**A Purchasing Strategy Proven to Be Cost Effective and Which Has Also Led to Better and More Consistent Quality**

White Paper

January 10, 2012

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This paper argues for a strategy that allows foodservice organizations to look further back in the supply chain and include in the purchasing function the procurement of raw materials directly from raw material suppliers. It has been our experience that when our clients get involved in the procurement of raw materials, it often leads to better and more transparent pricing, enhanced strategic partnerships with suppliers, and improved quality and consistency. This is not the case for every product, in every country, and at every point in time as different market growth rates may require different strategies. While for us this strategy has been extremely successful in some situations, it is not a silver bullet that can be used in all situations.

Further involvement by clients in raw material purchases may provide them and their stakeholders with increased savings, yet it also has its drawbacks and limitations. It presupposes more intensive management and the shift of some short term risks from the finished good (FG) manufacturer to the foodservice organization. The client will be responsible for the raw material orders placed with raw material suppliers and will need to find a home for this raw material even if it may no longer be needed in the system. Also, this endeavor requires more hands on involvement with all the details involved with raw material purchases and deliveries and daily monitoring of markets and trends.

**Bottom line**: Client involvement in raw material purchases provides a number of advantages and leads to improved profitability but requires additional management expertise and overall commitment to make it work. It also has proved to be a big advantage not only to the client foodservice organization but also to FG manufacturers that look at them as long term, multi decade, customers.

Executive Summary

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Section 1: Introduction

We would like to share with you success stories in which we have participated during the last three decades. The stories will be familiar to some companies as it may form the basis through which they purchase key products. For others, it may serve as a starting point to not only evaluate current processes but develop new strategies going forward. While this paper will lay out the strategy used and some of the benefits (and limitations) that have led to multi-million dollar achievements, we want to point out that it does not work for every product, in every location, at every volume level.

First, we have observed that most foodservice organization’s purchasing costs follow the following formulas:

and

Some examples of the ’Commodity Raw Material’ portion of formula #1 include:

Polyethylene pellets for plastic bags

90CL beef trim for ground beef in North America

Ham muscles for cooked Ham

Chicken breast for chicken patties and chicken strips

Eggs for various breakfast offerings

Pork trim for breakfast sausage, hot dogs, salami, pepperoni, and other offerings

Some examples of the ‘Fixed Charges’ portion of formula #1 include:

Direct labor

Overhead

Profit

Risk premium to cover price changes in raw material costs

Corrugated

Spices

Administrative costs and supplies

We have found that the production and distribution flow of many foodservice products can be represented by the attached Chart 2.

**Widening the Scope**

Steps 1 and 2 of the purchasing and distribution flow are often seen as outside the scope of the purchasing function in a foodservice organization. Negotiation and direct purchasing from the commodity raw material producer (Step 1) is generally seen as the province of the FG manufacturer. IT managers often say, “Garbage in, garbage out”, implying that the finished product is only as good as what goes into it. It is our contention that the foodservice organization’s focus on the raw material component is essential for the quality and consistency of their finished goods and is very important in determining the price paid by the local stores in Step 6. In essence **we propose a strategy that allows the Foodservice Operator to look further back in the supply chain and capture all the steps outlined in the product flow outline, steps 1—6 rather than 3 - 6**. This often results in lower costs and more consistent and better quality product at the store level. Also, by managing the raw material flow from the packer, the foodservice organization is more in tune with the market and can better align marketing and promotion with trends in raw material prices.

Different foodservice products have different profiles. For example: For cheese in the USA the Commodity Raw Material is Class III milk and it makes up the majority of the cost of the delivered cheese. While for bread the Commodity Raw Material is flour, generated from wheat, basis and a credit for mill feed and it makes up a minor portion of the overall cost of bread delivered to the foodservice establishment.

Transportation of raw materials from the raw material producer to the FG manufacturer (Step 2) is either controlled by the raw material producer or the FG manufacturer. The Foodservice Operator is rarely involved in this step although in some cases, it has been possible to leverage the significant relationships with transportation companies to find solutions that reduce costs in this step as well.

