, supports the findings.

   - *On-site/scratch preparation generates the lowest cost of goods; however, this method of production is difficult to implement because it requires skilled labor and it is difficult to achieve consistency of product quality.*
   - *Manufactured products are the most consistent and benefit from the economies of scale/efficiencies of the manufacturing environment. However, there is another profit margin in this system along with greater distribution costs, which result in a higher cost of goods than on-site preparation.*
   - *Commissary operations are frequently considered the optimum solution in terms of moving production labor from on-site preparation. However, commissaries seldom achieve the throughput required to have efficient production; and the multiple handling of the product adds another layer of costs. Commissaries do provide a higher degree of control and consistency, which are benefits to the system.*

Cost of goods sold, or the product cost, is only one consideration. Examples of other factors that must be part of the evaluation include:

- *anticipated sales volume — total department and for specific menu item;*
- *role of foodservice within the supermarket strategy and degree of culinary image to be created; and*
- *availability and skill level of the labor pool.*

FOR A SUPERMARKET FOODSERVICE OPERATION WITH ANNUAL SALES OF $780,000 THE SOURCING MODEL AND COST OF PRODUCTION

Sourcing Options	*Cost of Goods* ($000)	*As a Percent of Sales* (percent)	*Considerations/Characteristics*
On-site/Scratch Preparation	$355.7	46.0%	*Requires trained/skilled labor; can be beneficial for selected signature menu items; however, cost savings seldom realized due to requirement for higher handling cost in the selling phase*
From a Manufacturer	377.7	48.0	*Higher costs, but requires lower on-site labor input, less space, and greater flexibility; signature products are difficult to produce unless very high volume*
From Commissary Operations	397.7	51.0	*Allows for greater control and signature items, but double handling adds costs… costs combined with lower than necessary volume can make this the highest cost alternative*

It is recommended that supermarket managers involved with foodservice concept development tailor their sourcing to match the strategy and concept. The sourcing options are a means to an end, not the drivers of decisions. Furthermore, it is unlikely that one sourcing option will be right for every menu item.

5. The current profitability of supermarket foodservice operations is below what is achievable. An absence of clear concepts and of foodservice enablers are the main shortcomings. The P&L constructed for a typical supermarket foodservice operation, as well as one that describes what is "possible without revamping entire operations," follow.

ESTIMATED P&LS FOR A SUPERMARKET OPERATOR GENERATING $780,000 PER YEAR OR 3% OF STORE SALES

	Financial Profile of Supermarket Foodservice at a Store Level Operation		*"Possible" P&L for Supermarket Foodservice*	
	($000)	(percent)	($000)	(percent)
Production Costs				
Food/Ingredients	$196.1	55%	$180.0	56%
Labor	99.6	28	95.0	28
Shrink	7.5	2	4.5	1
Other Costs	23.8	7	23.0	7
Fixed Costs	28.7	8	25.0	8
Cost of Goods	$355.7	100%	$327.5	100%
Selling P&L				
Sales	$780.0	100%	$780.0	100%
Cost of Goods	355.7	46	327.5	42
Gross Margin	$424.3	54%	$452.5	58%
Feature Cost	42.4	5	45.0	6
Markdowns/Shrink	84.9	11	23.0	3
Gross Profit	$297.0	38%	$384.5	48%
Labor	196.0	25	182.2	23
Training	3.9	1	22.0	3
Other Controllables	40.6	5	30.0	4
Total Controllables	$240.5	31%	$234.2	30%
Advertising	3.9	1	3.9	1
Maintenance	8.7	1	8.7	1
Depreciation/Rent	27.8	4	22.0	3
Front End Management	35.1	4	35.1	4
Total Other	$75.5	10%	$69.7	8%
Net Profit	($19.0)	(2%)	$80.6	10%

It is recommended that supermarket management reassess their operations using this framework and put the enablers in place to achieve profitability.

