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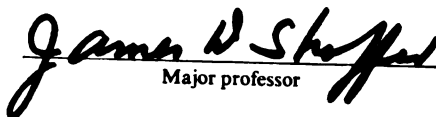
Large Limited-Menu Foodservice Firms:
Market Structure Changes and Procurement
Practices for Beef and Poultry

presented by

John Raymond Schmelzer

has been accepted towards fulfillment
of the requirements for

PhD degree in Agricultural Economics


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LARGE LIMITED-MENU FOODSERVICE FIRMS:
MARKET STRUCTURE CHANGES AND PROCUREMENT
PRACTICES FOR BEEF AND POULTRY

By

John Raymond Schmelzer

A DISSERTATION

Submitted to
Michigan State University
in partial fulfillment of the requirements
for the degree of

DOCTOR OF PHILOSOPHY

Department of Agricultural Economics

ABSTRACT

LARGE LIMITED-MENU FOODSERVICE FIRMS:
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The commercial component of the U.S. foodservice sector is a dynamic and expanding element within the food system. A driving force in the growth of this component has been limited-menu foodservice operations. These operations, which include fast food restaurants among others, accounted for about 36 percent of eating place sales in 1977.

This research examines and analyzes the interrelationships that exist between large limited-menu firms and their fabricated beef and poultry suppliers. Elements of organization and management theory were used to construct a conceptual framework to establish and evaluate these relationships. Specific, firm-level procurement standard operating procedures were examined for their relevance with respect to these relationships. Particular emphasis was placed on evaluating the aggregate effects of these procedures on vertical coordination and market performance in beef and poultry input markets. Among the major findings are included: (1) a systematic reliance on formula pricing arrangements to facilitate exchange between these market participants; (2) relatively stable procurement relationships between market participants; (3) limited usefulness of futures markets

as a risk management institution for most limited-menu firms; and (4) the possibility of increased price instability in input markets resulting from the interaction of procurement standard operating procedures with other standard management practices.

An integral part of the research effort was a delineation of the current structural configuration of the commercial foodservice sector. Within this sector, multi-unit, franchise restaurant operations, many of which are fast food operations, are particularly important. They alone account for over 40 percent of commercial foodservice sales.

The structural data assembled revealed a number of interesting facts. Included among them were: (1) the expanding ownership linkages between large food processors and foodservice firms resulting primarily from acquisitions by food processors since 1965; and (2) the increased importance of the largest multi-unit operations within the commercial sector.

ACKNOWLEDGMENTS

A dissertation is the culmination of a lengthy, and sometimes trying, educational experience. Many individuals contribute to the final product. I would like to thank everyone who has contributed, either directly or indirectly, to this research.

Professor James Shaffer, my academic advisor and principal thesis supervisor, has been unceasing in his support throughout my tenure at Michigan State University. His guidance and research experience were invaluable during this study. I gratefully acknowledge his intellectual and moral support, and I thank him for his professionalism, encouragement and honesty. Professor Donald Ricks was a valued member of my committee both for his professionalism and his support. The other members of my committee, Professors Bruce Allen and John Allen, provided timely and constructive criticisms which improved the quality of this research.

Many of my fellow graduate students in the Department of Agricultural Economics at Michigan State University were important contributors to this research. I would especially like to thank Gerry Toland, Jerry Rector, Larry Hamm, Ralph Christy, John Strauss, Merle Menegay and Jerry Skees for their friendship and support. I would also like to acknowledge the expert staff support provided by Cindy Cordes and Peggy Sheathelm.

Financial support for the research came from the Michigan

Agricultural Experiment Station and the Economic Research Service of the United States Department of Agriculture. I am indebted to these institutions.

TABLE OF CONTENTS

	<u>Page</u>
CHAPTER I INTRODUCTION	
Previous Treatment of the Subject Matter	3
Vertical Coordination	4
Research Objectives	5
Research Approach	6
Thesis Overview	13
 CHAPTER II VERTICAL COORDINATION: A CONCEPTUAL FRAMEWORK	
Introduction	15
Vertical Coordination: A Perspective	15
Conceptual Approaches	20
Firm Behavior	27
Standard Operating Procedures	29
Vertical Coordination and Standard Operating Procedures: A Synthesis	32
Research Application	34
 CHAPTER III THE COMMERCIAL FOODSERVICE SECTOR: GROWTH TRENDS, STRUCTURAL CHANGE AND MARKET ORGANIZATION	
Introduction	36
Factors Influencing Growth in Foodservice	37
Supply Factors	39
The Foodservice Industry	41
The Commercial Foodservice Sector	43
Growth in Commercial Foodservice	46
Structural Change in the Commercial Foodservice Sector	48
Commercial Foodservice Sales by Size of Establishments	53
Fast Food Sales by Size of Establishments	54
Commercial Foodservice Sales by Size of Firm (Establishments)	56
Commercial Foodservice Sales by Size of Firm (Sales)	58
Concentration Levels in the Foodservice Sector	62
Vertical Integration in Commercial Foodservice	64
Franchising in the Commercial Foodservice Sector	67
Elements of Franchisor Control	68
Types of Franchisor Assistance	71
Types of Payments	72
Regulation of Franchise Agreements	73
Antitrust Issues in Franchising	74
Future Antitrust Issues	78

	<u>Page</u>
Impact of Franchising on the Structure of the Commercial Foodservice Sector	79
Sub-markets in Foodservice Franchising	84
Fast Food Franchising	86
Franchisor-Owned Foodservice Operations	87
Franchisee-Owned Foodservice Operations	87
Large Franchise Foodservice Systems	88
The 200 Largest Commercial Foodservice Systems	91
Franchising Activity	95
Ownership Patterns in Commercial Foodservice	96
Mergers and Acquisitions in Commercial Foodservice	99
Mergers Involving Large Foodservice Firms	99
Market-extension Mergers	102
Horizontal Mergers	103
Mergers Between Large Food and Tobacco Processors and Foodservice Firms	104
Mergers in Major Market Segments	110
Mergers by Size of Processor	112
Food Processor/Foodservice Operations (1979)	115
Food Processor/Franchise Foodservice Operations	127
Foodservice Sales/Size of Food Processors	129
Four-Digit Classification of Food Processors	132
Merger Effects in 1979	135
Chapter Summary	137

CHAPTER IV BEEF AND POULTRY PROCUREMENT PROCEDURES EMPLOYED BY LIMITED-MENU FOODSERVICE FIRMS

Introduction	144
The Role of the Purchasing Agent	144
Procurement and Distribution Practices: A Perspective	146
Franchisor/Franchisee Procurement Arrangements	151
Non-Franchised Firms	157
Vertically Integrated Firms	158
Beef Procurement Procedures: An Overview	161
Procurement Relationships and Pricing Arrangements	167
Vertically Integrated Beef Operations	170
Hamburger Pricing Arrangements	170
Pricing Arrangements for Other Beef Items	176
Physical Product Flows	178
Franchisee Beef Procurement Procedures	181
Poultry Procurement: An Overview	182
Procurement Relationships	186
Pricing Arrangements: Shell and Pre-Cut Birds	188
Chicken Patty Pricing Arrangements	192
Physical Product Flows	195
Franchisee Chicken Procurement Procedures	197
Chapter Summary	198

	<u>Page</u>
CHAPTER V INSTITUTIONAL, ORGANIZATIONAL AND OPERATIONAL FACTORS INFLUENCING VERTICAL COORDINATION PROCESSES	
Introduction	200
Area of Inquiry: Risk-reducing and/or Shifting Strategies	201
Beef Procurement: Buy-ins	201
Poultry Procurement: Buy-ins	203
Uses of Futures Markets in Beef Procurement Strategies . .	206
Use of Futures Markets in Chicken Procurement Strategies	210
Vertical Integration: Beef Operations	212
Vertical Integration: Chicken	217
Advertising and Promotion: Market Coordination Mechanisms?	219
Menu Pricing Policies: Market Coordination Mechanisms? . . .	222
Formula Pricing: Market Coordination Mechanism?	226
Chapter Summary	231
 CHAPTER VI SUMMARY, CONCLUSIONS AND RECOMMENDATIONS FOR FUTURE RESEARCH	
Summary	233
Changing Structural Environment	238
Conclusions	240
Power Relationships	240
Vertical Integration	242
General Vertical Coordination Effects	243
Methodological Considerations	245
Recommendations for Future Research	246
 APPENDIX A FOUR-DIGIT SIC CODES	249
APPENDIX B FRANCHISOR APPROVED SUPPLIER CLAUSES	251
APPENDIX C HAMBURGER PROCESSING AND HANDLING SPECIFICATIONS .	254
 LIST OF REFERENCES	260

