Executive Insights

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Food and Facilities Services: 2016 Trends and Opportunities

Executives in the Food and Facilities Services (FFS) sector will face a number of critical issues throughout 2016. Amid constant cost pressures and an increasingly competitive and complex business environment, FFS firms ranging from the "Big Three" of Compass, Sodexo and Aramark to strong midsize regional players and smaller local firms must act strategically in order to maintain their vitality. In this *Executive Insights*, L.E.K. Consulting shares our views on the state of the FFS industry, including key market trends and implications for operators and investors.

Recipes for growth

The FFS sector — composed of interrelated food and beverage service providers as well as both "hard" and "soft" facilities management firms (ranging from capital project management to custodial services) — generates an estimated $950 billion globally across the business, education, healthcare, sports and entertainment, and government markets.

As in many markets, a sizable portion (roughly 40%) of addressable end users in North America conduct FFS services in-house — meaning that despite the industry's maturity, considerable outsourcing opportunities abound. Indeed, a number of trends have led end users to weigh the advantages of FFS outsourcing:

- Rising cost pressures in several industries — most notably, healthcare and education — are causing non-customers to revisit their decision to keep services in-house ("The experts can handle this more cheaply than we can …")
- Increasing complexity of operations is driving facilities to rely on third-party expertise ("I could use an experienced partner who has made these difficult decisions before …")
- Competitive pressures are causing end users to seek high-quality services to attract and retain employees and/or consumers ("Our in-state rival university just outsourced its food services and now has the most talked-about dining facilities in the region …")

Although these factors are expected to fuel FFS growth across most markets going forward, they also will intensify competition among FFS operators. Unlike "whale" contracts for which only a handful of operators can compete, outsourcing will arise mainly from small to midsize contracts that are likely to attract a significant number of bidders. For every new contract of significance, operators can expect competitive bids from at least one (if not all) of the Big Three, a couple of midsize industry specialists and, perhaps, local operators willing to sacrifice margins to compete on price.

Food and Facilities Services: 2016 Trends and Opportunities was written by **Alex Evans**, **Thilo Henkes** and **Aaron Smith**, Managing Directors, and **Kevan Moniri**, Manager, at L.E.K. Consulting. Alex is based in Los Angeles, Thilo and Kevan are based in Boston, and Aaron is based in San Francisco.

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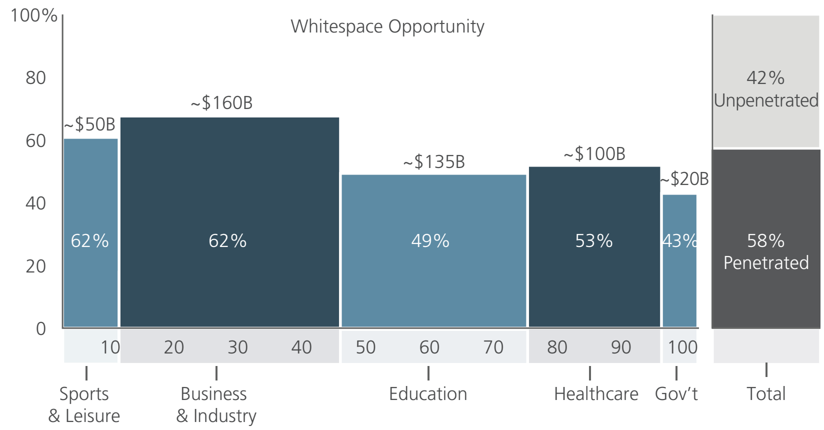
Accordingly, FFS firms must develop the strategic foresight to maintain and build market share. We recommend that operators seeking top-line growth consider taking some or all of the following actions:

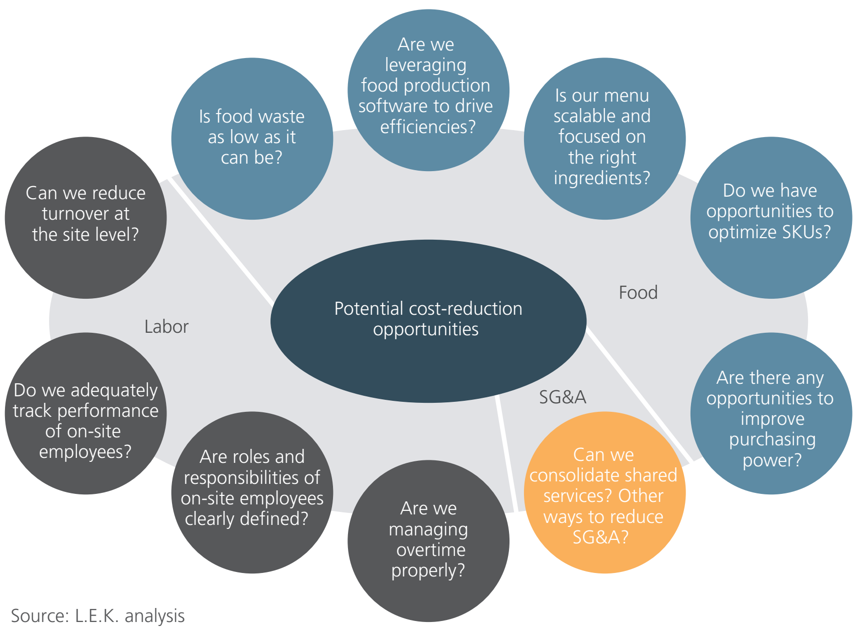
- Focus on increasing customer retention. Switching operators is costly for end users and results in service disruptions, equipment replacement and employee terminations. This reality is not lost on the Big Three, whose retention rates average around 90-95%. In our experience, lost contracts generally arise from account service issues — such as an on-site manager clashing with a customer point-of-contact or a customer leadership change disrupting a business relationship — rather than from price undercuts. Given the significant impact on top-line growth of increasing (or decreasing) retention by only 1-2 percentage points, it is crucial for companies to recognize and address these issues promptly.
- Drive incremental revenue from existing clients. In their recently published book, *Edge Strategy: A New Mindset for Profitable Growth*, co-authors and L.E.K. Managing Directors Alan Lewis and Dan McKone describe a methodical approach for companies looking to exploit untapped sources of high-margin profit that exist on the edge of their core business — through the sale of ancillary goods and services. Fixed FFS contracts preclude the upselling of core services, yet customers are often interested in ancillary offerings from the same trusted supplier (e.g., soft facilities services such as grounds keeping). Too many companies focus on their current core offering and lack the pattern recognition skills to identify and implement ancillary services that actually make a customer's interaction with the operator more complete.
- Expand new business. Poaching customers from competitors can be challenging and, if not handled carefully, margin-dilutive. By contrast, addressing the needs of "whitespace" customers — those that do not currently outsource FFS, typically because they fear rising costs and diminished control — often yields greater business development. Our market research indicates an abundance of such prospective customers (see Figure 1) despite contrary evidence suggesting that outsourcing can be both cost-effective and beneficial to the operator-customer relationship. Operators can overcome these misconceptions and increase their chances of winning business, even in RFP scenarios, by educating whitespace prospects on the benefits of outsourced FFS.

