

Joining the 40/40 Club

By Dr. Albert D. Bates
President, Profit Planning Group

Knowing Where You Rank When it Comes to Margins and Expenses is Crucial, Says Dr. Bates

The statement "gross margin minus expenses equals profit" is an accounting tautology. It's also probably the single most important concept in improving profitability. That is because gross margin and expenses are highly correlated. Firms with high margins tend to have high expenses, while low-margin firms have low expenses. The reality is that at all points along the spectrum, from low margin/low expenses to high margin/high expenses are inadequate.

The key to profit improvement is to break the linkage and either produce an enhanced margin without increasing expenses or lower expenses without sacrificing gross margin. This is incredibly easy to talk about, but frustratingly difficult to actually accomplish. This report will examine the linkage between gross margin and expenses from two perspectives: the nature of the margin/expense linkage (an empirical examination of the precise link between gross margin and expenses in distribution) and breaking the link (a discussion of the specific margin and expense improvement levels that are required to break the linkage).

The Nature of the Margin/Expense Linkage

Within every line of trade in distribution, including FEDA, there are wide variations in the gross margin percentage. The reasons are myriad, including different product assortments, variations in the firm's service profile and strategic decisions about the role of price in the firm.

At the same time, there are equally wide variations in expense percentages. These arise because of differing levels of technology usage, the complexity of operations and, as with margin, the firm's service profile. The critical issue in profitability improvement is that the gross margin percentage and the expense percentage are essentially joined at the hip in distribution. This relationship is presented graphically in Exhibit 1. (See page 25). The exhibit highlights results from a recently-published analysis of distributor profitability by the Profit Planning Group. It is the largest such study ever conducted, encompassing 885 firms from 17 different lines of trade. The size of the study ensures that the results are applicable to distributors in any segment, including FEDA members.

Across the horizontal axis, the graph reflects the gross margin percentage for firms relative to other firms in the same line of trade. For example, at the 20 percent point on the axis, the firm would have a gross margin percentage that is 20 percent higher than the typical firm. For FEDA members, this would mean a gross margin of 26.4 percent of sales versus the industry norm of 22 percent ($22.0\% \times 1.2 = 26.4\%$).

At first blush, such large variations may not seem realistic. However, they appear in every sector of distribution. FEDA is no exception, as such variations are reflected in the industry's PROFIT report. There is always an industry norm, but there is

also always a wide range of variation around that norm.

The vertical axis presents information for expense percentages. Again, the variations are from the norm in the industry. Also, once again because of strategic operating and product mix differences, the range is large.

There are two main points to be gleaned from the exhibit. The first point is that gross margin and expense percentages are inexorably tied together. The trend line from lower left to upper left clearly reflects that.

The second point is that the key to profitability is to either lower expense percentages while maintaining margin or raise margin percentages without impacting expenses. Ideally, firms should do both. The open issue is how much of an improvement is possible.

Breaking the Link

Despite the linkage between gross margin and expenses, some firms are able to break out of the margin/expense straight jacket. Three different improvement scenarios are evaluated here. They all involve producing just slightly better results than other firms in the industry, either on margin, expenses or both. Dramatically better is not required; slightly better is good enough.

Good Gross Margin/Adequate Operating Expenses—

This combination includes those in the top 40 percent of the firms in the industry with regard to gross margin and whose operating expenses are at least slightly better than the typical firm. That is, they are in the upper 50 percent on expense control. It can be thought of as a 40 percent/50 percent model.

Adequate Gross Margin/Good Operating Expenses—

This is simply the mirror image of the previous scenario. It includes firms whose gross margin is at least slightly better than the typical firm and is in the top 40 percent in controlling operating expenses. This is a 50 percent/40 percent model.

Good Gross Margin and Operating Expenses—

This raises the performance bar significantly by requiring results in the top 40 percent on both factors. This can be characterized as the 40 percent/40 percent model or the 40/40 club.

It is important to note the percentages used in the three bullet points. Firms in the top 40 percent on gross margin do not have a gross margin that is 40 percent higher than the industry norm. They "simply" outperform 60 percent of their peers with regard to the gross margin percentage.