LIST OF TABLES

<u>Table</u>	<u>Page</u>
3.1 Single and Multiunit Restaurant Sales by Type of Establishment, Census Years, 1967, 1972 and 1977.	50
3.2 Single and Multiunit Restaurant Establishment Numbers by Type of Establishment, Census Years, 1967, 1972, and 1977.	51
3.3 Distribution of Fast Food Establishment Sales, Census Years, 1967, 1972 and 1977	55
3.4 Size Distribution of Fast Food Firms, 1972 and 1977 . . .	61
3.5 Size Distribution of Foodservice Franchisors Classified by Number of System-Wide Establishments, 1972, 1975 and 1979.	83
3.6 Franchise Restaurant Numbers and Sales Classified by Ownership Status and Major Menu Offering, Selected Years	85
3.7 U.S. Foodservice Sales and Restaurant Units of the 25 Largest U.S. Franchised Restaurant Systems, 1979.	90
3.8 Distribution of the 200 Largest U.S. Foodservice Firms by Type of Foodservice Operation, 1979.	93
3.9 Ownership Patterns for the 200 Largest U.S. Foodservice Firms, 1979	98
3.10 Major Mergers and Acquisitions of U.S. Foodservice Firms Made by Large Firms Other than Food Processors, 1967-1980.	100
3.11 Mergers and Acquisitions Involving the 100 Largest U.S. Foodservice Firms of 1979 by Type of Merger or Acquisition, 1976-1980.	101
3.12 Major Mergers and Acquisitions of U.S. Foodservice Firms Made by the 200 Largest U.S. Food and Tobacco Processors of 1975, 1965-1980	105

<u>Table</u>	<u>Page</u>
3.13 Major Mergers and Acquisitions of U.S. Foodservice Firms Made by the 200 Largest U.S. Food and Tobacco Processors of 1975, Classified by Type of Restaurant Operation, 1965-1980.	111
3.14 Major Mergers and Acquisitions of U.S. Foodservice Firms Made by the 200 Largest U.S. Food and Tobacco Processors of 1975, Ranked by Size of Processor, 1965-1980	113
3.15 Major Mergers and Acquisitions of U.S. Foodservice Firms Made by the 200 Largest U.S. Food and Tobacco Processing Companies of 1975, Classified by Principal Four-Digit Industry, 1965-1980.	116
3.16 U.S. Foodservice Operations and Estimated Foodservice Sales Made by the 200 Largest U.S. Food and Tobacco Processing Companies of 1975, 1979.	118
3.17 Major Foodservice Market Segment Participation by the 200 Largest U.S. Food and Tobacco Processors of 1975, 1979	125
3.18 U.S. Foodservice Operations and Foodservice Sales of the 200 Largest Food and Tobacco Processing Companies of 1975, Classified by Type of Foodservice Operations, 1979.	126
3.19 Foodservice Franchising Operations of the 200 Largest U.S. Food and Tobacco Processors of 1975, Classified by Type of Foodservice Operations, 1979	128
3.20 U.S. Foodservice Operations of the 200 Largest U.S. Food and Tobacco Processing Companies of 1975, Ranked by Size of Processor, 1979.	130
3.21 U.S. Foodservice Operations and Estimated Foodservice Sales of the 200 Largest U.S. Food and Tobacco Processors of 1975, Classified by Principal Four-Digit Industry, 1979.	133
4.1 Methods Used by Franchisors to Control Quality and/or Source of Food Products Purchased by their Franchisees, 1979.	154

LIST OF FIGURES

<u>Figure</u>		<u>Page</u>
2.1	Subsector Structure, Conduct and Performance Framework with Elements Particularly Applicable to Vertical Coordination Processes	21
3.1	Distribution of Commercial Restaurant Sales, Single and Multiple Unit Operations, 1967, 1972 and 1977. . . .	52
3.2	Distribution of Sales by Fast Food Firms, 1972 and 1977	60
3.3	Distribution of Franchise System Restaurant Sales, 1972, 1975 and 1979.	82

CHAPTER I

INTRODUCTION

The commercial foodservice sector is a dynamic and growing component of the U.S. food system. Between 1960 and 1979, the sector increased its share of the consumer's food dollar from 25 to approximately 36 percent. As a result of this growth, the commercial foodservice sector has become a relatively more important marketing channel for many food commodities. Despite its increased importance, however, relatively few studies have focused research efforts on analyses of either the market or non-market forces that impinge on foodservice firms and their suppliers, and that ultimately affect the vertical coordination processes between these participants. In light of the sector's growth, such analyses will be valuable additions to the existing stock of marketing research.

This study focuses on the interrelations between selected commercial foodservice firms and their primary beef and/or poultry suppliers. The study was confined to firms which participate in the limited-menu segment of the commercial foodservice sector. A majority of these firms are fast food operations, but also included are firms which operate budget steakhouses.

The limited-menu segment of the sector has exhibited substantially higher growth rates during the past 20 years compared to the sector average. Consequently, the limited-menu segment has become relatively

more important within the sector itself. Data for 1977 indicate that fast food firms accounted for about 35 percent of total eating place sales. This share was nearly twice as large as their share in 1967.¹ The prospects for continued growth in this segment of the sector also appear strong. Hence, an effective research effort directed at this segment's participants will have current as well as future value.

Beef and poultry were selected for analysis for a variety of reasons. Recent estimates indicate that the commercial foodservice sector markets approximately 25 percent of all beef consumed in the U.S.,² and poultry marketings by the sector are estimated to account for between 14 and 18 percent of domestic consumption. These particular commodities are also extremely important elements in the marketing strategies of limited-menu foodservice operators. The market segmentation strategies of these firms tend to be organized around themes which emphasize the quality and/or variety of their primary menu items, which are often beef and/or poultry items. These commodities also represent a substantial proportion of the total food costs for limited-menu operations. It is not uncommon for beef products to account for 40 percent of total food costs, and in some instances may account for over 70 percent of these costs.³ Given these facts, a study that focuses on the beef and/or poultry procurement strategies used by

¹See Chapter II for details.

²Beef Marketing: Issues and Concerns, 1978, p. 13.

³"Ponderosa Designs Beef System to Cut Costs", Nation's Restaurant News, August 1, 1977, p. 81.

limited-menu restaurant operations, and the interface of these strategies with those of their primary beef and poultry suppliers, would expand our working knowledge of an increasingly important segment of the food system.

Previous Treatment of the Subject Matter

As noted earlier, there is a relative paucity of research that has focused specifically on the foodservice sector. This is particularly true for marketing studies funded through the public sector. Even the broad-based National Commission on Food Marketing gave only cursory attention to the sector in its technical studies of the U.S. food marketing system. Privately funded studies of the sector are relatively common, but they are not generally available to the public. These studies tend to be market research studies that are used by foodservice firms in planning geographic market expansion programs and market segmentation strategies.

The publicly funded research efforts that have been directed at the foodservice industry can be classified into two broad categories: 1) logistic/operations studies and 2) commodity flow studies. The former includes research that examines the costs and/or benefits of alternative storage, handling and distribution systems; labor requirement studies and studies devoted to enumerating the functional activities performed by firms within the industry.¹ Studies categorized in the latter group are primarily descriptive studies which provide data on specific commodity flows through the foodservice distribution system.

¹See, for example, Cost Comparisons of Five Institutional Food Delivery Systems, 1978; Labor Requirements and Operating Costs in Fast Food Restaurants, 1975; Stafford, 1974.

A few studies have attempted to estimate individual product and/or group commodity flows by type and size of foodservice operation in the U.S.¹ Others have focused at the local market level and/or have concentrated the research effort on a specific product or commodity group.² However, in general, the emphasis of these studies has not permitted a comprehensive analysis of the market and non-market forces which interact to shape firm decision-making. Hence, despite their relevance, these studies do not provide some important pieces of information pertaining to firm level decisions in procurement and their effect on vertical coordination processes.

Without information of this type, one can only speculate on the motivations which influence and/or reinforce organizational choice. A comprehensive understanding of the interdependencies that exist between intra-firm decisions and the external environment is an important element which can contribute to a more complete understanding of interstage coordination processes. Such information is also important from a public policy standpoint because it provides a base from which both the intended as well as unintended consequences of policy changes can be evaluated.

Vertical Coordination

What has been implied but not made explicit in the foregoing discussion is that decisions made and actions taken at one stage in a marketing system have an effect on the participants in adjacent

¹Van Dress, 1971; Van Dress and Freund 1967 and 1968.

²Baker, 1980; Dietrich and Williams, 1959; Jones 1979.

stages. Hence, the identification of those decisions that directly influence a firm's procurement practices has an obvious effect on the processes that tie together vertically adjacent stages in a distribution system. This effect is realized through the interaction of individual firm decision-making within the existing institutional structure. The aggregation of these firm/institutional interactions within a given vertical array constitutes vertical systems coordination.