Figure 1
North American food and facilities
market penetration by industry vertical (2014)



Source: L.E.K. analysis, annual reports, analyst reports

Figure 2
Cost-reduction questions to consider



Source: L.E.K. analysis

- Grow inorganically via M&A. In an FFS industry that remains fragmented, with many competitors (including the Big Three) accounting for only a small portion of global sales, the current market environment is ripe for inorganic expansion. Midsize regional operators are consolidating in order to achieve scale benefits not only in cost efficiencies but also in competitive positioning, whether from reputation ("the bigger, safer choice"), through broader geographic reach to accommodate multisite customers, or with the ability to compete for larger contracts. M&A also provides an attractive, immediate entryway into an adjacent service or industry — say, a business FFS specialist entering the healthcare space.

Increasing pressure on margins

Thanks to thin operating margins in the FFS sector — typically in the mid-to-high single digits for even the most scaled players — cost-containing measures can have as great an impact on the bottom line as a comparable increase in revenues. Yet this is not an industry that has already driven costs to the lowest common denominator. Most operators manifest multiple cost-cutting opportunities (see Figures 2 and 3). In fact, leading operators are not only fending off external pressures on margins, but also implementing greater initiatives to control costs.

Compass has proven that significant margin expansion is possible and serves as the gold standard for pursuing a successful cost-cutting strategy. Its 2006 "Management and Performance" margin expansion initiative lifted its operating margin by an impressive 270 basis points, from a modest 4.5% to 7.2% by 2015. Though partly revenue-driven, the bulk of the company's improvement was due to enhanced cost efficiencies that, in our experience, exist across the three primary cost categories: food, labor and SG&A (selling, general and administrative). Using Compass as the benchmark, operators ranging from Fortune 500 firms to local players revisited their own cost base in search of similar savings.

Conclusion

While FFS operators can choose from a number of revenue-generating and cost-containing strategies, there is no one-size-fits-all approach; one company's low-hanging fruit may be another's distraction. To boost margins, operators must think holistically, positioning themselves competitively in order to capitalize on market tailwinds while re-examining their ongoing operational cost base.

Whether adding higher-quality services to attract and retain employees and customers, or seeking the advice of an experienced third party to help manage increasing complexity, FFS companies that are truly proactive will be more likely to maintain their footing — and their investor base — going forward.

Figure 3
Cost-reduction questions to consider

	Component Checklist	L.E.K. Perspectives
Food	Waste reduction	Consensus feedback indicates this remains a "low-hanging fruit" issue for many providers
	Food production	Can often be improved by disciplined use of tools or software that drive in-unit efficiencies
	Menu optimization	Providers can leverage a scalable menu and focus on noninflationary ingredients
	SKU optimization	Rationing food types and SKUs can potentially be achieved through operational improvements
	Procurement	Sourcing can be improved with scale (e.g., analysts indicate that Compass' procurement arm, FoodBuy, provides a 50-100bps lift in company operating margins)
Labor	Scheduling management	"Smart scheduling" can reduce costs by reducing redundancies and managing overtime
	In-unit role standardization	Can more clearly delineate roles and responsibilities
	Turnover reduction	Can reduce turnover by investing in employees, tracking performance via KPIs and implementing tailored retention strategies
	Salaries and benefits	While wages are often inflexible, modest cost savings can result from strict benefit management
SG&A	Above-unit measures	Many competitors have room for improvement via shared services, improved reporting spans and reduced layers

About the Authors

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About L.E.K. Consulting

L.E.K. Consulting is a global management consulting firm that uses deep industry expertise and rigorous analysis to help business leaders achieve practical results with real impact. We are uncompromising in our approach to helping clients consistently make better decisions, deliver improved business performance and create greater shareholder returns. The firm advises and supports global companies that are leaders in their industries — including the largest private and public sector organizations, private equity firms and emerging entrepreneurial businesses. Founded more than 30 years ago, L.E.K. employs more than 1,200 professionals across the Americas, Asia-Pacific and Europe. For more information, go to www.lek.com.