The payoff for being somewhat better than the industry norm is substantial, regardless of which one of the three combinations a firm produces. The impact is reflected in both

refrigeration is now being introduced in North America, so the challenges of evacuating refrigerants during service calls has been largely resolved. Multiyear tests in Europe have proven that it's a safe product. Products using R-290 aren't yet available in three-door reach-in or walk-in coolers, but for basic one- and two-door coolers, it offers the lowest carbon footprint of any refrigerant.

Display Cases go Square

The shape and design of display cases has changed. Square or slanted glass is replacing curved glass in upscale outlets. The new shapes provide a "jewelry box" appearance and architects/designers love it. Curved glass has a tendency to reflect any store lighting that is above the case and can have minor waves within the glass that distort the view of the food inside the case, so this is a positive change.

Coffee Ground and Brewed by the Cup

The popularity of pod brewers has

changed the way we look at coffee in our homes and offices, evolving from batches to single cups. This concept has moved into the commercial equipment market with a new family of single-service coffee brewers that brew a single cup of fresh ground coffee and can do it in about 35 seconds—which research shows is the maximum time a customer will wait. There were a dozen new machines that are ideal for operators that want to offer the freshest coffee all times of the day, especially decaf and/or exotic choices. Hopefully this will end the serving of coffee sludge that sits in some restaurant coffee pots at 3:30 pm. Several of these new bean-to-cup brewers provide a swing-out spout on the side to brew larger batches for higher volume periods.

The Quest to Avoid a Type I (grease) Exhaust Duct

The one word that was featured most often on signage at the show was "ventless." I counted at least 50 products that offered some product or accessory that

would eliminate the need for a grease hood. From counter-top rapid cook or "speed ovens" (at least four new manufacturers at the show) to all-in-one ventless cooking stations, the mission is to be able to install hot food production in sites where grease hoods are not possible, or so costly it would bankrupt the operator. While these solutions offer options for operators, they also raise the question of where do heat, smoke and food odors go that used to exit up the exhaust stack. Anyone thinking of purchasing these systems should think grease ventless and not just ventless. With limited or no general ventilation, operators may be disappointed with some of these products.

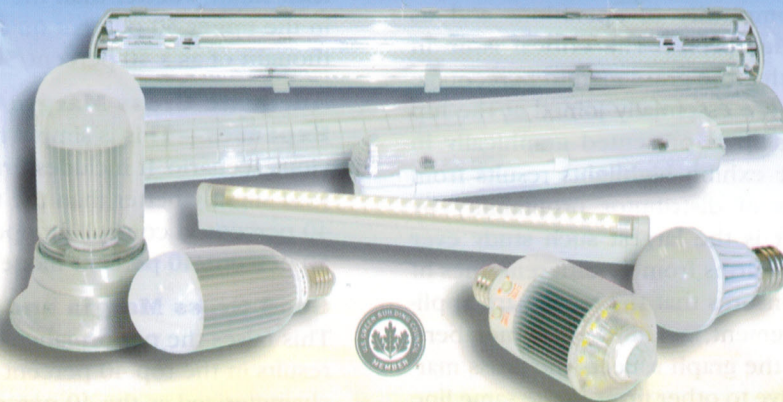
Recognizing and Addressing Confusion over Regulatory Issues

Building and operating a restaurant in the U.S. is becoming quite difficult in many areas of the country because of increased regulatory scru-

continued on **page 26**

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tiny. Manufacturers have tried to address some of these issues with new products that incorporate controls that monitor and/or raise alarms when they sense conditions that could impact food safety or produce high levels of effluence or odors. Regardless of how well thought out these products are, overall I sensed growing frustration with an increasing lack of uniformity in code requirements and compliance that will continue to challenge kitchen designers and operators.

Ever-Growing Number of Products Made Overseas

Five or 10 years ago, attendees might see half a dozen Asian manufacturers of mixers, refrigerators, and soft-serve machines. Imported European equipment was mostly from Italy and Germany, usually in the form of pizza ovens, espresso machines, and combi ovens. If all the products at the show were tallied up, including those items that are part of a range of models from American brands and manufacturers, my guess is that more than 50 percent are manufactured overseas.

