BEFORE YOU LEAP: HIDDEN IMPLICATIONS OF FOOD HUB BUSINESS GROWTH

July 28, 2016
Presentation Outline

- Technical Orientation

- Welcome

  *Wallace Center at Winrock International*

- Managing Typical Hub Growth Scenarios
- Questions and Answers
- Upcoming Opportunities, etc.
WALLACE CENTER at WINROCK INTERNATIONAL

- Market based solutions to a 21\textsuperscript{st} Century food system
- Work with multiple sectors – business, philanthropy, government
- Healthy, Green, Affordable, Fair Food
- Scaling up Good Food
NATIONAL GOOD FOOD NETWORK: VISION
NATIONAL GOOD FOOD NETWORK: GOALS

Supply Meets Demand
• There is abundant good food (healthy, green, fair and affordable) to meet demands at the regional level.

Information Hub
• The National Good Food Network (NGFN) is the go to place for regional food systems stories, methods and outcomes.

Policy Change
• Policy makers are informed by the Data and Analysis and outcomes of the NGFN and have enacted laws or regulation which further the Network goals.

http://ngfn.org | contact@ngfn.org
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- Technical Orientation
- Welcome
- Managing Typical Hub Growth Scenarios

Tera Johnson
University of Wisconsin Extension

- Questions and Answers
- Upcoming Opportunities, etc.
Agenda

• Why Expand?
• Adding Frozen
• Going Direct
• Getting a Big Account
• Questions
Why Expand?

• You are cash flowing and want to have a bigger impact
• You are too small to be financially sustainable
• When doing more of the same won’t address the problem because:
  – Initial expressions of interest by customers haven’t turned into sales
  – Your prices are not competitive
  – You’ve realized that your market is actually too small

With the benefit of experience, you now know that the concept of a food Hub is appealing to most consumers, compelling to some, and actionable to far fewer. You also know that running a low margin business is a hard thing to do, and you have little margin for error in executing this expansion. This is why we’re here today...
Steps in a Successful Growth Program

• Design your offering to meet customer requirements
  – Understand market size and customer requirements
  – Optimize your packaging & positioning
• Organize your business for success
  – Optimize your sales & marketing effort
  – Understand how this will change your operations
• Document your cost of entry
  – Equipment & facilities
  – Working capital
• Raise sufficient capital to support a successful launch

This all starts with the consumer. New lines of business that solve real customer problems succeed; those that only solve the business’s problems rarely do.
Option 1: Yum......????

There are real consumer perception problems with frozen vegetables. Success will require an effort to overcome this.
Frozen is a Small Category with Stagnant Growth; Fresh-cut Salad is THE Growth Category in Veggies

Source: based on Information Resources Inc., InfoScan Reviews; Bureau of Economic Analysis; Bureau of Labor Statistics, Consumer Expenditure Survey/Mintel
# The Frozen Consumer

Your best target consumer is a high income family with young children who is looking for convenience. Frozen is not currently perceived as nutritious or natural.


<table>
<thead>
<tr>
<th></th>
<th>Most Likely</th>
<th>Least Likely</th>
</tr>
</thead>
<tbody>
<tr>
<td>Age</td>
<td>35 – 44</td>
<td>18 -24</td>
</tr>
<tr>
<td>Income</td>
<td>$100 - $149K</td>
<td>$25k orLess</td>
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<tr>
<td>Children</td>
<td>5 or Younger</td>
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</tr>
<tr>
<td>Region</td>
<td>Western Midwest</td>
<td>West Coast</td>
</tr>
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</table>
What Would Get Them to Buy More Frozen Vegetables?

Local and organic are compelling claims.

Price is more compelling.

9% won’t buy frozen no matter what you do.


% Indicating Purchase Influencers

Where are More Located?

05 Country Squires
Upscale Middle Age w/ Kids
The wealthiest residents in exurban America live in Country Squires, an oasis for affluent Baby Boomers who've fled the city for the charms of small-town living. In their bucolic communities noted for their recently built homes on sprawling properties, the families of executives live in six-figure comfort. Country Squires enjoy country club sports like golf, tennis, and swimming, as well as skiing, boating, and biking.