**Case Prices**

Once you have an idea of what Formula 1 (see chart on page 4) looks like for a particular foodservice product, you have an excellent tool to negotiate with your suppliers when things change (and over time things ALWAYS change). When Commodity Raw Material prices move up by 20% what does that do to the FOB Manufacturer’s Plant Price? For some items that might mean a 16% price increase to the FOB Manufacturer’s Plant Price is fair and reasonable, maybe even cheap. For another item it might mean that a 4% increase is much too large of an increase. It is impossible to know whether a requested increase in the finished goods price is reasonable or warranted until/unless you know the contribution of raw material costs to the overall case price.

Section 2 of this paper will focus on the benefits of having Foodservice Operators negotiate purchase commodity raw materials while Section 3 will outline potential drawbacks and limitations.

Some Foodservice Operators have become more involved in recent years in directly negotiating the price of raw materials, effectively pooling the purchasing power of individual suppliers. Below is a list of some of the benefits of this strategy:

**Better Pricing**

Our experience has been that, in some cases foodservice organizations can negotiate more advantageous prices from the “Commodity Raw Material Producer” than their FG manufacturer can. In most scenarios, it is in the best interest of the stakeholders to have the foodservice organization and their agents negotiate these prices. This is particularly evident for those suppliers that operate on a cost plus basis and who do not have the same incentives as the foodservice organization; namely to minimize raw material costs while maintaining product quality and consistency. As commodity markets become more vertically integrated, the Commodity Raw Material Producer will benefit from having to negotiate with one large buyer rather than a number of smaller buyers thus becoming more amenable to negotiate prices lower.

**Strategic Partnerships**

By taking over the purchases of raw materials, the Foodservice Operator is able to establish better strategic relationships with large raw material supplier companies as well as FG manufacturers.

*Raw Material Suppliers*

A number of large commodity raw material producers are multinational companies that operate in multiple continents. The opportunity exists to establish strategic relationships with raw material suppliers and be able to service FG manufacturers in various parts of the world. In the case of raw material disruptions in one country, such strategic partnerships could allow the foodservice organization to re-establish supplies more quickly and at a lower cost than by having to find new suppliers on short notice.

*FG Manufacturers*

As the foodservice organization and its agents take over the procurement and management of the raw material supplies and flow, the FG Manufacturer generally gets the same long term average profit for being a converter. Those profits, however, are much more consistent from month to month and year to year. Consistent profits, rather than erratic profits, have significant advantages to many manufacturers (especially if they are a growing concern relying on borrowed money). This consistency is likely to align the foodservice purchasing function with the FG manufacturers in developing long term strategic relationships that benefit all parties involved.

**Transparent Pricing**

The worldwide or country wide total volume of the foodservice operation can be used to negotiate better deals. In some cases, especially with small volume items or for smaller markets the local FG manufacturer can do a better job. If the FG manufacturer always passed through the savings to the foodservice organization involved then that would represent an optimal solution. However, sometimes the FG manufacturer can obtain a better price than the foodservice organization, but the manufacturer does not pass those savings through. The only way for the Foodservice Operator to be sure that they can maximize all the value out of their market power vs. raw material suppliers is to negotiate directly with them. Increased transparency allows the Foodservice Operator to: a) see all the steps involved and the associated costs; and b) negotiate directly with suppliers and, in the process, lower the overall case price delivered to the store.

**Allow Manufacturers to Focus on Quality and Consistency**

As the foodservice organization takes over the sourcing of raw materials into the FG Manufacturer, a number of things take place.

There is no longer an incentive for the FG Manufacturer to cut corners and substitute lower grade raw materials for more expensive ones, particularly when this has not been specifically disallowed in the specification. The risk of using less than desirable raw material is a risk whenever the responsibility of purchasing raw material falls on the manufacturer.

If the FG Manufacturer saves on the Commodity Raw Material portion of Formula 1 and has given the foodservice company a fixed cost, the manufacturer keeps all those savings .

If the foodservice organization negotiates the Commodity Raw Material, the costs of that component are perfectly transparent. The foodservice organization or its agents buy the right raw material, allowing FG manufacturers to make great and consistent products with no effect on their bottom line profit. The foodservice company gets better, more consistent quality, often at a lower price. Manufacturers get good, consistent profits if they run their operations effectively.