6. The tools and approaches to help achieve the "Possible" P&L in supermarket foodservice departments exist in traditional foodservice and can be adapted to meet supermarket needs.

Supermarket foodservice can be a profitable operation. Net profits are driven by:

- *driving the top line;*
- *constructing an efficient menu mix;*
- *managing costs;*
- *training the staff; and*
- *creating the right sized equipment and facilities.*

Driving the Top Line

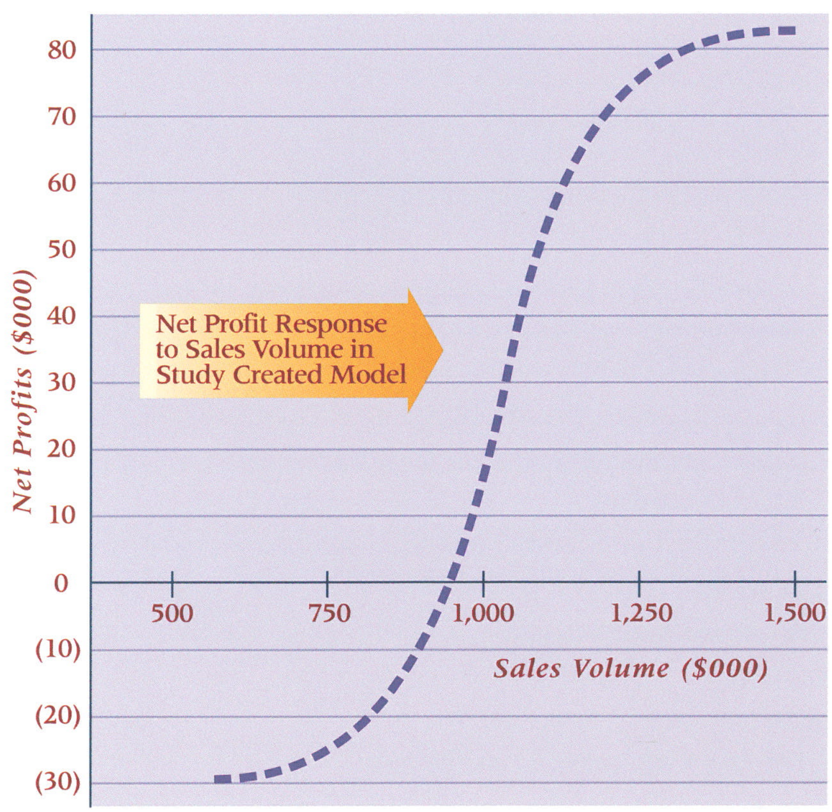
The volume of sales generated by the operation is the beginning point in the quest for a profitable operation. The drivers of sales volume involve:

- *superior value proposition so the consumer has the desired outcome and chooses supermarket foodservice as a meal solution option on a regular basis;*
- *using features and advertising to communicate the consumer's value proposition and the brand value of the supermarket foodservice operation; and*
- *operating the supermarket foodservice concept as it is designed to be executed and do so consistently—everyday, all day—so consumers will learn to trust the concept as a consistent, credible, and safe provider of meal solutions.*

Sales volume begins to address shrink issues, overhead absorption issues, and sufficient staffing to maintain a high service level. Sales volume can play a major role in achieving acceptable profitability.

Sales volume is one of the critical factors to success in a foodservice operation. It is difficult to operate any foodservice operation at low sales volumes, i.e., $1 million or less unless food costs are extremely low; and/or miniaturized concepts, such as kiosks, carts, or facade type units are used.

SUPERMARKET FOODSERVICE NET PROFIT
RESPONSE TO SALES VOLUME



Constructing an Efficient Menu Mix

A significant factor impacting the negative net profit realized in the supermarket foodservice operation is the ***shrink factor***. This can account for 12–15% of costs. It is a non-value-adding cost and should be managed to a lower level.

