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2014 L.E.K. Consulting U.S. Foodservice Operators Study: Optimism and Opportunities

After several years of relatively modest growth, foodservice operators across all segments of the industry are now feeling strongly optimistic about the future. The 2014 L.E.K. Consulting U.S. Foodservice Study found several leading indicators of that optimism, including that three out of four senior foodservice decision-makers and executives believe business will be better over the next three years than it was in the past three. In L.E.K's view the market now has strong tailwinds behind it and there are numerous growth opportunities for foodservice operators.

Operators believe that healthier eating is here to stay and say changing their menus to support that trend will be their biggest priority for 2014. Farm-to-fork, operators say, matters: they expect growing demand for healthier foods, locally sourced items, cleaner ingredients and value products. Similarly, operators say they are convinced that gluten-free dining is not a fad. A remarkable 56% say they have already changed or are changing their menus to include gluten-free items. See also the L.E.K. *Executive Insights* "Fresh-Food Nation: The Economic Promise of the 'Farm-to-Fork Strategy" for more perspective on this key food industry trend.

However, Sysco's announcement in late 2013 of its intention to acquire US Foods is a big concern for operators. The owner of a bagel restaurant noted, "[t]here was definite panic in the restaurant industry among small businesses when the merger was announced. I have used bids from US Foods to negotiate lower prices from Sysco. We know that we are going to get squeezed…"

Most operators who participated in the L.E.K. study agree: 60% of them think consolidation of the two biggest suppliers will mean higher prices. Fifteen percent say they expect the combined supply giant will take preferred products off the shelves and offer them pricier house brands instead.

Operators are also not happy with their relationship with manufacturers. It is time, they say, for food makers to start paying closer attention to operators' needs and preferences. Operators told us that what they really want is more customized solutions to their problems.

Growth Accelerates: Four Key Trends Driving it

For all the economic headwinds of the Great Recession, foodservice has grown over the past decade, significantly outpacing retail. The U.S. foodservice industry had a 4.9% compounded annual growth rate from 2003 through 2012, as compared to 3.5% for the retail industry.

Like much of the rest of the economy, though, foodservice has experienced the "hourglass effect": growth at the top and bottom ends of the market and contraction in the middle. Since

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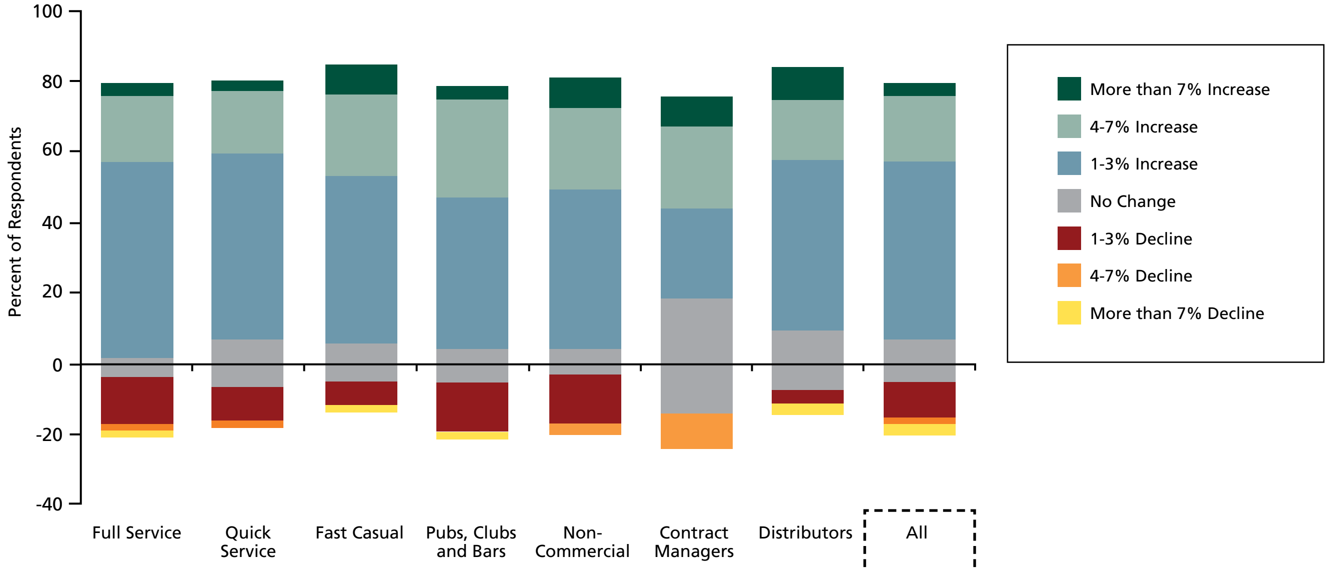
Figure 1

