Foodservice Marketing Insights

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"I'll Try the Crow, With a Slice of Humble Pie!" - acknowledgement that "something is happening" in the foodservice broker agency industry, contrary to my earlier beliefs

"Separation Anxiety" - suggests that major distributors' appetite for "decoupling" logistics costs and product costs might be taken to a new level

"Get Smart About Foodservice Pricing" - introduces a White Paper by Signal Demand, with a refreshingly scientific approach to foodservice pricing

I think you're going to find this month's issue pretty interesting.

To start, you'll have the unique opportunity to see a consultant admit he was wrong. Then I'm going to continue tilting at the windmills of manufacturer-distributor business practices. And finally, you're going to read about a company that is bringing an entirely new level of sophistication to bear on the complex issues of foodservice pricing decisions

Thanks for reading, and as always, let me know what you think. **Tell Dave**

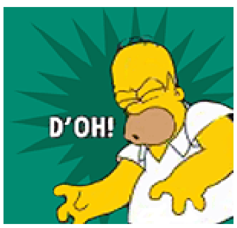
Dave

"Mistakes are the portals of discovery." - James Joyce

"I'll Try the Crow, With a Slice of Humble Pie!"

Back in February of 2007, I sat on a panel of manufacturers, brokers, and other distinguished foodservice folks at the FSMA Top2Top Conference. We were discussing the prospects for consolidation and regionalization of broker agencies in the foodservice channel.

I remember telling the audience that I didn't like making public predictions, because they're so often wrong and there is really no downside to throwing out opinions. But I also said that although there was certainly some consolidation of foodservice agencies underway, I did not see it as a major trend or an issue that would significantly impact our business.



As 2008 winds to a close, consolidation and regionalization of foodservice broker agencies certainly IS happening, and certainly IS the big news in that industry.

Not everyone is excited about it, not everyone is going to do it, but:

-right or wrong, most manufacturers I talk with are intrigued, if not excited by the prospect of simplifying and standardizing management of brokers

-whether or not they think it's a good idea, some manufacturers are starting to feel the impacts, as their formerly independent brokers sign on with the big groups and step into newfound conflicts. When it comes to longstanding manufacturer/agency relationships, it's been described as "all of the cards have been thrown up in the air - we'll see where they fall!"

-many broker agencies are at least taking a serious look at whether or how they should respond to this trend

And I have seen first-hand the power of agencies belonging to a respected group or association. Some manufacturers now appear willing to consider appointing a group of agencies without directly interviewing each company. It seems that as long as a manufacturer knows and respects a few of the group's members, he is willing to extend the benefit of the doubt to the others, in exchange for greatly reducing the time and effort required to establish a broker network.

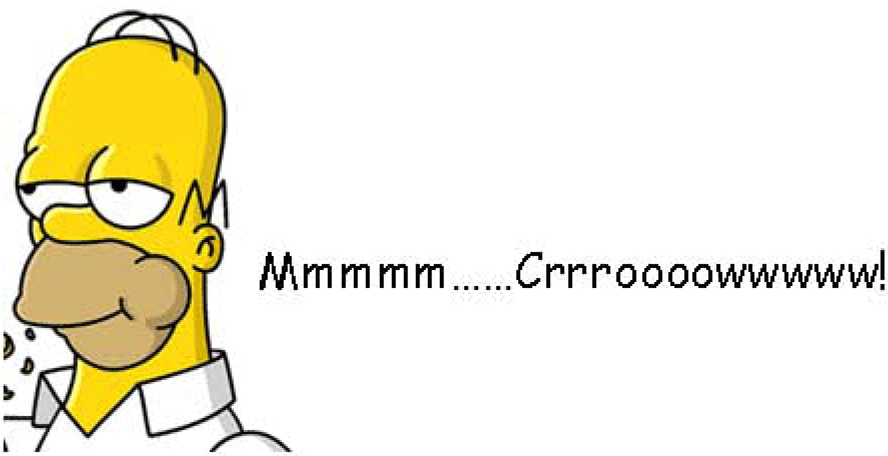
Right or wrong? Smart or stupid?

It's way too early to tell if this movement will deliver the goods for manufacturers, and for the agencies who sign on. It's possible that in a year or two, we'll be carefully deconstructing these associations and dealing with the fallout in the form of tossing all the cards in the air once again.

But it's equally possible that this is just an interim step on the way to formation of one or more national foodservice broker agencies.

What do I think?

I'm not touching THAT with a ten foot pole!



"Separation Anxiety"

The major distributors are working with their key suppliers in an effort to separate product costs from logistics costs. Beginning a few years back with the launch of Sysco's RDC initiative, the big guys have been seeking a new, clearer understanding of the total costs of storing and shipping finished goods. Once these costs are on the table, sophisticated distributors are saying "let's work together to optimize these costs, and share in the savings." Others are saying "we want to take over as much of the logistics activity and costs as possible; you focus on R&D and production, and let us focus on moving product."

