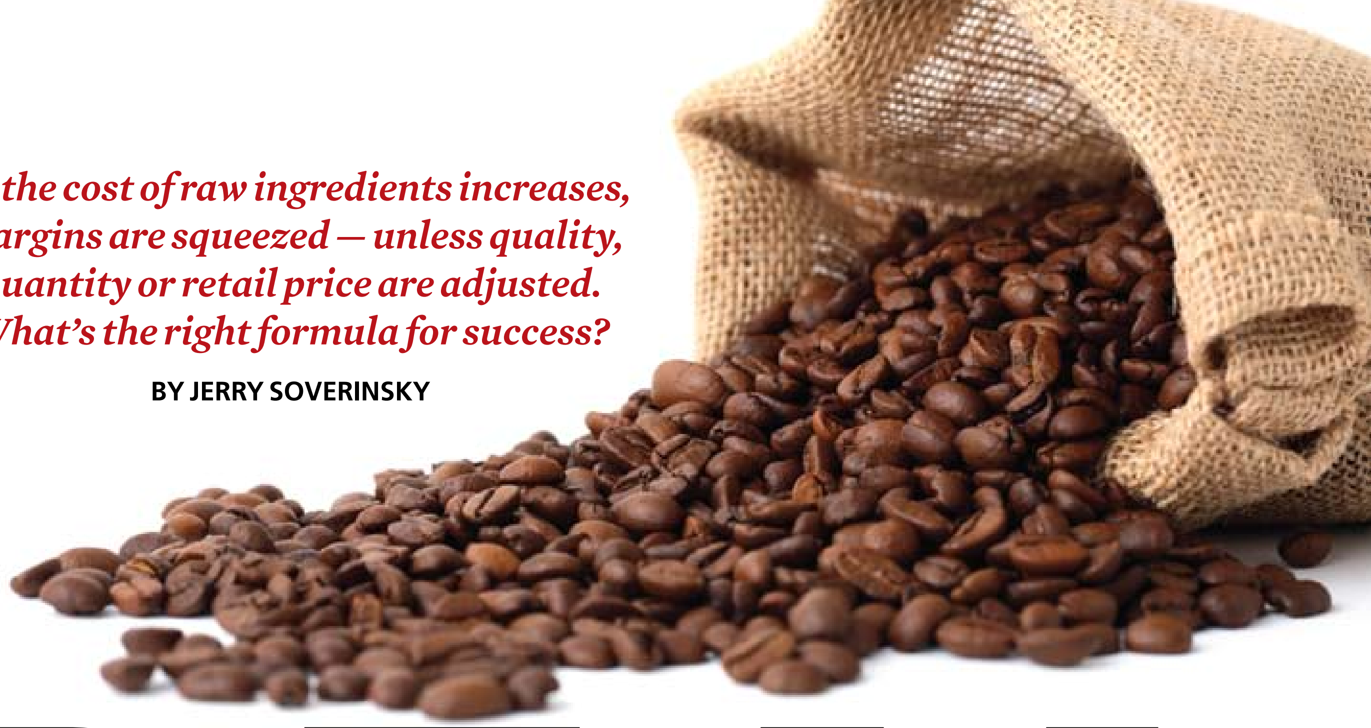
RAW

As the cost of raw ingredients increases, margins are squeezed — unless quality, quantity or retail price are adjusted. What's the right formula for success?

BY JERRY SOVERINSKY



DEAL

Earlier this year, the coffee shop near one of my clients selectively increased the price of espresso drinks. Both the medium and large sizes incurred a 20-cent surcharge, while the small size retained its status quo. While I had routinely purchased the medium latte, I immediately switched to the small.

I felt guilty paying nearly $4 for a medium cup of coffee — despite continuing to pay $2.25 for a muffin. While I could tolerate a sub-$6 splurge for my weekly java-sweets indulgence, I felt uncomfortable crossing that six-buck barrier. Three months later during my weekly client visits, I continued to purchase the small latte, now a routine purchasing behavior.

This is representative of scenarios played out at foodservice retailers throughout the country these days, as the rising cost of raw materials affects consumer-purchasing behavior and as a result, retailer profits.