Expected Nominal Growth Per Year in Food Industry – By Segment



Expected Growth Next 3 Years vs. Last 3 Years

	Full Service	Quick Service	Fast Casual	Pubs, Clubs and Bars	Non-Commercial	Contract Managers	Distributors	All
Expect Increase	76%	71%	77%	71%	74%	55%	76%	74%
Expect No Change	7%	18%	14%	11%	10%	36%	16%	12%
Expect Decrease	18%	11%	9%	18%	16%	9%	8%	14%

Source: L.E.K. Foodservice Survey

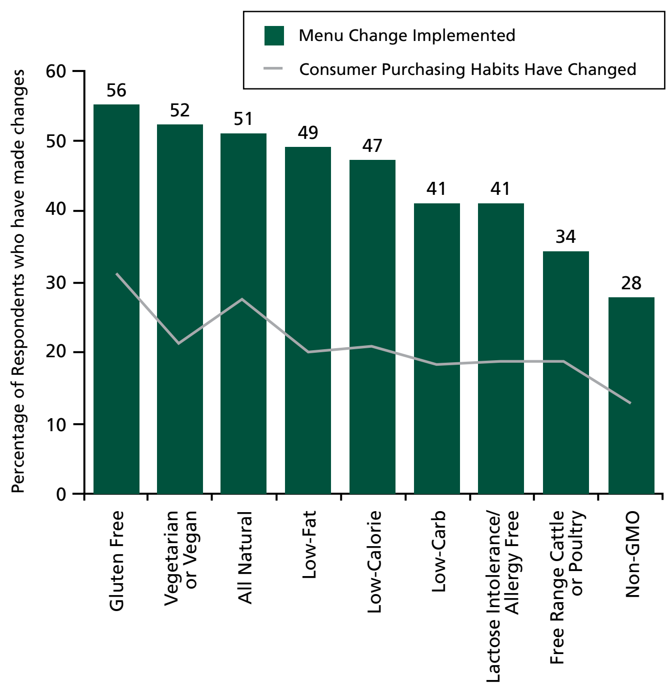
2007, the fastest growth has been among quick service restaurant (QSR) and fast casual brands, with middle-of-the-road sit-down chains shrinking.

A large majority of operators across the board say they are optimistic that business will improve over the medium-term future. Seventy four percent told us they expect that growth over the next three years will be stronger than in the past three (see Figure 1).

Operators say they think the growth they're expecting will come via four key trends: healthy food, locally sourced (farm-to-fork) food, clean ingredients and value. In fact, these trends are already driving operator behavior. More than 50% of operators say that in the past three years they've added gluten-free, vegan or all-natural items to their menus (see Figure 2).

Figure 2

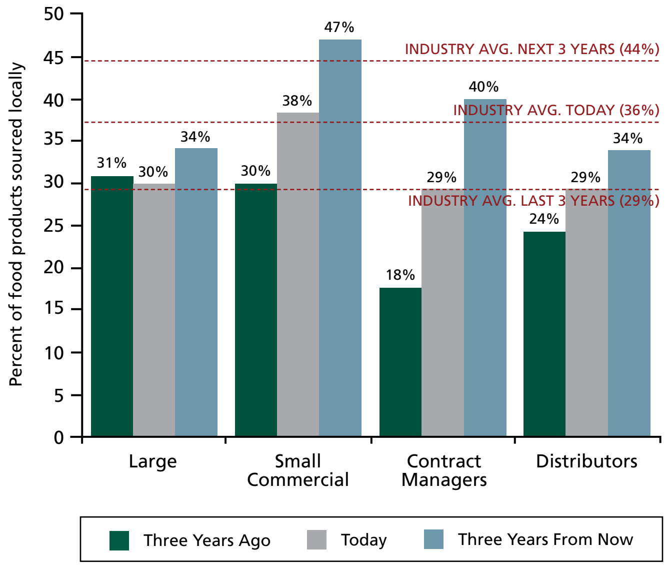
Health-Related Changes in Menus and Purchasing Habits



Source: L.E.K. Foodservice Survey

Figure 3

Locally-sourced Food – By Segment



Source: L.E.K. Foodservice Survey

Operators also say they don't think those shifts in consumer tastes are going away anytime soon. The trend towards farm-to-fork, for instance, is only expected to grow – and rapidly (see Figure 3).