Social Group: 11 Landed Gentry
Lifestage Group: 04 Accumulated Wealth

How Will a Consumer Find You?
Adding Innovation to Your Offering

“From farm to freezer in hours”

Single serve mixed with fruit

Does it have to be a bag?

Visit our home farm

Key Issues for Food Service and Institutional Markets

**Food Service**

- *Chefs use frozen vegetables very selectively.* Their selections show a keen sense for **cost** and **convenience** but ultimately focus on **flavor**. Vegetarian Times, 2016
- *Food service distributors have initiatives for local & humane sourcing & traceability*
  - 78% Humane treatment
  - 78% Product & ingredient safety
  - 89% Locally sourced

**Institutions**

*Making this market work has proven exceptionally difficult for Hubs:*

- Schools are the most price sensitive customers in food
- Need highest quality frozen product (IQF), which is expensive
- Group purchasing contracts make it difficult for small distributors to sell to large accounts; often leaves Hubs with small volume accounts
- Extensive farmer and sales management is necessary

Technomincs, Top 10 Trends, 2015

**How is your Hub going to differentiate itself from large food service distributors if they’re doing what you’re doing?**

**Why would it work to pay farmers more for their products then sell them to the most price sensitive customers?**

Wallace Center, “Common Market” pilot study report
Organizing to Do This

• Operations
  – You are now a manufacturing company.
  – Blending product from multiple farms into one package will be necessary, which raises the QA bar significantly.
  – You will need operations and QA personnel in your organization to run your manufacturing.
  – You will need a HAACP plan and QA certifications like GAP.
  – You will have to take constructive possession of product and hold inventory, meaning you cannot use a cross docking business model.

• Sales
  – Frozen food store buyers and brokers are rarely even talk to their counterparts who do produce, so you are probably starting over on the sales side.
  – You are likely to need different sales management background, relationships, and capabilities.

• Marketing
  – You are now marketing a branded product and need brand management expertise to succeed.
  – You now have packaging that doesn’t just hold product but communicates the value of your brand to the consumer.

• You are going to need more money to succeed
Documenting Your Cost of Entry

Facilities & Equipment

- IQF line
- Cooling line for inbound vegetables
- Cold and frozen storage with racking
- Fork lift
- Loading dock
- Certifiable processing room
- Space for QA testing equipment

Working Capital

It is often the case that the working capital requirements for a food business expansion are actually larger than the equipment purchase. Fully loaded capital requirements, and the size of the business required to reach breakeven cash-flow, will be larger than you think.
Financing This

- The complexity of manufacturing drives up the minimum scale of your business.
- You cannot be a manufacturer without a relationship with a conventional lender - find one that is an SBA 7a lender.
- This scale of equity will most likely require a formal equity offering, or the backing by a few large supplier farmers.
- Get help with this.

These sales levels are sufficient for a Hub to reach fully-loaded financial sustainability, meaning it is generating sufficient cash out of operations to be profitable and cover all of its debt service and working capital requirements with no grant income.
Option 2: Going Direct

Moving from cross-docking to becoming a distributor

- Allows you to handle case quantities of value-added products. Potentially improves seasonality of sales. Adds very little margin potential and a lot of expense and management challenges.

OR

Moving from cross-docking to selling directly to consumers

- Allows you to handle case quantities of value-added products. Potentially improves seasonality of sales. Adds more margin potential. May be the ONLY way small HubS can be financially viable.
There isn’t a lot of net income to capture through consolidating functions, and a lot of functions to perform:

- Farmer – 2%
- Distributor – 1.5%
- Broker – 2%
- Restaurant – 3%
- Grocery Store – 3%

Hubs can only achieve value chain optimization benefits if they replace one or more of these boxes and can do the functions cheaper than the existing players do. Be realistic about the potential gain versus efficiency loss when taking over functions from existing players.
The Bar is High for Distributors

This is ONE aisle in a UNFI warehouse. UNFI reported net income of 1.7% in 2015. How are you going to be as profitable as they are while being less draconian with your farmer members? Farmer + Distributor net income = 3.5%