Vertical coordination has been characterized by Marion as ". . . a process by which the various functions of a vertical value adding system are brought into harmony . . ."¹ This process is basic to all economic systems for it is the process through which value is created. If we are to gain a more complete understanding of the organization and control of vertical distribution systems, knowledge of vertical coordination processes within these systems is crucial. Such an understanding is grounded in the knowledge of both the existing institutional and market structures which condition the opportunity set of participants, and the actual behavior exhibited by participants. Hence, in the broadest sense, both structure and conduct are critical elements which influence performance in vertical distribution systems.

Research Objectives

The focus of this research is directed at the vertical coordination processes that tie together limited-menu foodservice firms with their major beef and/or poultry suppliers. Thus, the study examines the interface between two separate stages in a vertical distribution

¹Marion, B., 1976, p. 180.

channel. The results of the research are complementary to other research efforts that have examined the vertical coordination processes operative at different levels within the distribution system (e.g., producer--first handler exchanges).

The specific objectives set forth for this study are as follows:

- . To describe the market structure of the commercial foodservice sector in general and specifically the structure of the limited-menu segment.
- . To detail the current standardized procedures used by limited-menu firms in procuring beef and/or poultry products.
- . To describe and evaluate the effects of those procedures on vertical coordination processes.
- . To assess the appropriateness of the research methodology in examining vertical coordination processes.

Research Approach

A broad spectrum of data sources were drawn upon to meet the objectives set forth for this study. This spectrum included both primary and secondary data sources. The initial research phase consisted of a literature search and the development of secondary data sources. The purpose of this initial effort was twofold. First, it provided the necessary background information from which a comprehensive description of the current structure of the commercial foodservice industry could be developed. Second, it served to identify questions of interest that were specific to the industry.

Important secondary data sources included both periodic and special reports by federal agencies, particularly those published by the Department of Commerce, and industry trade journal publications (e.g., Institutions and Restaurant Business). Census reports

(supplemented in some instances by industry trade reports) were particularly important in identifying major shifts in industry structure. When these data were combined with trade journal information, which was often firm-specific, a relatively comprehensive description of the market structure of the industry was made possible.

A systematic search of major industry trade publications covering the decade of the 1970s revealed a substantial body of firm and commodity-specific information. By organizing this information on an individual firm basis, firm profiles were developed. These profiles were extremely useful in tracing the development of some firms and often provided insights into a firm's organizational and operational characteristics. The information contained in these profiles, although generally not specific enough for the task at hand, was important because it helped sharpen the research focus by identifying key areas of inquiry and by providing additional detail needed in the sample selection process. These profiles also broadened the researcher's knowledge of firm activity in the industry. This knowledge proved to be very important in establishing the researcher's credibility and hence in facilitating the collection of primary data at the firm level.

The need for additional information pertaining to the product procurement practices of limited menu foodservice firms became evident as the firm profiles were organized. The specificity of detail concerning firm procurement strategies required in the study was lacking. Primary data were needed to add this detail. Given the research objectives, the diversity of operations within the industry, and the anticipated complexity of the procurement process, a case study approach was deemed appropriate. The focus of these studies was the specific

standard operating procedures (SOPs) used by limited-menu foodservice firms in their procurement of beef and poultry products. The ultimate goal was to bring greater detail to, and hence a clearer understanding of, the micro-forces that influence the coordination processes within the beef and poultry subsectors.

The coordination process is a multi-stage process. Therefore, primary data were gathered at two different levels in the distribution system. Special emphasis was given to the collection of data from firms that operated at the retail level. However, some data were also gathered at the beef and poultry fabricator/distributor stage of the distribution system.

The process employed to gather primary data consisted of conducting personal interviews with managerial decision makers.¹ The interview procedure was organized so that a description of the firm's procurement SOPs was obtained. Consistency across interviews was attained by developing the interview format around areas of inquiry. These were broad areas which circumscribed the procurement process. By combining these data with information pertaining to the market segment within which the firm operated and the firm's organizational structure (e.g., franchisor), a comprehensive description of the firm's procurement SOPs was obtained.

The organization of the data base in this way also provided the opportunity to compare and contrast the procurement SOPs used by firms with different organizational structures. The structure of the

¹In a few instances telephone interviews were used when the interviewee's schedule could not accommodate a personal interview.

commercial foodservice industry is not monolithic.¹ For this reason it was necessary to provide control elements to account for expected differences in procurement SOPs that might arise as a result of differences exhibited across firms in their organizational and market characteristics.

The sample survey process proceeded in two stages. The first stage involved the identification of the forty largest limited-menu restaurant operations in the U.S. that feature beef and/or poultry as standard menu items. Once identified these firms were stratified into various categories on the basis of their organizational structure (e.g., franchisor or vertically integrated operations) and their primary product offering (e.g., beef and poultry products). Where appropriate, sub-categories were developed to further stratify firms according to the specific type of beef product used (e.g., hamburger, roast beef, etc.). The categorization of firms along organizational and market segment lines provided control to the sample selection process and served as a preliminary format for cataloguing the primary data after its collection.

The second stage of the sample selection process consisted of the identification of the major beef and poultry suppliers of the firms that were interviewed. This information was obtained during interviews with the retail firms. Once identified, these firms were contacted (primarily via telephone) and managerial personnel specifically involved in servicing the retail firm were interviewed. Specific attention was given to methods used by these processor/fabricators

¹See Chapter III for details.

in servicing their foodservice clientele.

Ideally, the survey at the retail level would have included all the firms ranked among the 40 largest limited-menu firms. However, a complete enumeration of these firms was not possible.¹ This was an unfortunate, yet not totally unexpected, development. Interviews were completed with personnel from 20 of the 40 largest firms. The firms that did grant interviews reflected the diversity of organizational form and primary product usage exhibited by the 40 largest firms. For example, 31 of the 40 largest firms were franchisors and 18 of those franchisors were interviewed. This included seven of the nine largest and 13 of the 18 largest franchisors. An interview was also conducted with one of the six large franchisees in the group and with one of the three non-franchise firms in the group.

The firms surveyed also reflected the primary product usage patterns of the 40 largest firms. Twenty-seven of the 40 firms used some type of beef product as their primary menu item and an additional seven firms used beef for at least some menu items. Personnel from seventeen of these 34 firms were interviewed including 15 of the 27 where beef was a primary menu item. Interviews were also conducted with three of the six firms which specialized in the preparation of chicken.

Interviews were conducted between September 1980 and May 1981 with the majority being completed during the first four months of that period.

¹A variety of reasons were offered when a request for an interview was declined. The most frequent response was that company policy would not accommodate such an interview. Increased requests for firm-specific data, the recent survey of franchisor/franchisee purchase tie-ins by the FTC, and the continuing sensitivity of franchisor/franchisee relations probably contributed to the refusal of some firms to participate in the survey.

The corporate titles of the personnel interviewed varied across firms; however, most were either Directors of Distribution, Directors of Purchasing, Directors of Purchasing and Distribution, or purchasing agents. Interviews were conducted using a non-directive interview format and ranged from two and one-half to five hours in length.¹ Most interviews were conducted with the express understanding that neither the name(s) of the interviewees nor that of their respective organization would be revealed. This understanding also extended to certain product specifications and methods of operation which the firm viewed as proprietary information but was willing to share so long as adequate safeguards were maintained concerning their use in the study.

A total of 32 persons who were directly involved in the purchasing of beef and/or poultry products for commercial foodservice firms were interviewed. An additional 15 persons, primarily customer account executives, with major beef and/or poultry processors were also interviewed. These totals do not include the numerous discussions held with interested parties in the U.S. Department of Agriculture, industry trade groups or informal interviews held with limited-menu franchisees in the Lansing, Michigan and Columbus, Ohio areas. If the latter interviews are included, a total of over 60 individuals contributed to the study.

The primary emphasis of the study is not to enumerate the quantities of beef or poultry products that currently flow through foodservice operations. Rather it is to delineate, within the context of a firm's decision-making environment, those decision rules and

¹The average length of interview per foodservice firm was approximately four hours.

procedures that firms actually employ in procuring primary inputs to their production process. Thus the findings of the study are complementary to, but not a substitute for, broader surveys which provide data on commodity flows within the sector.¹

Given the general research emphasis in the study, it was necessary to develop and aggregate the primary data in such a way that both the organizational diversity and the operational similarities exhibited by firms were taken into account. This was accomplished through the use of a composite case study approach. In this approach, firms with similar organizational structures and market orientations are collapsed into a single general classification developed on the basis of those characteristics. For each general classification aggregated primary and secondary information yield a data set from which a composite case analysis can be developed. This procedure is then repeated for each structure/market classification with control across cases provided by the development of key areas of inquiry. These areas of inquiry, which remain constant across the composite cases, serve as an organizational format through which the results of the case studies can be generalized. Such a format is particularly useful for making comparisons and drawing contrasts across the composite cases.