**Remove “Built-In” Risk Premiums**

When the Foodservice Operator asks a manufacturer for a long term fixed price, the manufacturer generally (this is likely always the case but we will say generally) has some risk premium included in the “Fixed Charges” portion of the formula. If the FG Manufacturer has no raw material price risk then the Foodservice Operator should be, and in the past has been, able to negotiate lower prices in the form of a lower formula by removing this risk premium.

**Support High Quality Producers**

Sometimes the best manufacturer is a small operation with limited resources. They often make superior and more consistent quality products. One of the constraints in using ‘smaller producers’ is that large “Commodity Raw Material Producers” often are unwilling to sell these smaller manufacturers products out-front because of credit risk concerns. **The ability to take out front positions often is important for large Foodservice Operators as it allows for better risk management and menu price stability**. On behalf of our clients, we have often negotiated raw material supply deals for extended periods of time out-front, which have benefited the Foodservice Organization and their stakeholders. This represents millions of dollars in savings made possible because the “Commodity Raw Material Producer” has confidence that the Foodservice Operator will live up to its commitments. These are savings that the smaller manufacturer might not be able to realize because of their financial situation.

**Optimize Transportation Costs**

When a manufacturer purchases freight to move raw material from a beef packing plant in Nebraska to a steak cutting plant in Atlanta, it does not matter if you put 20,000 pounds on the truck or 40,000 pounds on the truck. The cost of the truck is often the same. Some manufacturers like to produce to order, i.e. they will order only enough raw material to cover orders on the books. A $4000 freight charge on a full truckload of raw material is the equivalent of 10 cents per pound. By bringing in a truck that is only half full, the freight charge now is 20 cents per pound. Considering that a large foodservice company purchases millions of pounds of raw material, those freight charges, which are built into the cost of the product, add up quickly. When the Foodservice Operator or its agents take over the purchasing of the raw material, they are able to pool a larger volume and allow for full optimization of the transportation from the raw material supplier to the manufacturer (Step 2). While the Foodservice Operator may not negotiate the day to day freight rates, the foodservice operator can make the decision to only receive product in full truckloads and work with raw material suppliers on that basis.

**Overview**

The question needs to be asked “**Are the advantages the FG manufacturer gets when the Foodservice Operator negotiates the purchase of the raw materials intuitively apparent to the manufacturer?**” The answer in general is no. Those advantages need to be explained and sold to the manufacturer. In general, the first response from the manufacturer is that they don’t want to give up the “buy” because they look at the “buy” as a profit center for them because from time to time they are able to charge higher prices for a while when the market declines and often buy for less than some published market they share with the Foodservice Operator . When the Foodservice Operator makes the “buy” all the misinformation disappears as things become transparent. This perceived manufacturer benefit is offset by the ability to establish long term partnerships, reduce risk and provide consistent high quality products.

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| **Formula #1** | **Commodity Raw Material**  | **x** | **Yield** | **+** | **Fixed Charges** | **=** | **FOB Manufacturer’s Plant Price** |
| **Formula #2** | **FOB Manufacturer’s Plant Price** | **+** | **Distribution Fees** | **=** | **Delivered Price to the Foodservice Stores** |
| **Step 6** |  | **Step 5** |  | **Step 4** |  | **Step 3** |  | **Step 2** |  | **Step 1** |
| FoodserviceStore | **** | Distribution System  | **** | Logistics, Transportation from Manufacturer to Distributor | **** | Manufacturer (converts RM to FG product) | **** | Transportation into the Manufacturer | **** | Commodity Raw Material Producer |

**Chart 2: Flow of Purchasing and Distribution for Foodservice products**

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**Drawbacks/Limitations of Buying Commodity Raw Materials**

**Responsible for Raw Material Purchases**

When the FG manufacturer purchases raw materials, they are generally responsible for the volume of product that has been bought out front. Normally a manufacturer will purchase raw material out front in order to support expected sales to the foodservice customer. If that sales volume does not materialize, or is smaller than expected, the manufacturer cannot renege on the contract with the raw material supplier and will try to find a home for the product, either by using it for other customers, or by selling it in the open market. However, the price of that raw material will depend on what the spot market price is at the time of sale and there is the possibility that the manufacturer will take a loss in order to remove this liability. When the Foodservice Operator purchases the raw material, it becomes responsible for finding a home for the product and, in some cases, could end up selling raw material at a loss if sales do not meet planned goals. The take away from this is that the Foodservice Operator will have to do a better job planning for sales out front and have better communication with the marketing team about promotions that could impact sales in the coming quarters.