The numbers are formidable: According to the U.S. Department of Agriculture, from April 2010 to April 2011, the Consumer Price Index (CPI) for food staples was up nearly across the board, with the following registering double-digit price increases: ground beef, 12.1 percent; pork, 10.4 percent; milk, 10.9 percent; butter, 16.2 percent; potatoes, 13.4 percent; and coffee, 13.8 percent (the price of green, unroasted coffee on commodities exchanges has shot up nearly 92 percent in the past year). And crop prices have skyrocketed since last year, with corn, wheat and soybeans up 88 percent, 76 percent and 37 percent respectively, from February 2010 to February 2011.

For 2011, the USDA projects the CPI for all food to rise nearly 4 percent, led by beef and veal (+7-8 percent), pork (+6.5-7.5 percent), dairy products (+5.0-6.0 percent), fresh vegetables (+4.5-5.5 percent), and cereal and bakery products (+3.5-4.5 percent).

In light of such news, how can retailers best adapt to maintain healthy foodservice operations?

"It is imperative to protect foodservice margins, particularly as price increases trickle down to the street and manufacturers and distributors are no longer able to absorb cost surges," instructs the recently released *NACS State of the Industry Report of 2010 Data*. "In the short-term, smaller portions, alternate ingredients and new specials, which make up for the decreased margins on other items, might come first before higher price tags."

Indeed, carefully scrutinizing every phase of foodservice operations is essential to maintaining profitability while prices remain high, with a final execution that balances portion size, ingredients, procurement and price.

PORTION SIZE

It's an old strategy: When the cost of materials increases, resale costs can be maintained by subtly reducing the portion size. The hope is that consumers will not notice (or mind) the shrink, or at least not as much as if the cost increased. And as food costs have risen globally, it's a strategy that has become increasingly popular.

"Size reductions in China are a way for companies to absorb cost increases without gaining too much attention," said Torsten Stocker, an analyst for Cambridge, Massachusetts-based consulting firm Monitor Group in a recent *Wall Street Journal* article. Indeed, over the past several months, companies in China that sell brand name brand soft drinks and beauty products have launched smaller product sizes while holding prices steady.

Although a shrewd packaging technique, the practice risks alienating consumers by making them feel slighted. And in an industry where customer relationships are paramount, many convenience store retailers are disinclined to reduce portion size.

"We always look for alternatives for the packaged product that might lower costs, but one thing I've always been opposed to is altering the portion," said Jerry Weiner vice president of food service for York, Pennsylvania-based Rutter's. "I'd much prefer to raise the price."

While echoing a similar sentiment, Jack Cushman, executive vice president of food services for Canastota, New York-based Nice N Easy Grocery Shoppes, said there are certain items where a transparent portion overhaul is appropriate.

"For instance, we used to sell a huge, oversized muffin. It was far more than what people [preferred], so it was an opportunity for us to make it 1.5 ounces smaller without raising the price," Cushman said.

INGREDIENTS

While trimming the portion is one way to maintain pricing, some foodservice operators are adopting a more creative approach that doesn't involve quantity.

For more than 15 years, Ridgeland, Mississippi-based McAlister's Deli prepared sandwiches with six ounces of meat. But as the cost of meat began escalating in the past year, executive chef David Groll sought a creative solution that pleased both his customers as well as his bottom line. And all it took was a slight recipe shift.

"Our customers were used to six ounces of meat, and we didn't want to challenge that formula," Groll said. "So we decided to develop a line of paninis; they're hip and stylish and a standard, acceptable portion includes three ounces of protein, versus six ounces for sandwiches on bread."

The solution is not just a temporary one, either, as McAlister's paninis have proved popular with consumers. "They are now 14 percent of our total sandwich sales," Groll said.

PROCUREMENT

Yet another strategy for dealing with rising food costs is to work with suppliers. Especially as the economy struggles to regain footing, retailers have some leverage in (re)negotiating prices from distributors. "We redid the agreement with our prime distributor and secured better prices," Cushman said. "We negotiated things down a little bit, so for some items, we didn't have to raise our prices."