Meanwhile, the biggest obstacles to growth, operators told us, would likely be on the cost side of the business, especially labor and supply prices. Forty-four percent said they expect the biggest stumbling block over the next three years will be higher labor costs. Forty-one percent said the biggest headache would be upward pressure on prices.

The Fallout from the Sysco-US Foods Deal: Fewer Choices and Higher Prices

Meanwhile the Sysco–US Foods deal is very much on operators' minds (see Figure 4). If approved by regulators the deal will be completed later this year.

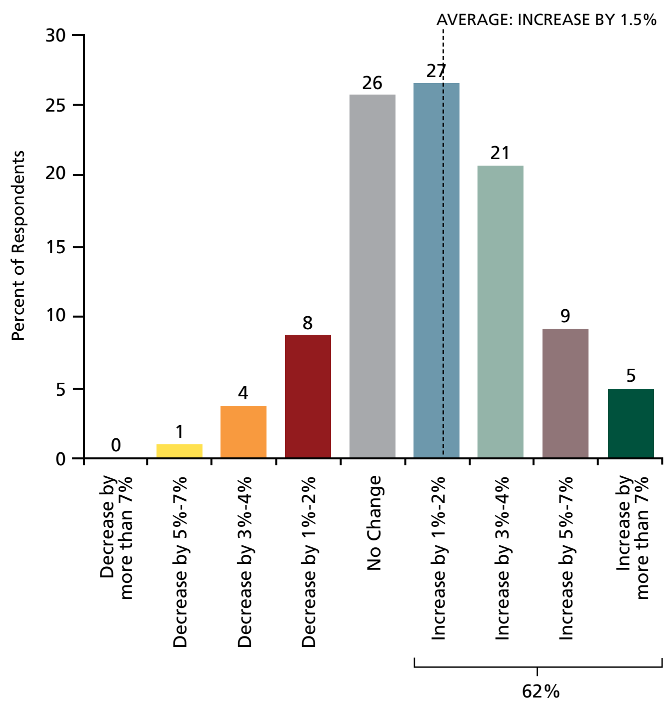
The main decision maker at one small non-commercial operator told L.E.K. "Sysco has always been one to supply their own labels and minimize the choices of alternative brands…" Some operators believe that a hardball approach means not only high prices for them, but also fewer of the kinds of products customers want. The chief decision maker at a small full-service restaurant said, "We will lose choice by being pushed into private labels with higher profit margins for distributors who are less concerned with local, sustainable and artisanal products."

The effects of the deal are already being felt. One small restaurant operator noted, "[i]n our area, Quandt's Foodservice was bought up by US Foods. They have already dropped the ice cream line we prefer, changed the portion size on our sliced beef liver we have used for over 30 years, and we no longer have access to some of our locally produced items."

Sysco has acknowledged some operators will take their business elsewhere, creating opportunities for other distributors and second tier outlets, like Restaurant Depot. According to Sysco CEO Bill Delaney, "Sysco and US Foods together collected about 27% of the revenue in the U.S. food-distribution market last year. Some customers that use both Sysco and US Foods may now look elsewhere to diversify their sourcing. As a result, combined market share is expected to start out around 25%."

Figure 4

Effect of US Foods Acquisition by Sysco on Industry Prices



Source: L.E.K. Foodservice Survey

Operators to Manufacturers and Distributors: More Attention, Please

Operators told L.E.K. that they purchase private label products from distributors mostly for commodities (eggs, fresh fruit and vegetables, etc.) and brand name products for pre-prepared and manufactured foods. Most said they purchased brands mainly because consumers recognized and preferred them, not because they were of higher quality than private labels. But despite the expectation that a merged Sysco-US Foods will be pushing private labels, few operators expect to be buying significantly more private product over the next three years.

As for manufacturers, operators believe that food makers aren't paying enough attention to them. If manufacturers want more of operators' business they need to do three things:

1. "A better understanding of my needs"
2. "More customized solutions, less off–the-shelf"
3. "More frequent visits from manufacturer reps"

Digital promotions offer another way for manufacturers to build stronger bonds with operators. Twenty-two percent of operators told us they used digital coupons and blog promotions, two effective yet underutilized online sales tools.

Now is a time of great opportunity and optimism in foodservice. Operators are challenged to evolve their businesses to better meet consumers' needs and manage labor costs while navigating a consolidating supply chain. At the same time, manufacturers have an opportunity to better help operators succeed in this complex landscape through a stronger understanding of their needs and by delivering solutions tailored to address their primary concerns. As always, deep experience and knowledge of the players and the changing dynamics will be necessary for success.

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