**Credit/Cash Flow Constraints**

Generally manufacturers know what their credit constraints are and will order raw material accordingly. When the Foodservice Operator takes over the raw material purchases, it will try to order product with the goal of minimizing overall costs. This includes building raw material inventories at opportune times. However, these inventory builds could negatively impact cash flow for FG manufacturers and their lines of credit may not be able to support significantly larger deliveries during certain parts of the year. As a result, it is important that the Foodservice Operator work closely with manufacturers to understand what their limits are and to also communicate with them plans for any inventory builds in the future. When manufacturers go to their bank to finance raw material purchases, if they do not have firm orders in hand the banker views them as a speculators and may not provide favorable terms. If manufacturers go to the same bank to finance the same raw material but with a signed contract from the Foodservice Operator that assures the raw material risk will not be the manufacturers’, the banker views them as successful, smart businessmen and will likely provide much more favorable treatment than for a higher risk customer.

**Reduced Flexibility**

When the Foodservice Operator extends the window for out-front orders and puts significant raw material out front commitments on the books, it also reduces the flexibility with regard to future promotions or finished good changes. It is no longer the case where the Foodservice Operator notifies a supplier that a product will be discontinued. Now the Foodservice Operator also has to consider out front commitments for raw material and how best to remove those obligations without damaging relationships with raw material suppliers. This requires that Foodservice Operator to have contingency plans in place to deal with any such disruptions.

**Overview**

A point that is obvious from all the issues raised above is that purchasing raw materials is much more management intensive and requires significant attention to detail. When actively managing raw material purchases, it is imperative that buyers be in tune with daily activities in raw material markets and be able to work with raw material suppliers on issues that come up (and issues ALWAYS come up) with production, transportation and delivery of these products. It is also imperative that the Foodservice Operator be able to quickly find a home for the raw material when a converter manufacturer has a production breakdown or there is a storm that delays trucks.

From time to time we hear foodservice buyers tell us how they refused to allow a manufacturer to raise prices as raw material commodity prices increase. Our general reaction is that if the raw material market goes up significantly and the manufacturer can stay in business without raising prices, there must have been a considerable RISK MARGIN IN THAT MANUFACTURER’S PRICING. While higher commodity prices will dig into that margin, from time to time, if the Foodservice Operator bought the commodity raw material, these risk margins could be at ZERO ALL THE TIME.

**Chart 1: Case Price Formula**

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Section 3

Section 4: Summary

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When Foodservice Operators become involved in contracting for raw materials going into their manufacturers, in many cases we have seen:

The cost of raw materials declines and with it foodservice store costs.

The alternative ways to price raw material, including time frames, expand and this benefits foodservice store costs.

A significant reduction in the “market risk” premium included as a component of the fixed charges included in a manufacturers pricing structure. Often the premium can be negotiated to zero, with the long term benefit accruing to the foodservice stores.

More consistent profitability for the manufacturer.

Improved ability to quickly respond to promotion opportunities because the information flow chain is shorter. This often results in lower costs to the foodservice stores.

Product quality improvements since the profit incentive has been removed from the manufacturer to cut corners on raw material quality, which results in happier customers and larger customer counts for the foodservice stores.

Better ideas from converter manufacturers are often generated and given to the Foodservice Organization because they understand that their long term growth is directly tied to the growth of the Foodservice Organization, not how they can manipulate a better margin with a limited amount of business. This tends to benefit everyone: the manufacturers; the Foodservice Organization and its stakeholders; and the foodservice stores.

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**Chart 2: Flow of Purchasing and Distribution for Foodservice products**

Section 2: Benefits

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