A Few of My Favorite Products from NRA Nitrogen-Infused Cold-Brewed Coffee

The next step in cold-brew coffee is to dispense it in a tower-like beer or wine piece of equipment. The magic ingredient shown by at least three vendors at the show was adding nitrogen gas as a propellant and flavor enhancer. In addition to enriching the taste of the coffee, it brought out the natural sugar in the bean. Visitors to the booths, who regularly use sugar with their coffee, were surprised that no added sugar was required with the nitrogen-infused product.

EVO Event™ Ductless Downdraft Ventless Cooking Station

EVO has offered portable round grills to caterers and hotel event spaces for more than 10 years, but were limited to outdoor or temporary locations because they didn't have exhaust hood and fire protection systems integrated with their

equipment. EVO has now developed and secured major approvals for two large griddles with an innovative downdraft grease and odor-capture system and elegantly placed fire suppression nozzles. In tests at several Benihana restaurants, these EVO ventless grills open up the potential for a wide variety of exhibition cooking stations in dining areas, serveries and buffets, where it was previously impossible to cook with no ductwork for ceiling-mounted hoods.

Franke Air Purification System (APS300) for Refrigeration

Food spoilage/reduced shelf life create air quality and odor control challenges in refrigeration units. While UV air purification has been available in luxury residential refrigeration for some time, this 120 Volt/25-pound add-on box brings this technology to new or existing walk-in coolers, safely removing mold, fungus, bacteria and food odors as well as extending fresh produce shelf life.

Merrychef R Rapid Cook Oven with Panini Grill

High-speed ovens and microwave-assisted Panini grills have been winning over sandwich operators in high-volume locations where a traditional two-sided sandwich grill was too slow. Unfortunately, speed ovens didn't create the "marks" that a two-sided grill accomplishes. Merrichef developed a simple and easily removable semi-automatic non-stick Panini-press attachment that fits inside their smaller eikon R oven, which is activated by the mechanical motion of opening and closing the oven door. It's a clever and simple solution, and when the attachment is removed, the oven can be used for rapid cooking. Great engineering!

Edlund Titan™ Max-Cut Food Prep Tool

The market versatility of several of the manual food prep machines is offset by the challenges of changing and cleaning various blades and accessories. Edlund's new design incorporates four prep functions (cutting, coring, wedging, and dicing) into a single manual machine that makes this effort a lot easier. Just swap the quick-change pusher and cartridge

and the machine is ready for the next task.

Fryergate (Dagda Technologies)

Open-pot deep fat fryers are a leading cause of burns and serious injuries in kitchens. Slipping and catching oneself on a fry vat has caused horrible burns in our industry. This NSF-approved safety cover provides a spring-loaded barrier that protects against hands, feet (slipping off a ladder while cleaning) or dropped objects. It does this without slowing down the operation and can be attached to most existing electric or gas fryers. A great add-on sale to existing customers, with more to follow, including covers for pasta cookers.

EnviroPure Digester with Ozone Recirculation (T&S)

There has been good success with garbage digesters in a variety of kitchens, but issues with odors and the need for lots of water (up to 400 gallons a day) have presented problems. T&S developed an ozone recirculation system for its existing digester as part of an overall design improvement. What made this one a standout was my visit to see one of them in operation the day before the show at the new Virgin Hotel in Chicago. When I asked the Executive Chef how he liked it, he was elated. "Best piece of equipment he had, totally happy with the performance and local support and service." A chef this excited about a digester—WOW!

I wish there was an opportunity to present some of the other great products that were exhibited and hope to share some more in another article. For those who may have skipped NRA because it was a "NAFEM Year," there were a lot of great products. I estimate that at least 30 percent of what I consider really great products at the NRA Show (from smallwares to heavy equipment) was not at this year's NAFEM. NRA has really made a comeback over the past five years, and this year's show was fantastic. □

profit before taxes (PBT) and return on assets (ROA):

Gross Margin	Oper. Exp.	Improvement In	
		PBT (%)	ROA (%)
Top 40%	Top 50%	163.5	128.6
Top 50%	Top 40%	154.7	151.5
Top 40%	Top 40%	226.3	189.7

According to the PROFIT report, the typical FEDA member has a PBT of 2 percent of sales and an ROA of 6 percent. Firms in the 40/40 club would have a PBT of 6.5 percent and an ROA of 17.4 percent. It is a striking improvement in performance.