The procurement process involves more than just contract negotiation, though. Groll, for instance, assesses the commodities marketplace when planning his menus. "You must plan the whole year out," he said. "You don't run salad promotions in January, the price is [almost always] too high."

Groll stays abreast of supply markets, tracking commodities fundamentals as well as treasury instruments, an academic approach that gives him a greater understanding of his products.

"It's important to know when crops are harvested to determine the best time of year to bid out certain products and when to avoid them," he said. "The food business is really [like] the fashion business — we need to constantly come out with limited time offers."

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For those unwilling to take Groll's hands-on approach, partnering with a commodities procurement company can help yield similar cost savings.

DeWayne Dove, director of commodity procurement for Denver-based Spen-Difference, is a "strategic supply chain partner" that assists foodservice companies with procurement. He cites several elements that help his company manage food price risk for his customers.

"First, we manage risk around individual businesses, not commodities," Dove said. "That involves setting targets around a company's budget and margins. We don't want the commodity market to dictate risk management."

"Second, we need to be proactive, not reactive," he said. "We understand commodity drivers and we implement programs that avoid market volatility [and] third, we look beyond raw material costs, gaining a firm understanding of all pricing components that influence the price of goods, like transportation and freight."

PRICING

No matter how successful your strategy at managing portion size, ingredients and procurement, inevitably, raising prices becomes essential for maintaining profitability.

"At some point, you have to raise prices; you don't want to lower your quality," Cushman said, "but when you do, it's important to time it correctly ... When you have to do a price increase, you do it when everybody is hearing about inflation on the news, so the reasoning is understood."

Cushman said over the past several months, his stores raised food prices about four percent, but there was a selectivity to the process.

"Some things, like our $5.99 sub, you don't want to cross a dollar barrier," he said. "But for others, like our six-inch sub, we went from $3.99 to $4.09."

Cushman said to offset the modest price increase, he runs ongoing specials. "While we raised the prices of many of our subs, we retained one at the old price. It's important to give the consumer an option."

And while for many companies, raising food prices is fraught with anxiety, Cushman explained that for programs where the product line is mature and the customer base is loyal, the resistance can be minimal.

"Food is different than retail," Cushman explained. "For a two-liter Coke, you can't differentiate yourself, but you can do it with food items. You have to be unique, so a customer can't compare you to another shop down the road. That's what makes food less susceptible to customer anger — unlike gasoline."

Weiner agrees, and he says despite two recent price increases, he hasn't seen a falloff in sales. "I did a small increase in August of last year on a few items, and we followed up with a bigger increase on a number of items four months ago," he said. "I have not seen any detriment to our units."

Weiner emphasized that while raising prices is a delicate practice, it's not nearly as sensitive as gasoline pricing, because his menu items are unique, quality offerings.

"I always keep an eye on competitors, but I don't have to be the cheapest, because I think our product is better," Weiner said. "I just look for a price point that will fit into the market."

And of course, it always helps to emphasize your key operational attribute with your food offering — convenience — which adds value to any proposition, even one accompanied by a modest price increase. NACS

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Commodity Watch

Bill Lapp, president of Omaha, Nebraska-based Advanced Economic Solutions, a consulting firm that specializes in assisting food companies with risk management and commodity issues, cites five elements to managing commodity pricing risks:

- Always own at least three months of hedge-able commodities.
- Buy on any 10 percent decline in prices.
- Time your purchases to coincide with seasonal values.
- Book your contracts when margins are acceptable. ("Go for the single, not the homerun.")
- Purchase additional product when prices fall below predetermined levels.

The Expert Says…

Todd Hale, SVP of Consumer & Shopper Insights, Nielsen, offers these tips for dealing with rising food costs:

- Raise prices when you have the opportunity.
- Leverage the expertise of proven foodservice operators (Subway, Dunkin' Donuts) rather than going it on your own.
- Cater to the foodservice tastes of your core shoppers.
- Greater volatility in commodity prices is something that winning accounts will need to master to survive. Don't forget your secret weapons — convenience, convenience, convenience.