Implicit in this approach is a suspicion that some manufacturers operate their supply chains as a profit center, with price structures and allowance programs which do not accurately reflect costs. Another motivation is a concern that manufacturers' policies tend to be based on averages, and that high-volume distributors somehow are subsidizing lower-volume distributors. Then there is the understandable desire on the part of distributors to make sure they are utilizing their warehouse and transportation assets to the fullest possible extent.

In addition to overcoming the fear of "opening their books to their customers," manufacturers must cope with the fact that new patterns of moving product might make existing networks obsolete.

For instance, if high-volume customers decide they want to pick up more of their products at the plant, the manufacturer's assumptions and plans regarding forward warehouse utilization go out the window. If a multi-branch distributor wants to roll up volume from several houses, pick up a truckload, and deliver it himself to his branches, the manufacturer's freight lanes, sailing schedules, and costs are affected.

That said, participating in these exercises is a good move for manufacturers who want to strengthen their relationships with distributors. Any time the conversation can move away from marketing programs and prices, and toward service improvement and cooperation, everyone benefits. So as frightening as it may be, I believe manufacturers are well-served to go down this path with trusted customers.

But it makes me wonder:

Will the manufacturers who agree to this new world also say *"as long as we're breaking out and divvying up costs, let us show you what happens when we separate product cost from distributor marketing cost?"*

Specifically, will these manufacturers show how much the distributor's product cost is driven up by mandatory participation in distributor marketing programs, label allowances, food shows, and the like?

And having spelled it out, will these manufacturers then say *"we will focus on R&D, production, and* ***MARKETING*** *of our branded products; while you focus on moving products?"*

And when it comes to distributor private label, a manufacturer speaking the plain truth might say *"let's face it; we will never really get behind promoting your label, even when we pack it. We all know we'd rather sell our national brand, and besides, we're probably packing several competing labels in each of your markets.*

So shouldn't our private label relationship be more like a co-packer relationship? We can focus on producing great products within your specs, but you really should have full responsibility for the marketing and selling activities and costs associated with your brand. Can we take a look at what your distributor-label product costs will look like if we also strip out our marketing costs?"

Bottom line, I'm all for taking the "pixie dust" out of pricing, and getting everyone on the same page about the Cost of Goods Sold, Logistics Costs, and Marketing Costs associated with foodservice products.

With the Supply Chain folks leading the way, are the manufacturer Marketing and distributor Purchasing folks willing to follow?

"Get Smart About Foodservice Pricing"

We know all too well how complex our business is. As one colleague puts it, "we have too many deals. Every manufacturer makes a deal with every distributor and every major operator. Then the distributors make deals with other manufacturers, and have their own deals with operators. It's a miracle that there is ever alignment!"

As a result, we have pricing practices that defy logic, and programs that usually don't deliver the results that are shown on paper. And because of the seemingly endless variables around commodity costs, production capacity, and customer demand, pricing decisions tend to be much more art than science. And we're not talking about Rembrandts here, are we? For a lot of us, it's more like finger-painting!

But there is a company that has brought a new level of sophistication to addressing this problem.

I recently became aware of Signal Demand, a company that uses "advanced math and sophisticated algorithms" to turn pricing decisions into a consistent, repeatable, defendable science. And while I have no direct experience in working with them, a recently-published White Paper titled "Pricing in Complexity: Profitability Challenges in Foodservice Manufacturing" demonstrates a keen understanding of the challenges faced by foodservice manufacturers.

I've published the paper in its entirety below; those of you who would like additional information are invited to visit **www.signaldemand.com**.

Pricing in Complexity: Profitability Challenges in Foodservice Manufacturing

By Dr. Robert Pierce

The foodservice processing and manufacturing industry is poised for a promising long-term future as populations and consumer wealth grow and available time for at-home food preparation declines. The smart manufacturer can withstand foodservice industry declines (like 2008) by proactively adjusting pricing, product mix and production.

However, making the right adjustments is no small feat. Price, product mix and production decisions are inherently complex for foodservice manufacturers due to a wide variety of products, customers and channels. Foodservice manufacturers' multi-tiered selling and distribution networks further complicate already difficult decisions and frequently result in the inefficient or ineffective use of valuable trade spend dollars.

Many foodservice manufacturers now find that their current means of determining prices, margins and forecasts fail to generate the net margin results required to compete and win in a rapidly changing business environment. In addition, list price becomes meaningless and inconsistent, and inappropriate prices often result (for example, smaller customers receiving lower prices).

Forward-thinking foodservice companies are increasingly turning to optimization powered by advanced math and sophisticated algorithms to provide their pricing teams with more accurate forecasts, better recommendations on price, product mix and production and a defensible methodology for determining prices.

The stakes couldn't be higher--manufacturers who make better and faster pricing decisions will ultimately control their profitability instead of having the market dictate success or failure.