- *Shrink will always be part of a foodservice operation; it will not completely go away.*
- *Shrink can be managed to an acceptable level; acceptable is estimated to be less than 5%.*
- *Shrink drivers should be identified—products or raw materials, recipes, preparation steps—and managed.*

The first step in managing shrink is to plan the menu with consideration for the shrink factor.

- *The concept should have a menu scope that is manageable—not too broad, or shrink will be a factor. An efficient menu assortment is planned within the context of the concept format.*
- *The menu should attempt to use versatile ingredients—multiple roles in multiple recipes/finished products. The goal is a limited number of raw materials that produce an efficient assortment.*
- *The menu should accommodate the ability to use perishable finished products reworked into other more highly stable finished products. For example:*
  - Boston Market's overproduced rotisserie chicken is used to make chicken pot pies.
  - Wendy's fresh hamburger that is not used on the day of preparation is used as an ingredient in chili.
  - Vegetables, meat, and chicken that are not used during a planned day find their way into soups, sauces, and/or casseroles.

"Just like Mom—use the left-overs!"

The menu should not be a random assembly of finished products but should have a rationale—the concept—and be crafted with an eye to operation efficiencies.

Managing Costs

A foodservice concept can be executed successfully and consistently across multiple stores if it has a staff/management that has access to, and uses, a real-time measurement and management system at the store level.

The supermarket foodservice industry must put back-room management systems in place that have:

- *set productivity standards for all aspects of the operation—food yield, labor productivity, and space productivity, as well as other drivers of cost;*
- *a forecasting and scheduling capability that allows management to anticipate sales volume and, thus, food preparation, food merchandising, and labor needs; and*
- *a tracking component that can track performance versus plan and the areas, or reasons, for deviation.*

These systems are widely used in foodservice. They are now mostly computerized. These systems provide the manager with a real-time picture of the business—top line to bottom line—so they can be proactive in managing the business.

Training the Staff

One of the major findings of the study was the lack of training of managers and employees operating the foodservice concepts. Staffing was drawn from all parts of the supermarket and training was, in most instances, non-existent. It would be difficult, if not impossible, to expect the foodservice department to be profitable or to meet consumers' expectations under these conditions.

Training is the executional backbone of a successful foodservice operation. Training provides:

- *the overall concept—expected delivered value proposition to the consumer;*
- *knowledge of what is expected of the employee and why;*
- *the way to carry out the various "jobs" in the operation and tasks associated with that job/position;*
- *the skills and tools available to perform the tasks efficiently and correctly; and*
- *the way to work as a team and the benefits/rewards of being a team player.*

Training must be a major, on-going function in a successful foodservice operation at the manager level and employee level.

Creating the Right Sized Equipment and Facilities

The final major category of cost to be managed in the context of the foodservice operation is the investment—the equipment, space, and ambiance. The focus should be to have what is needed; no more, no less. Therefore, the starting point is, of course, the concept design and planned value proposition/desired outcome for the consumer. These should be established and committed before the first piece of equipment is purchased or space allocated.

Once the concept is established and commitment is gained:

- *carefully plan the equipment requirement, and select equipment that is efficient and versatile in the concept planned;*
- *plan the amount and layout of space to assign to the working environment that is not hostile to employees and is efficient; and*
- *create work and serving stations that enhance efficiency.*

The system is more important to successful operations than equipment which is not linked into an operating system.

7. The successful, i.e., robust and profitable, supermarket foodservice operations observed in the course of the study were the result of:

- **long-term management commitment**—*not a one-year program;*
- **a clearly defined role of foodservice**—*a foodservice concept designed specifically to fit the supermarket chain; and*
- **the right tools to manage the business**—*unlike the tools used by grocery departments.*

Keys to success are vision, commitment, and prudently applied patience. Supermarket foodservice is a new business for most supermarkets. Organizational learnings and experience must be built; and while the development cycle can be shortened, it cannot be eliminated.

The Coca-Cola Retailing Research Council is
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