Some broad areas of inquiry which were examined included:

- . Search procedures for inputs and input suppliers, including the use of "franchisor approved" distributor and supplier networks.

¹ A broad survey of these commodity flows was recently undertaken by a coalition of industry trade groups with the cooperation of USDA personnel. Data from this survey are currently being evaluated and the results forthcoming in the near future.

- . Pricing practices, particularly those related to procurement of inputs by the foodservice firm.
- . Buyer-seller exchange arrangements, including the use of specification buying, credit and payment practices and contractual linkages.
- . Nature and extent of vertical integration.
- . Inventory control practices.
- . Risk-reducing or shifting arrangements, including use of fixed price contracts and futures markets.

Thesis Overview

The organization of the thesis parallels that of the actual research process. Chapter II is primarily a theoretic chapter where a conceptual approach to the research is developed. Chapter III is primarily descriptive. It draws on a variety of secondary data sources in examining structural trends in the commercial foodservice sector. Special emphasis is given in this chapter to the impact of franchising on the sector's structure and to the expanding corporate linkages between commercial foodservice firms and large food and tobacco processors.

The following three chapters present the research findings and discuss in detail the standard operating procedures used by commercial foodservice firms in beef and poultry procurement and their effect on vertical coordination processes. Chapter IV develops and summarizes the findings using the composite case study approach. Chapter V examines the impact of various institutional and market factors on vertical coordination processes and provides insights into the forces shaping particular patterns of coordination and exchange. Chapter VI summarizes the research findings and the policy implications emanating

from them. Selected support data are included in attached appendices.

CHAPTER II

VERTICAL COORDINATION: A CONCEPTUAL FRAMEWORK

Introduction

This chapter outlines the various conceptual approaches which have been used to examine vertical coordination processes. It commences with a brief discussion of what vertical coordination is and the importance of understanding this process in marketing and related public policy research. The chapter emphasizes the importance of firm level decision processes as a key element influencing firm behavior and thus, the coordination process. Concepts developed by organizational theorists are used to focus on specific aspects of firm behavior that directly influence decision processes. Special consideration is given to those rules influencing decision processes that have direct impacts on the interface between vertically tangent firms. The chapter concludes with a brief discussion of the relevance and applicability of these concepts to an examination of the inter-stage coordination process involving linking limited-menu foodservice firms and their major beef and poultry suppliers.

Vertical Coordination: A Perspective

"The economic problem is relatively uninteresting except where economic events are changing and sequential adaptations to changing market circumstances are called for."¹

¹Williamson, O., 1975, p. 5.

The interest in vertical coordination stems from the realization that firms operated not only within a specific horizontal industry, but also within a larger spectrum of activity--a vertical marketing system. Important issues relevant to the organization and control of these systems can be addressed by examining both the vertical and horizontal relationships that exist between firms. Since these relationships are conditioned by the existing institutional structure, research on vertical coordination processes tends to include important elements of the institutional structure which impact on vertical market participants.

Marion has characterized vertical coordination as ". . . a process by which the various functions (performed within) a vertical value adding system are brought into harmony . . ."¹ Admittedly, such a definition is open-ended and vague but it does capture the essence of vertical coordination as a process. This process influences the quantity and quality of products produced and marketed as well as when and where within the system products are produced. Thus, vertical coordination processes lie at the very heart of economic processes because they influence form, time and place utility and therefore directly affect the creation of value within the system.

A similar view has been expressed by Shaffer:

"Vertical coordination is a special problem of preference articulation. The issue is the effectiveness of coordination of supply decisions with demand. It deals with the sufficiency of price as a carrier of information and incentives and the behavior of participants in strategic positions."²

This statement emphasizes the importance of the structure of the incentive

¹Marion, B., 1976, p. 180.

²Shaffer, J., 1980, p. 317.

system and the resulting influence on the behavior of system participants. Vertical coordination processes are not independent of either institutional or market structures, but rather are conditioned by these structures. Both of these circumscribe the opportunity sets of participants, affect behavior and influence the coordination process.

Vertical coordination results from the aggregation of actions taken by participants in a vertical distribution system. The actions taken influence the physical flows of inputs and outputs through the various stages in a vertical, value adding system, as well as information flows and flows of property rights. Conceptually, these flows can be visualized as occurring at exchange/transaction points where functionally independent entities interface. Although such interfaces often occur in markets, they may also be internalized within an entity (firm) whose functions span more than one vertical stage. The latter obtains when a firm is vertically integrated.

Since vertical coordination processes may take place both in market-mediated transactions and in transactions internal to a firm, it is possible to view markets and internal organization hierarchies as alternative instruments for completing a related set of transactions. This view has been expressed by Williamson (1975) and Alchain and Demsetz (1972).¹ The substitution of hierarchal control for market mediation

¹These authors differ on the reasons for the substitution of hierarchies for markets. In Alchain and Demsetz's view, this substitution occurs because of the nonseparable nature of the production function and the resulting problems of evaluating the marginal value product of factor inputs. This is a technological determinism viewpoint.

Williamson suggests that the substitution takes place as a result of market (institution) failure. He argues that a variety of factors contribute to this failure. Central among these are: 1) the interaction of opportunistic behavior with uncertainty which gives rise to information impactedness, and 2) the joining of these with bounded rationality. This gives rise to a situation where the transaction cost of completing full contingent claims contracts are prohibitive, and internal organization (hierarchy) is substituted for market exchange.

effectively removes the integrated function from market disciplining forces and replaces these forces with administrative rules. These rules are also disciplining forces but are generated internally by the organization and hence are subject to the rationality norms and goals of the organization. In vertically integrated organizations, administrative rules allocate resources and the role of price as an allocative mechanism is diminished.

Vertical coordination processes take place within vertical market systems. These systems are often complex in their organization. Some market systems involve many separate, distinct stages that are ultimately linked together through markets. Others may involve series of firms that are vertically integrated. Still others may exhibit mixed structures which contain both integrated and nonintegrated firms. The basic research design(s) used to study vertical coordination processes must be flexible enough to accommodate these different vertical market structures.

One approach that has been developed to examine vertical coordination processes in the food system is the subsector approach.¹ This approach is not so much a research design as it is an alternative conceptual framework for organizing knowledge about the functioning of a vertical distribution system. The approach differs from earlier marketing research in the sense that the subsector itself, rather than a particular firm or industry, is the unit of analysis. Much of the marketing research in the 1950s and 1960s was oriented toward delineating the breadth of functions performed by firms or industries which

¹Shaffer, J., 1970.

comprised identifiable stages in the marketing system. Relatively little attention was given to the interface of these functions with those performed in adjacent stages. As a consequence, there was no unifying theme which served to tie together the research efforts conducted at different stages in the marketing system.

The subsector research that has been undertaken has generally been organized along commodity lines. Early attempts at applying this framework were directed toward examining producer/first handler exchange arrangements for major agricultural commodities.¹ Subsequent research efforts have examined coordination and exchange processes at other levels in the distribution system.² While none of these efforts have examined a subsector in its totality, their orientation is compatible with a systems-type analysis. Hence, future research efforts which focus on heretofore unexamined inter-stage linkages can ultimately be merged with the existing body of subsector research to yield a description of the entire subsector. In turn, this description could be utilized to identify specific problems within the subsector, and as an aid in predicting the consequences, both intended and unintended, of institutional and market structure changes within the subsector. The enhanced diagnostic and predictive capacities offered by the subsector approach to market research are perhaps its most important benefits.

Marion has offered a generalized view of some important market and institutional structures, behavioral considerations and performance

¹ Coordination and Exchange in Agricultural Subsectors, 1976.

² Boynton, R., 1978; Campbell and Hayenga, 1978; Chase-Lansdale, W., 1981; Hayenga, M., 1978 and 1979; Lang, M., 1977.

dimensions within subsectors.¹ His representation is depicted in Figure 2.1. While the listing may be incomplete and inadequate for specific subsectors, it indicates some of the more important elements to be considered in subsector research.

Conceptual Approaches

There is no unified theory of vertical coordination. Rather there are a number of conceptual frameworks that have been employed in vertical systems analysis. These are widely divergent in their emphasis. Marion has reviewed these approaches and has classified them into three broad categories based on their perspective of vertical systems. He labelled these approaches: 1) technological determinisms, 2) behavioral and 3) institutional.² A brief review of each will help clarify the differences between them.

Researchers that have emphasized the organization of vertical market systems from a logistics-production viewpoint are included in Marion's technological determinism classification. This group includes the work of Stigler, Paul and to some extent that of Alchain and Demsetz.³ The overriding emphasis in these works is the view that technology and efficiency concerns dictate the structure of vertical market systems. Factors such as market growth, which might accommodate increased functional specialization, or technological advancement, which might change the optimal size and/or location of plants, are seen

¹Marion, B., 1976.