As stated before, being in the top 40 percent with regard to either gross margin or expenses does not represent dramatically superior performance. It simply reflects being a little bit better than the norm. The challenge is being better on both factors at the same time.

Management needs to develop plans to produce somewhat better than typical performance. To start the process, the firm must first know where it stands in the industry. This necessitates a close review of the PROFIT report on an annual basis. It provides percentile rankings for both margin and expenses for each participating firm.

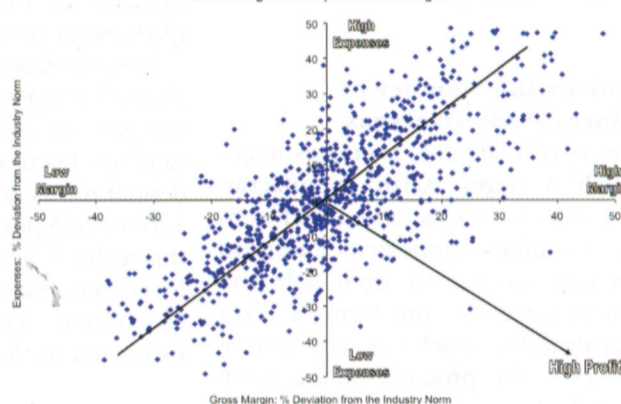
Moving Forward

Simply put, gross margin and expenses are the name of the game in improving profitability. However, margin and expenses cannot be viewed as an either/or proposition. They must be managed simultaneously. □

About the Author

Dr. Albert D. Bates is founder and president of Profit Planning Group. His recent book, *The Real Profit Drivers*, is the basis for this report. It is a book every C-Level manager should read and is available in trade-paper format from Amazon.

Exhibit 1
The Relationship Between
Gross Margin and Expense Percentages



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Increased Government Rules, Regulations, Standards, etc.

A growing number of countries around the world have, and continue to introduce, legislation that is impacting all segments and constituents within the foodservice industry. The "Energy-Related Products" Directive (ERP) is one of the latest regulations coming out of Europe that will affect all equipment manufacturers wishing to sell into that marketplace. Look for a growing number of countries to implement similar type of standards and regulations.

Increased Competition

New manufacturers across all product categories of foodservice equipment are entering the marketplace every day. They are originating from countries such as India, China, Thailand, Brazil, Indonesia, Vietnam, etc. And look out for Africa! Billions are being poured into that continent.

Growing Use of Non-Fossil Fuels for Energy

As alternative energy sources are becoming cheaper and more efficient (solar and wind power in particular), a growing number of foodservice operators are looking to become users of non-carbon-based energy. Several chains have preliminary plans already in place to have their stores become energy independent, as alternative energy sources and technology make such goals attainable.

Global Political Instability

The Russia/Ukraine situation certainly highlights this dynamic. Already, chains have contracted their expansion plans into Russia and Eastern Europe as they wait to see the outcome of the current situation. This is not the only political hot-spot of the world. Growing numbers will continue to have an impact on the foodservice industry.

Changing Distribution Strategies

The growth of the Internet as a distribution component has changed the landscape forever in this industry. New players in the distribution field are also expected to emerge as "value proposition" becomes the key driver in how distribution strategies are designed and implemented.

Greater Focus on the End User/Operator for Innovation Ideas

As manufacturers begin to put more emphasis on developing value chains versus supply chains, greater focus will have to be put on the end user/operator in order to ascertain their true needs, wants, desires, etc., of this constituent group. They are the only customer!

Local Chains Like to Deal With Local Manufacturers

Whether it is in North America, Europe, Asia, Australia, you name it, a growing number of "local" chains want to deal with companies that are "local."

