TECHNOMIC'S TAKE

The Changing Face of Foodservice Purchasing

Independent restaurants have been central to the success of both foodservice distributors and food and beverage companies serving the industry. They are more profitable (mostly due to inefficiencies of the purchase process and pricing practices that aren't transparent), and their health has been a stabilizing force in an industry where many chains (particularly large casual-dining chains) have struggled to grow as saturation, value issues, competition and lack of differentiation have impacted their success.

As costs increase at the operator level, due to commodity swings, labor costs, rent and other input costs that continue to rise, operators are increasingly looking for options that are perceived to save them. As a result of this changing nature of foodservice purchasing, Technomic estimates that there is $1 billion to $2 billion in additional manufacturer profitability at risk over the next five years. This will be driven by the following:

Penetration of GPOs is continuing across all foodservice segments, but

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However, while independents are generally healthy (relative to the rest of the industry), distributors and manufacturers cannot assume that these operators will continue to drive incremental profitability.

critically we see that many GPOs are now focused on growing share within the independent restaurant segment. Recent Technomic research indicates that nearly 14% of independent operators are active within GPOs and a larger number than ever before are considering joining in the near future.

While chains don't have the same growth trajectory that they did several years ago, they continue to add units, and **smaller midsize chains continue to excel**. Most of these operators negotiate directly and receive contract pricing, further reducing the profitability of the market place.

Most major noncommercial segments (not only healthcare, but colleges, B&I, etc.) are heavily driven by contract pricing. For most of these segments, actual discretionary purchases that are not part of a GPO or foodservice management firm contact amount to 10% or less of their purchases.

These dynamics have several major implications for the foodservice industry:

Distributors and manufacturers have less leverage as chains and group purchasing organizations become power buyers. To a large degree, the growing nature of contracted procurement in foodservice has prompted many of the mergers and acquisitions over the past several years.

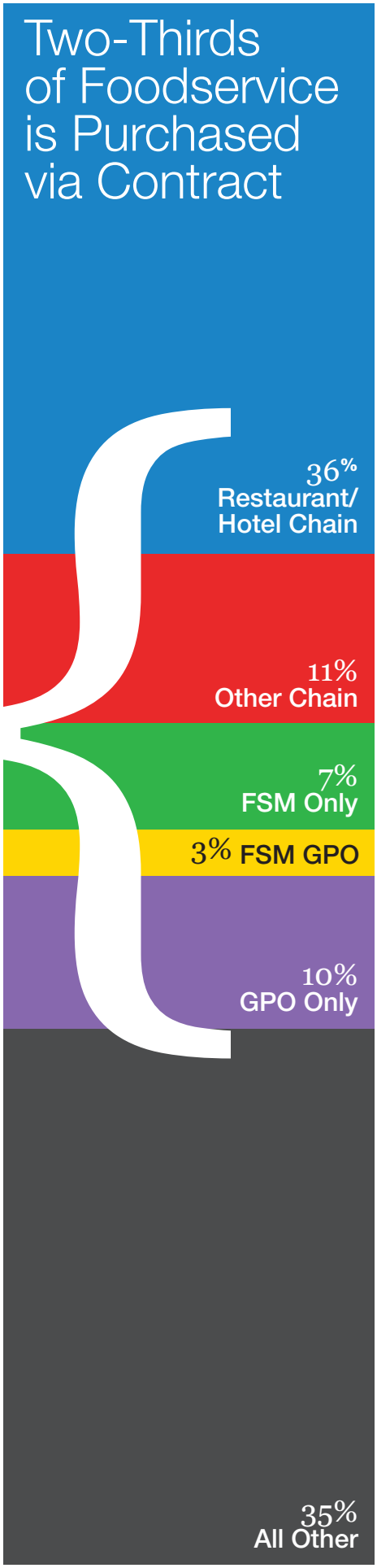
Distributor economics don't work as well with contracted business. Most of this is cost plus and distributors, who covet the higher profitability of the true independent operator, need to become much more efficient in terms of logistics and drop sizes in an environment where the margin is generally under 10%.

GPOs have taken their negotiated prices meant for certain customers and have extended them into adjacent operator segments, often without manufacturer or distributor approval, further suppressing margins throughout the value chain.

The nature of the operator sales call, particularly for manufacturers, changes to one where they are not truly selling their products or solutions, but working to ensure compliance with a contract. It also impacts the fees and compensation that manufacturers are willing to pay to brokers and distributors, given that manufacturers often perceive selling to a GPO account to be less valuable to the manufacturer than bringing in a higher-margin independent account.

Technomic predicts that over 70% of the foodservice purchases will be contracted within the next five years (up from about 65% today) and the industry needs to be prepared as this shift continues. Margins, which have already been compressing over the past several years, will continue to tighten, and forward-thinking companies should strategically address this as part of longer range strategic planning and work to manage the change proactively to ensure the continued health and strength of the business. To do so, Technomic recommends that companies:

Fully understand the sales and volume incrementality of GPO and other contract business relative to the lower overall margin. While lower margin, contracted business can be desirable if it provides incremental sales or volume opportunities. Manufacturers and distributors must understand and view



GPOs and other contracted business in light of strategic priorities and which segments, products and entities will drive growth. While often lower margin, contract business can benefit distributors by increasing drop size and giving primary distributors a bigger share of purchases.

Understand and expand upon your leverage. Contracted business is often viewed negatively because of the perceived loss of control of the operator. However, understanding key leverage points is critical, particularly for manufacturers to create pull at the operator level to avoid the commodity trap.

Audit contract compliance. Another reason that GPOs and other contracted business is often viewed negatively is due to compliance and the complex nature of the purchase. Auditing and managing trade-spending programs, understanding true cost to serve and having dedicated personnel to oversee contract compliance are all best-in-class methods of reducing the leakage of funds that can have a negative impact on profitability.

Construct proper guardrails to ensure that higher margin business remains profitable. Contract pricing should only be used for the entities for which that pricing is intended; manufacturers and distributors must ensure that guardrails are in place to avoid price-extendibility, where favorable pricing based on the contract is offered to other operators.

Realize that sales force realignment may be necessary. As the industry heads toward higher share of contracted business, the nature of the sales call is changing. This may necessitate deployment of sales as activities change from demand creation to driving compliance.

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—David Henkes, Senior Principal, Technomic