²Marion, B., 1975.

³Stigler, G., 1951; Paul, A., 1974; Alchain and Demsetz, 1972.

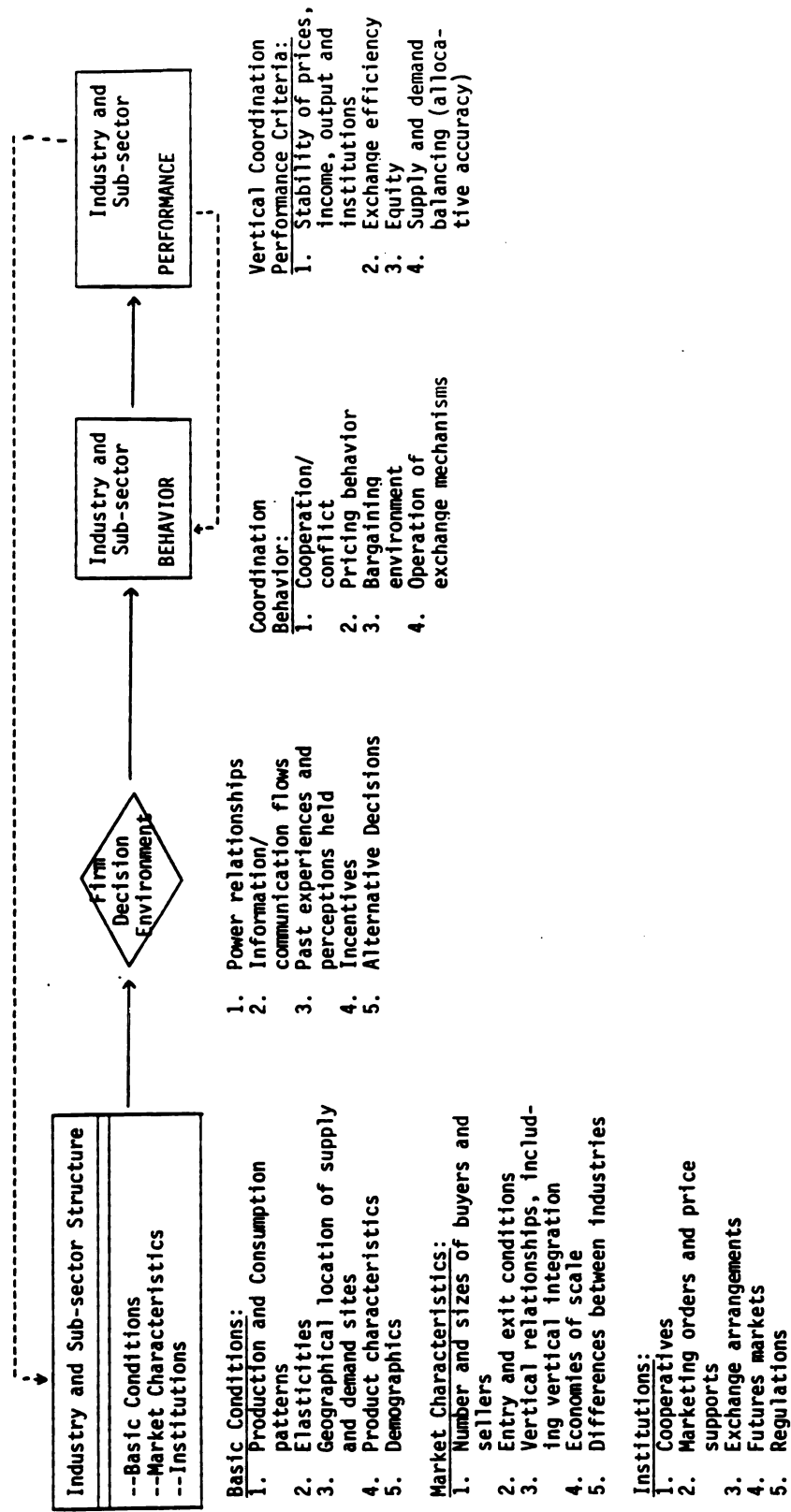


Figure 2-1. Sub-Sector Structure, Conduct and Performance Framework with Elements Particularly Applicable to Vertical Coordination Processes.

as the driving forces which shape vertical market structures. In this view, market systems are responsive to changes in consumer preferences and other exogenous changes. With their emphasis on intra-firm technical efficiency and functional specialization, the market interactions of tangent vertical market participants are largely ignored. Hence, the coordination and performance consequences of sector change are not adequately addressed in these studies.

Marion's second broad classification--approaches with a behavioral emphasis--actually encompasses three distinct conceptual approaches that stress different behavioral aspects of inter-firm vertical relationships. Despite their differences in emphasis, each of these conceptual approaches is concerned primarily with how vertical market systems function. In the cybernetic-feedback approach, the modeling techniques of system science are used to evaluate the effect of decision rules, delays, and decision points on inter-firm coordination processes. System dynamics are stressed. Particular emphasis is given to the effect of alternative decision rules on the response patterns of system participants and the resulting impact on supply and demand conditions.

An alternative conceptual framework which has been used to examine various behavioral elements within vertical market systems is the conflict-cooperation approach. Researchers who embrace this framework tend to view vertical market systems from a "systems cooperation" standpoint. They recognize that individual vertical market participants may establish goals and objectives which are inconsistent with one another. In some instances conflict arises which leads to dysfunctional behavior. Such behavior disrupts coordination between functionally independent

vertical entities. Since cooperation is a preferred state within vertical systems, emphasis is placed on identifying those exchange arrangements which can be implemented to reduce dysfunctional behavior, thereby improving system cooperation and ultimately, system coordination. Again, as was the case in the cybernetic-feedback approach, this research approach evaluates performance in terms of the match between supply and demand within the system.

The market failure approach is the third behavioral approach identified by Marion. It could also be called the organizational failure approach.¹ Like the technological determinism approach, this conceptual framework focuses on the causes of change in vertical market structures. But instead of emphasizing technological and growth imperatives as the driving force behind these changes, the emphasis is placed on human and environmental factors operative within the system. Bounded rationality and opportunistic behavior (human factors) interact with uncertainty and small numbers in bargaining situations (environmental factors) to produce a state where it becomes prohibitively costly to ". . . write, execute and enforce . . ."² contingent claims contracts. Under these conditions firms may elect to bypass the market altogether and substitute hierarchal organization. The final decision on whether market or internal exchange is preferred hinges on the relative transaction costs of each. Williamson has offered this conceptual framework both as an explanation of vertical integration and as a partial theory of conglomerization.

¹See Williamson, O., 1975.

²Williamson, O., 1975, p. 9.

Marion's third broad classification includes those conceptual frameworks that have an institutional orientation. He identifies three distinct frameworks with this orientation. Each of these tends to emphasize structure-performance relationships; however, performance is viewed in broader terms than just technical and exchange efficiency. Greater emphasis is given to the competitive consequences of changing vertical market structures and to the various exchange arrangements and institutional factors which influence change.

The market structure approach examines the effect of vertical market structure on industry structure, conduct and performance. This approach is a variant of the structure-conduct-performance (S-C-P) used by industrial organization theorists in horizontal (industry) studies. As applied to vertical systems, this approach examines the effect of vertical integration, tying arrangements and various contractual forms on horizontal relationships between competing firms. The competitive consequences of these arrangements, as reflected in the conditions of entry and market foreclosure at a given vertical stage, are of primary interest. In this approach, conduct (behavior) is not usually assigned an active role. The framework tends to rely on structure-performance relationships and to infer from these the underlying incentives and motives which give rise to the observed performance.

Closely related to the market structure approach is the legal-institutional conceptual framework. In this approach, emphasis is given to the role of laws and other institutional arrangements as they affect performance in vertical market systems. Important dimensions of performance are the distribution of rights and risk within the

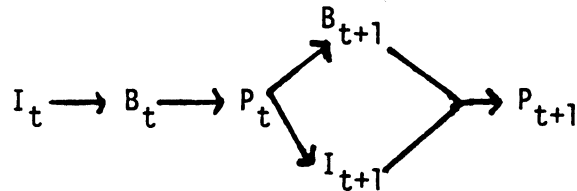
system and the implications of these as they relate to vertical control and power relationships.