Import Tariffs

As the world seems to be gravitating toward more and more free-trade blocks, there are still a very large number of countries (Brazil is a prime example) that just can't give up those high import tariffs. This obviously has a significant impact upon companies trying to sell products to high-tariff countries, as well as operators in high-tariff countries that want to purchase foreign manufacturers' equipment and supplies.

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Operational Trends Impacting the Industry

Entry Cost of Capital Equipment for Operators

As chains try to expand in a very competitive global environment, franchisors are constantly under pressure from new and existing franchises to provide the lowest cost equipment package that they possibly can. This trend is somewhat diabolically opposed to some of the other trends that are in play, such as efficiency, total cost of ownership, sustainability, etc. This market dynamic has obvious product and marketing implications for equipment manufacturers. (This dynamic not only applies to global, national, regional, and local chains, but to independent operators as well.)

Growing Use of Technology

End user/operators are embracing the use of technology to enhance their customers' experiences as well as to garner sales and marketing data to improve their competitive positioning. Equipment manufacturers have opportunities to find ways to integrate their equipment into these "systems" as a way of assisting operators to gain a greater degree of knowledge about their entire operating environment and hence become more effective managers of their assets.

Speed of Cooking/Speed of Cooling

For food safety and operational effectiveness and efficiency, enhanced speed of cooking and the speed at which cooked product is cooled will have a greater impact upon operators in the future as they look to streamline their operations in a growing competitive environment.

Growing Importance of Total Cost of Ownership

Tied directly with energy efficiency, sustainability, product reliability and service, to mention a few, this subject is gaining a considerable amount of attention from a growing number of global chains (foodservice and hotels as well as several institutional segments) as a means of decreasing overall costs and improving profitability.

Multipurpose/Functional Equipment

As kitchens become smaller and smaller (real-estate costs, equipment costs, quality and quantity of labor, etc.) the demand for multipurpose/ multifunctional equipment will continue to grow. However, such equipment needs to be easy to use and maintain.

Improved Reliability of Equipment

Downtime diminishes operators' sales and profitability. Keeping equipment at peak operating performance will be a challenge for foodservice equipment manufacturers and their end user/operators. The use of technology can enhance this dynamic and is a possible key differentiator.

Customer Service as a Key Differentiator

Innovation and service are the only two areas in which a company can truly have a sustainable advantage in today's marketplace.

Data Mining

The gathering of relevant data; the analysis of that relevant data; and making that relevant data actionable will help companies provide superior customer service and drive true, sustainable innovation.

And that's it: Doug's thoughts with respect to those global trends affecting our industry today and as we move forward. If you would like to discuss any of these trends further, or if you would like to add some to the list, please feel free to give me a call or send me an e-mail with your thoughts. I would appreciate any and all comments. □

About the Author

Douglas K. Fryett is the president of the Fryett Consulting Group, a management consulting firm specializing in strategy development and execution, market research, and leadership development for companies from all segments in the foodservice industry. He also is the author of An Introduction to the Foodservice Industry as well as numerous articles published in various trade journals and magazines. To contact him, call 318-865-2611, or email him at dfryett@fryettcg.com.



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President's Message continued

Information- Consumers are hungry for data. When a customer places an order in the consumer world, they receive immediate order confirmations, timely tracking information and status updates every step of the way. I recently purchased a new laptop and had visibility of the entire fulfillment process, beginning with its production in China to the arrival at my doorstep 48 hours later in Florida. Meanwhile, in our industry, there's many times when dealers don't even get vendor tracking numbers until after the item has already arrived at the customer's location. In regards to this particular issue, FEDA is already actively collaborating with partners in the industry to solve this problem. I urge dealers, manufacturers, reps and service agents to embrace this data interchange initiative, which will allow our industry to better serve our mutual customers.

Lastly, I encourage you to take a look at your business and compare your operations to those in consumer-oriented markets. There's definitely a divide between outdated practices vs. the modern-day expectations of customers. One step at a time, work to narrow the gap between the two and you'll begin to stand out from the crowd. Embracing technology takes time, money and talent, but with proper execution, it can be reengineered into a driver of increased revenue and customer loyalty. □

Data Snapshot

Burgers top the list of growing menu items

Increase in number of servings and percent change for year ended Nov. 2014