<u>Three Key Challenges</u>

Challenge # 1: Knowing True Net Margin at the Product/Customer Level

Because of complex distribution and selling networks, few foodservice manufacturers know exactly what customers pay for products, making it impossible to identify true net profitability at the product/customer level or create what is commonly described as the "margin waterfall." However, this information is vitally important as profit leakage occurs every day when thousands of small pricing opportunities are missed.

Building real-time margin waterfalls is a data manipulation and organizational management challenge. Aggregating information and uncovering optimal net prices at the product/customer level is beyond even the most advanced spreadsheet and requires a sophisticated price management and optimization solution.

Challenge # 2: Developing Accurate Forecasts

Foodservice manufacturers have always faced challenges in forecasting ingredient/commodity prices and projecting the impact on product market prices. However, this need is more acute as ingredient/commodity prices change at an unprecedented pace.

The best possible forecasting to balance risk is critical to manufacturer performance. Reliable short-term, mid-term and long-term forecasting helps a manufacturer know the profitable pricing floor on a fixed price contract, and when to opt for a commodity market price formula contract. Customers appreciate the dependability of manufacturers whose accurate forecasting makes them an outsourced manager of their underlying ingredient/commodity costs.

The forecasting challenges for foodservice manufacturers are three-fold:

1. Maximize the use of historical, current and futures markets price data to create the best possible forecast based on "the numbers." (This requires sophisticated and tested mathematical models.)

2. Produce a forecast that allows opportunity for management to also inject judgment

3. Adjust forecast product prices based on real-time analysis of the marketplace's reaction to new price levels.

Challenge # 3: Establishing "Optimal Prices and Margins"

Optimal, consistent and profitable true net margins require complete knowledge of the margin waterfalls.

The means to develop such pricing necessarily requires bringing together: (a) all the elements of the organization that influence margin waterfall component values, (b) the production capacity constraints and available capacities, (c) finished product inventory levels, (d) forecast ingredient, commodity and resultant product costs, (e) historical customer price levels and (f) estimated price elasticities of demand and resultant optimum price points. Layered on top of these ingredients should be (g) management judgment of current marketplace realities such as the acceptance of commodity cost spikes in the product.

This effort is extremely complex as trade-offs clearly make it impossible to optimize without the help of serious information systems and massive amounts of data, especially given the huge number of product/customer combinations with ever-shifting costs and prices. In fact, technology and computer processing power have only recently advanced to the point of being able to solve this very large "optimization" challenge.

The Price Management and Optimization Solution

Ideally, an optimization solution provides the information necessary to not only bring pricing at the product/customer level under control, but to optimize it. Six components are essential for success:

1. Margin Waterfall: incorporates all elements that define true net profitability.
2. Price Consistency Analysis: makes it easy to discover outlier prices, outlier net margins and other outlier elements of the margin waterfall.
3. Input Ingredient/Commodities and Output Products Price Forecasting: forecasts commodity prices weekly over the next year, using sophisticated historical modeling techniques.
4. Optimal Prices Determination: advanced mathematical models determine what to make at which price to maximize total net margin within the production capacity constraints.
5. Price Action Adjustment: flexible business rules embedded in an automated price optimization solution allow you to adjust the optimum prices for the realities of today's market.
6. Value Measurement Performance Tracking: represents the opportunity areas, so you can identify, implement and track the results of the optimal price.

Addressing the challenging complexities of profitability in foodservice manufacturing is far from simple, but it can have significant rewards. Implementing price optimization can be transformational for foodservice manufacturers, resulting in increased profits of more than 20 percent, in addition to the benefits of institutionalizing price strategy in case of changes in key staff, as well as increased sales effectiveness as sales reps have confidence in defensible prices and improved customer relationships, based on fair and accurate prices that can be provided quickly.

Dr. Pierce combines academic and practical business experience to guide the process of developing the science behind SignalDemand's software solutions. Prior to SignalDemand, Dr. Pierce held senior level research and development roles at Khimetrics and ConceptLabs, as well as academic posts with the National Academy of Sciences as an NRC Fellow, Penn State University, and U.C. Berkeley. His professional contributions have spanned a wide variety of fields including Econometrics, Oceanography, Hydrodynamics, Partial Differential Equations, and Nonlinear Dynamics. He is the author of numerous peer-reviewed papers and has a number of patents pending. Dr. Pierce holds a Ph.D. in Theoretical Physics from the University of California at Berkeley.

Finally, I suggest you check out Signal Demand's pricing blog, which I find has a lot of relevant (and often entertaining) content. You can find it at **www.chiefpricingofficer.com**

Now get back to work, then have a wonderful, safe relaxing holiday and we'll pick it up again in 2009!

Comments? Questions? Further Thoughts? Criticism? All are welcome at **Tell Dave**

My Website: **Franklin FS Solutions**