The third and final conceptual framework identified by Marion is the coordination-adaption approach. This approach contains elements of both the market structure and legal-institutional approaches. Consideration is given to both market and institutional structures as direct influences on the evolution of market systems. Conduct (behavior) has a more active role in this framework than in others. Behavior takes place within, and is therefore conditioned by, both the market and institutional structures which define and shape the opportunity set(s) of participants. However, the existing structural configuration may accommodate a broad variety of behavior. Behavior (decisions) is reinforced through the positive feedback effects resulting from the convergence of actual and expected performance (outcomes). Behavioral changes are implemented when there is an unacceptable deviation between actual and expected performance. Convergence in performance tends to rigidify institutional structures; divergence tends to modify these structures through behavioral changes. Either situation may lead to modifications in the market structure of the system.

Although changes in market and institutional structures may occur as a result of endogenous factors, it can also result from exogenous factors. For example, technological advancements may influence opportunity sets which, in turn, modify behavior and affect performance. The recognition of the impact of both exogenous and endogenous factors as they relate to vertical market systems is an important consideration in the coordination-adaption approach. This is reflected in the broadening of performance dimensions to include elements of technical and

transactional efficiency as well as the distribution of rights, risks and control within the system.

The coordination-adaption framework has an implicit dynamic orientation. This orientation is illustrated in the following schematic:



where I, B and P represent Institutions (including market structure phenomena), Behavior and Performance.¹ This framework is highly flexible. It can be used to examine individual stages within a subsector or to examine an entire subsector. An important element in this conceptualization is the feedback effect of performance (outcomes) on both behavior and institutions. An understanding of vertical coordination processes requires more than simply delineating the exchange arrangements and institutional factors operative in the system; it also requires knowledge of feedback flows and the incentives (contingencies of reinforcement) that shape and condition the use of these arrangements.

As noted earlier, vertical coordination results from the aggregation of actions taken by individual participants in a vertical distribution system. It is the behavior of individual firms as reflected in the decisions they make and act upon that in the aggregate results in vertical coordination. If we are to adequately understand the vertical coordination process, we must examine the origins and rationale for decisions that take place at the firm level.

¹Shaffer, J., 1980.

Firm Behavior

"Instrumental action is rooted on the one hand in desired outcomes and on the other hand in beliefs about cause/effect relationships."¹

Some of the concepts developed by organizational theorists may provide useful insights into the decision anatomy of firms as they relate to vertical coordination. The modern view of the firm is one of a rational, problem-facing, problem-solving organization. The focus is on organizational processes related to choice of actions in an environment in which alternatives, and their consequences, are not fully disclosed or anticipated. The external environment is a source of continuing uncertainty for the firm. Uncertainty, coupled with a firm's limited capacity to gather, process and analyze information, confounds the decision process, making choices difficult. In order to deal with these constraints, firms develop processes for searching and learning, as well as for deciding on appropriate courses of actions.

The organizational theories and concepts developed by Simon¹ and Cyert and March² provide insights into these processes. In their formulations the omniscient, profit-maximizing firm of the neoclassical economist is supplanted by the view of the firm as a multiple goal-oriented entity. Firms establish goals and objectives and seek them within the constraints imposed by bounded rationality and environmental uncertainty. Goal achievement is the driving force behind firm actions. Goal achievement is measured in terms of satisfactory levels of

¹Thompson, J., 1967, p. 14.

²Simon, H., 1959.

³Cyert and March, 1963.

accomplishment, rather than on the basis of maximization criterion (i.e., firms satisfice rather than maximize). Goals and objectives may include, but need not be limited to, profit considerations alone. The system of goals and objectives used by the firm are a means to provide closure, order and rationality to its task environment.

This order is not achieved without costs, however. The concept of satisficing behavior also suggests that there are elements of slack within organizations. Leibenstein argues persuasively that this slack results from two factors: 1) decision-making under conditions of uncertainty and 2) the need to delegate authority within the organization to reduce decision costs.¹ Although slack can be viewed as an unnecessary cost of organization, alternative formulations suggest that it may serve as a buffer or reserve to be drawn upon in times of organizational distress.² Regardless of one's perspective, however, there is little doubt that organizational slack persists in various forms. Perhaps the more relevant question is how slack is used by management as a discretionary vehicle for managing both internal and external conditions. In this regard, slack elements may be important considerations as they relate to the implementation and enforcement of operating rules within the organization. These elements may also have relevance for vertical coordination processes in that the use of these rules have effects that extend beyond the confines of the firm proper.

Once goals have been established, the firm seeks rational means

¹Leibenstein, H., 1966.

²Hirschman, A., 1970.

for achieving them.¹ They accomplish this through a system of rules which to a great extent standardize behavior within interdependent functional elements of the firm. These rules facilitate intra-firm coordination processes by delimiting responsibilities and control over resources within the various functional units of the firm. The structure of rules is the fundamental vehicle through which firms achieve bounded rationality and organizational goals.

The firm, as a complex organization, finds it necessary to adapt to its environment at many different, yet interrelated, levels and to do so within varying time horizons. Thus, it finds it expedient to delegate authority within the firm. One method for achieving this while still maintaining some overall control is to develop standardized rules that delimit the response patterns of functional units within the firm. Cyert and March referred to these rules as standard operating procedures (SOPs).²

Standard Operating Procedures

SOPs are used as rational, adaptive response mechanisms within the firm. These rules are commonly utilized to facilitate a firm's behavioral response to short-run changes in environmental conditions. They are also utilized as control mechanisms within the firm and as mechanisms for intra-firm coordination. By simplifying the coordination and control processes within a firm, these rules conserve resources and

¹The process of goal formation is complex. It is important in a dynamic context, but can be taken as given in short run analyses. Since the interest here is primarily in the processes used to obtain goals rather than goals themselves, the processes involved in goal formation are not explicitly considered.

²Cyert and March, 1963.

attenuate dysfunctional behavior, thereby lowering costs.¹

In their original formulation, Cyert and March identified four broad areas where SOPs are used by firms. One of these relates to task performance within the firm; two deal with information handling and routing within the organization, and the fourth deals with organizational planning functions. A brief description of the use of SOPs in these areas follows.

Task performance rules define the procedures used by firms in procuring inputs, transforming them into intermediate and final products, and marketing final outputs. They are also used in various support activities such as inventory management and control. Task performance rules related to input procurement might specify the conditions under which suppliers are selected and the timing and frequency of input purchases. They might also specify when, and if, purchases of commodities are hedged.

Task performance rules may originate from a variety of sources. Some originate from the firm itself and are reinforced through experience; others originate from established practices within the industry that have shown to be effective. In general, these rules are specific relative to the functions performed within the firms.

The SOPs that deal with information are of two types: 1) records and reports dealing with external environmental conditions, which are

¹Harvey Leibenstein also recognized this point. Although Leibenstein does not specifically address SOPs in his seminal article on X-efficiency, he implicitly refers to them in his discussion of cost reducing methods that are unrelated to capital expenditures. He specifically states that, "(These cost reducing) methods usually involve some simple reorganizations of . . . materials handling, waste controls work methods and payments by results." (emphasis added) p. 399.

used for control and prediction purposes, and 2) records and reports pertaining to internal performance. Both of these are important because the array of variables monitored and analyzed condition firm response to changes in either external or internal conditions. Timeliness is important also. Without up-to-date records, firm responses to change, either from internal or external sources, may lag and result in situations where unintended dysfunctional behavior surfaces.

A fourth area where SOPs are used by organizations is in planning functions. Plans are media through which organizational goals are communicated. They can serve both as precedents within the organization and as vehicles for redirecting organizational action. Plans function as precedents when the performance history of a plan indicates that goals have been achieved. This reinforces the use of that plan in subsequent periods, assuming constancy of goals. Plans are used to redirect organizational action when organizational goals change or are expanded to include activities that had not been previously within the purview of the firm.

Although the Cyert and March classification scheme might suggest that the different types of SOPs are independently instituted, this is most certainly not the case. In fact, all of them are usually operational and directly influence the operation of functionally independent elements in the organization.

The concepts developed by Cyert and March help explain how firms organize and control internal processes to achieve intra-firm coordination of input and output activities. It must be recognized, however, that because organizations are embedded in larger spheres of action, some parts of the organization must be interdependent with other

organizations. It must also be recognized that some choices (decisions) made within organizations have an influence that extends beyond the confines of the organization itself. Since in many instances SOPs are utilized to facilitate internal decision-making processes, it follows that SOPs often have external (to the firm) effects. These external effects are not observed directly, but instead are reflected in the decisions made and subsequent actions taken by the firm.

If we are to understand the decision processes within the firm, it is fundamental that we have knowledge of the forces which shape and reinforce these decisions. To the extent that SOPs impact upon decision processes, their study can result in a broadening of our understanding of decision processes.