This is ONE aisle in the Food Bank of NYC warehouse. The Red Cross used the Food Bank of NYC to get relief supplies to all 5 borrows of the city after Sandy. They hire former private sector distributor managers and have state of the art systems.
Taking This all the Way to the Consumer

Net Income potential = Farmer 2% + Manufacturer 5% + Distributor 1.5% + Broker 2% + Retailer 3% = 13.5%
Aggregating CSA & Wholesale Hub

- $300k in sales generates positive cash flow with no grant income
- $35k in investment from members at startup
- CSA prepayments generate remaining working capital
- 75% of sales direct to customer
- Can scale up incrementally and reach profitability quickly

The Bayfield Farms Producer Cooperative is an example of a fully financially sustainable Hub that adapted its business model to succeed in its unique geography. This is probably the most promising business model for HubS in small rural communities.
Option 3: Should You Take This Deal???

- You are a Hub with $100,000 in sales that gets the opportunity to sell to a larger account through distribution
- $400,000 account
- Hub buys from farmers 88% of customer invoice
- Net 30 day terms from customer
- Net 15 days post customer payment to farmers
- Distribution center stocking 1 week of sales
- Will reject whole loads if any product is non compliant
- One week for stores to pull inventory
- First reorder likely to be 7 days after first shipment
- 5% promo required in lieu of slotting deducted from invoice
- 6 month trial – pull without sell through
Results

• The net income of this deal is $28,000 contribution margin
• $0 in cash contribution is generated in first 4 weeks – this is what makes starting up every season so difficult
• Cash generation peaks at $141,00 in week 9 as long as weekly sales are consistent
• All of the cash generation depends on delayed payment terms to farmers; change your payment terms and your cash surplus can become a deficit
• Operating losses make this worse

Strategically setting payment terms is critical to the financial viability of most Hubs. Either the supplier farmers shoulder the burden of the working capital requirement or the Hub needs a line of credit to access during the season.
Should You Take This Deal???

• You are a Hub with $1M in frozen veggie sales that gets the opportunity to sell to Target nationally
• $4M account
• Net 30 day terms
• Distribution center stocking 2 months of sales
• One month for stores to pull inventory
• First reorder likely to be 60 days after first shipment
• 20% promo required in lieu of slotting deducted from invoice
• 6 month trial – pull without sell through to maintain $4M annually
Results

- The net income of this deal is $1.2M contribution margin
- Cash deficit starts at $220,000 and peaks at $388,333 in month 6
- The large disconnect between net income and cash for this opportunity are typical for food companies selling through distribution
- Trying to do this without a LOC from a conventional lender is very difficult
- Equity is still needed
- Cash burn is worse if cogs % is worse
- JIT helps cash flows significantly; very difficult to achieve

You need way more money to do this than you think you do to get into large accounts. Successful entrepreneurs take calculated leaps.
What This Means

• Anything other than organic growth brings significant change to a food enterprise
• It takes planning to successfully take on new initiatives like frozen, going direct, or supplying a big box account
• Seek out market research data that you can use to optimize your business
• It also takes money

Do Your Research and Develop a Plan  ➔  Secure Sufficient Funding  ➔  Execute Your Plan
Questions?

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TOPICS!

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3rd Thursday of each month
3:30p EST (12:30p PST)

http://ngfn.org/webinars

- Next three months:
  Stimulating Sustainable Production in the Center of the Plate
  - Meat
  - Grains and Legumes
  - Fish
Learn From Food Hub Experts
Become A Food Hub Success

Start Date: January 9, 2017

UVM FOOD HUB MANAGEMENT PROFESSIONAL CERTIFICATE

Space is limited - Inquire now
Hub Camp 2.0 - November 7-9, 2016 - Ann Arbor, MI

Join us for the next chapter of Local Orbit’s acclaimed Hub Camps, with new curriculum designed to connect local food hubs and non-commercial foodservice professionals working to increase local procurement and expand their impact.

This hands-on workshop will bring together leaders and changemakers who have pioneered local food distribution and procurement and are managing second stage challenges and opportunities.

Participants will work with colleagues, coaches and discussion catalysts on current business problems, discover tools to collaborate more effectively with partners and customers, and proactively plan for the future. You will come away with increased
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