Vertical Coordination and Standard Operating Procedures: A Synthesis

It was noted earlier that vertical coordination processes result from the aggregation of firm actions at each stage in a vertical marketing system. The behavioral responses of firms are conditioned by the prevailing institutional structure which shapes the firm's opportunity set. It can be stated that these behavioral responses are also conditioned by the existing institutional structure within the firm as reflected by the specific SOPs adopted. The SOPs used by a firm directly influence what actions a firm takes. While these actions are constrained by the opportunity set of the firm, the opportunity set may accommodate a broad range of behavior. By emphasizing the more specific aspects of firm behavior, a richer understanding of vertical coordination processes may be attained.

The coordination-adaption approach to vertical marketing systems

readily accommodates the addition of standard operating procedures as behavioral elements of the firm. The addition of SOPs as institutional factors to be considered merely broadens the scope of analysis and brings more information to light concerning firm behavioral responses and their influence on vertical coordination processes. Such information is important when considering the effects of institutional changes on the external environments within which firms operate.

Although firms utilize SOPs in a variety of ways, it can be reasonably expected that certain subsets of rules are more likely to directly influence the coordination process than others. For example, the specific SOPs used in the physical transformation of inputs into intermediate and final products are less likely to be important from a vertical coordination standpoint than are the rules firms use to procure inputs and market outputs. This is especially true in short-run analyses of market systems. This is not to say that the technical functions performed by firms are to be ignored, but rather, that in the short run they may be considered fixed. In the short run, SOPs which influence input and output-related decisions are also fixed for the firm but they do impact on the coordination process because at least some of their effects are external to the firm.

It can also be reasonably expected that some SOPs will transcend individual firms and thus can be viewed as standard industry practices.¹ When and where such practices exist and are identified, it becomes possible to abstract from individual firm SOPs without encountering

¹Hamm has demonstrated the effect of standard industry practices on vertical coordination between grocery retailers and processors of canned and frozen fruits and vegetables. Hamm, L., 1981.

aggregation bias and directly assess the effect of these procedures on inter-stage coordination processes. Where procedures are standardized across an identifiable subset of firms, but not across all firms, the effect of these procedures must be analyzed in a more constrained manner. Nevertheless, through careful consideration of organization structure and other intervening structural variables, it may be possible to assess the impact of SOPs used by organizations exhibiting similar structures.

Research Application

A major premise of this study is that by examining specific subsets of firm SOPs one can gain insights into a firm's decision processes. And further, that since firm decisions influence the inter-stage vertical coordination process, knowledge of specific SOPs themselves are important to our understanding of these processes. Thus, SOPs are viewed as instrumental to the coordination process and therefore their effects on these processes warrant attention.

Although conceptually it is possible to examine the effects of SOPs within any vertical marketing system, the emphasis in this study is the food system. Specifically, the thrust of the research is directed toward delineating the SOPs used by limited-menu food service firms in the procurement of beef and/or poultry products. Of particular interest is the effect of these procedures on the coordination process linking these foodservice firms with their major beef and/or poultry suppliers. Since both beef and poultry products are examined, the results of the study have relevance for both beef and poultry subsectors.

The primary emphasis of the study is on gaining an understanding of how the inter-stage vertical coordination process between limited-menu

foodservice firms and their major beef and poultry suppliers functions. Once this process is understood, it becomes possible to assess the probable effects of any changes which impact on the existing institutional structure or alternatively, to suggest modifications in the existing institutional structure which might facilitate the coordination process.

CHAPTER III

THE COMMERCIAL FOODSERVICE SECTOR: GROWTH TRENDS, STRUCTURAL CHANGE AND MARKET ORGANIZATION

Introduction

The foodservice industry is a dynamic segment of the U.S. food system. This chapter examines the current market structure of the commercial component of the industry in detail and traces the major structural changes that have occurred over the past two decades. Many different aspects of the segment are treated. Included among these are: 1) demographic factors which have influenced growth; 2) impact of franchising on market structure; 3) rules and regulations governing franchisor/franchisee relationships, and 4) structural effects of mergers and acquisitions involving commercial foodservice firms and other firms, particularly large food and tobacco processors.

A wide variety of secondary data sources were drawn upon to provide insight into the current market structure of the industry. Where possible specific market segments and sub-segments within the industry are examined in detail. Particular emphasis is given to limited-menu foodservice operations. These operations have expanded rapidly over the past 20 years and are a major factor influencing structural change within the industry.

Factors Influencing Growth in Foodservice

The U.S. foodservice industry has grown rapidly over the past two decades. Between 1963 and 1977, the total retail sales of meals and snacks consumed away-from-home expanded from \$13.1 billion to \$58.7 billion, an increase of over 340 percent in current dollars. This represented an increase of nearly 126 percent in real terms. Industry retail sales reached an estimated \$70 billion in 1979 and are expected to grow to over \$100 billion by 1985. Current estimates indicate that industry sales account for about 36 percent of total consumer food expenditures and that more than one out of every four meals are now consumed away-from-home. Estimates from 1960 indicate that the industry accounted for about 25 percent of consumer food expenditures. If current trends continue, the industry will account for about 40 percent of consumer food expenditures and about one out of every three meals will be consumed away-from-home by 1985.

The growth in the industry can be attributed to a variety of factors. On the demand side, the key determinants of growth appear to be demographic and income variables. Studies by independent consultants and industry trade groups indicate that the most important demographic factors are age, household size and location, general lifestyle and income. In the commercial segment of the industry, consumers 18-45 years old are the primary customers. Although consumers in this age group comprised an average of only 38.8 percent of the U.S. population during the decade of the 1970s, they accounted for over 75 percent of the total sales made by commercial foodservice firms during the decade. With nearly 30 percent of the 1980 population accounted for by persons 18-34 years of age, compared to only 25

percent 10 years earlier, the prospects for continued growth in the commercial foodservice sector during the 1980s seem strong.

Household location and size are also considered critical variables in the growth of commercial foodservice operations. Urban dwellers patronize commercial foodservice operations more frequently than either their rural farm or non-farm counterparts. The same is true for households comprised of three persons or less. Proximity to a wider variety of foodservice operations and lower transportation costs for urban dwellers, and the mobility inherent in smaller households contribute strongly to the observed patronage patterns.

Changing consumer lifestyles have also contributed to the trend toward "eating out." A major factor influencing this trend is the higher proportion of working women, and in particular working wives, in the labor force. Census data indicate that between 1970 and 1980 the proportion of working women rose from 41.4 percent to 47.9 percent, and the proportion of working wives rose from 39.2 percent to nearly 50 percent. With fewer hours available for at-home meal preparation, the convenience factor associated with "eating out" has encouraged increases in both restaurant patronage and the number of eater occasions for the average household.

Expanding real household income has also contributed to the growth in commercial foodservice sales. Although income elasticities of demand are not available, a few studies have estimated either expenditure income elasticities or quantity income elasticities for foods consumed away-from-home.¹ These studies report expenditure income elasticities that are positive but generally less than unity. In the Hiemstra

¹Hiemstra, S. and H. Eklund, 1967; Prochaska, F. and R. Schrimper, 1973.

and Eklund study, which analyzed aggregate consumption expenditures, the expenditure elasticity of income was estimated at .84, or about twice the expenditure elasticity for food-at-home. Prochaska and Schrimper, using cross sectional data from the 1965-66 USDA Household Food Consumption Survey and implicit wage rates for homemakers, found somewhat lower expenditure income elasticities for rural non-farm and farm households than the Hiemstra estimate. But their estimates for urban households were similar--ranging from .79 in the Northeast region to 1.16 in the North Central region.

Prochaska and Schrimper also estimated quantity income elasticities which measure the percentage change in the number of meals eaten away-from-home associated with a one percent change in income. The estimated elasticities are positive and consistent with, yet systematically smaller than, their corresponding estimates of expenditure income elasticities for each region and urban/rural category. This suggests that in a given region and urban/rural category, higher income households not only tend to purchase more meals away-from-home, but they also tend to purchase higher priced meals. This result is consistent with the results of various market research surveys which indicate a positive relationship between household income and the frequency of meals purchased and eaten away-from-home.

Supply Factors

Although demand factors have been, and will continue to be, key determinants of foodservice growth, it would be misleading to suggest that they are the sole determinants of growth. Supply factors are also important elements.

In this context supply is viewed in a most general way and

refers not only to the commodities available, but also to the entire bundle of goods which constitute the foodservice product offering. This broader definition of supply allows specific recognition of factors such as increases in the number of foodservice outlets, easier access to foodservice outlets, expanded service and product offerings and market segmentation activities of foodservice operators, all of which have contributed to the growth of the foodservice industry.

Clearly, the ready accessibility to foodservice outlets has stimulated growth as have the expanded product offerings provided to potential patrons. Prior to 1960, the majority of commercial foodservice operations were primarily located in, or adjacent to, central business districts. In the past 20 years, however, there has been a marked shift in the spatial distribution of commercial foodservice outlets toward fringe-urban and suburban areas. This shift has enhanced public access to these facilities from a pure locational standpoint. Today, not only are foodservice outlets located in close proximity to suburban residential areas, but problems such as parking, which plagued central business district operations, have largely been solved.

Today, consumers have a vast array of foodservice product offerings to choose from that were not available 20 years ago. This array includes expanded options in the level and quality of service available as well as the products available. Fast food restaurants are a prime example. With their emphasis on minimum service levels and limited menu offerings, fast food operations filled a niche in the foodservice industry. The subsequent market

segmentation activities of fast food operators expanded the available product offerings to include items such as seafood and Mexican entrees that previously had only been available in table-service operations. The aggregate effect of these efforts was to expand the available supply of foodservice offerings and at the same time to broaden the market for their services. The interactions that exist between these demand and supply factors have created an environment conducive to rapid growth in the foodservice industry and have fostered profound changes in the structure of the industry during the past 20 years.

The Foodservice Industry

Before any meaningful discussion of the structure of the foodservice industry can begin, it is important to recognize that the industry is not monolithic. It encompasses a broad range of activities and has many identifiable market and sub-market segments. Although the totality of these segments constitute the foodservice industry, there exist sharp distinctions between segments. Perhaps the sharpest distinction can be drawn between the commercial and non-commercial segments of the industry. These two segments differ substantially in the types of services and products they provide and in their marketing and operational techniques.

The commercial segment of the industry is comprised of those foodservice operations that are readily accessible to the public-at-large. These are public eating places and include fast food operations, traditional table-service restaurants (e.g., coffee shops, family restaurants and dinner houses), recreational eating places and the

restaurant operations of motels and hotels. With the exception of motel and hotel foodservice operations, commercial foodservice operations are not run as subsidiary or complementary operations to other business activity. They are operated on a profit basis and generally advertise in an effort to attract and hold customers. They also attempt to expand sales through variations in their product/service mix. Franchising is an important activity in this segment.

The non-commercial segment of the industry is comprised of those foodservice operations that are run primarily as subsidiary or complementary operations to other business or service activities. The foodservice operations of primary and secondary schools, colleges and universities, nursing homes, prisons, hospitals and airlines and the in-plant feeding facilities provided by some manufacturers and offices are major components of the non-commercial segment. The access to these foodservice facilities is largely confined to those persons who either work in or are users of the primary service or business activity. Public access to these facilities is limited. In general, non-commercial foodservice operations are not operated as profit centers by the providing organization. However, these organizations may contract with foodservice management firms that are operated on a profit basis. These contracts are usually awarded on a bid basis. Compared to the commercial segment, advertising is not very important in the non-commercial segment of the industry. Franchising is virtually nonexistent in this segment.

Although both the commercial and non-commercial segments continue to be important elements in the foodservice industry, their relative importance has changed dramatically over the past 20 years. Whereas in the late 1950s and early 1960s each segment's share of total

industry sales was about 50 percent, the share held by the commercial segment had increased to about 60 percent by 1970 and was close to 70 percent in 1979. Because of its increased prominence, the commercial sector of the industry will be the focus of the remainder of this chapter.

The Commercial Foodservice Sector

The caveats that apply to the foodservice industry in general are also relevant to the commercial sector. The sector is not monolithic; it is comprised of many different types of foodservice operations that offer a variety of products and services to potential customers. The constituent parts are limited-menu restaurants (primarily fast food operations), coffee shops, family restaurants, dinner house/theme restaurants and the foodservice operations of hotels and motels. Each of these parts or components is distinguishable from the others on the basis of their product/service mix and/or the marketing strategies they employ.

Fast food operations are generally limited menu/limited service restaurants that offer counter, but no table service. They emphasize quick service and high customer turnover. The product offering is usually centered around a primary menu item (e.g., chicken, hamburger, roast beef, etc.). These restaurants are generally operated from free-standing buildings that provide limited seating and often have drive-thru windows. A high proportion of sales are made to customers who consume the prepared food off the premises. As a rule, these restaurants do not serve alcoholic beverages. A high proportion of these operations are franchised, and chains, 11 or more outlets operated under common ownership, are common. Except for a few firms which

operate foodservice distribution facilities, vertical integration is not commonplace. McDonald's, Burger King and Kentucky Fried Chicken are examples of fast food operations.

Coffee shops provide a broader menu offering than fast food operations. They emphasize breakfast and lunch items in their menus and provide waitress service to seated customers. Due to their broader menus, selected menu items are often used as weekly or monthly specials to attract and hold customers. Although many coffee shops are located in free-standing buildings, they also often occupy space in commercial structures. Essentially all the food sales made by these operations are consumed on the premises. Coffee shops, like fast food operations, generally do not serve alcoholic beverages. However, unlike fast food operations, franchising is not ubiquitous. Vertical integration, primarily through commissary/distribution operations, is more prevalent for multi-unit, multi-market coffee shop operations than it is for fast food operations. Howard Johnson's, Sambo's, and Denny's are examples of chain coffee shop operations.

Family restaurants are similar to coffee shops in many respects. Most family restaurants offer broader menus than do fast food operations, but some (e.g., Ponderosa, Bonanza, Pizza Hut, etc.) have a relatively narrow menu offering. In general, these operations provide some waitress service to their customers. Weekly or monthly promotions, featuring standard menu items at reduced prices, are often used to attract and hold customers. These restaurants are located in free-standing buildings designed specifically for their particular restaurant operation. Unlike coffee shops, however, family restaurants orient their menu and marketing strategies more toward lunch and dinner

customers. Some offer beer or wine, but most refrain from selling alcoholic beverages. Franchising is relatively important in the family restaurant segment, but less important than in fast food operations. Chain operations are common. There is a mixed pattern of vertical integration in this segment. Some firms operate commissary/distribution facilities, others only distribution facilities, and still others have no commissary or distribution capability. Bonanza, York Steak House, Ponderosa and Pizza Hut are prime examples of chain family restaurants.

Dinner house/theme restaurants and the foodservice operations of hotel and motel operators are the remaining two sub-segments of the commercial component of the industry. They are discussed together because they are more similar than different in their type of operations. The major difference between them is that dinner house/theme restaurants are generally located in free-standing buildings, while the restaurant operations of hotels and motels are integrated within the hotel/motel complex. Both tend to orient their menus toward dinner items. Often these operations are organized around a common ethnic theme or motif and specialize in the preparation of entrees that are consistent with that theme. These operations tend to be higher priced and more service-oriented than other commercial food-service operations. Alcoholic beverages are standard menu items and are an important element in the sales mix. Chain operations are common, but franchising activity is not heavy. Vertical integration is not common, but a few firms do operate commissaries. Magic Pan, Red Lobster and Steak and Ale are examples of some of the better known dinner house/theme restaurant operations.

Growth in Commercial Foodservice

Food and non-alcoholic beverage sales by commercial foodservice firms have grown rapidly over the past 13 years. Estimated sales for the commercial segment were \$70 billion in 1979, a 220 percent increase over the \$22 billion sales estimate in 1967. Even after adjusting sales for inflation, there was a 30.9 percent increase in sales over the period. Industry sales are expected to increase to approach \$80 billion in 1980.

The number of eating place establishments, those establishments primarily engaged in the sale of prepared foods and non-alcoholic beverages, has also increased substantially.¹ Census data for the 11 year period 1967-1977 reveal that total establishment numbers increased from 236,563 to 274,337, or about 16 percent. With sales growing faster than establishment numbers, sales per establishment rose from \$79,804 to \$202,600 over the period. Average sales per firm, which were nearly \$87,000 in 1967, increased to over \$245,000 in 1977. This 182 percent increase reflects not only increases in prices and/or tonnage, but also the growth in multi-unit establishments operated under common ownership.

Although the data presented above are useful in gaining insight into aggregate trends in sales and establishment numbers, they do not provide sufficient detail to allow comparisons to be made between the growth and relative importance of the various segments within the sector that were identified earlier. A comprehensive analysis of the

¹The Census collects data on an establishment basis. It defines an establishment as ". . . a single physical location at which business is conducted." A firm may consist of a single establishment or multiple establishments.

Throughout this chapter the terms--establishment and unit--are used synonymously.

industry demands this detail. Census data and industry sponsored studies are useful in gaining this insight.

Data from the Census of Business indicate that total retail sales of meals and prepared snacks, including food sales by hotels and motels, were \$58.7 billion in 1977. Eating places accounted for 83.8 percent of the total, while hotels/motels accounted for 7.2 percent. The remaining 9 percent was accounted for by department stores, grocery and other food stores, drug stores and other retail stores, none of which individually accounted for more than 3 percent of the total. Comparable data for 1967 indicate that eating places and hotels/motels accounted for about 82 percent and 6 percent, respectively, of total commercial foodservice sales.

Disaggregation of Census data provides insights into the differing growth patterns exhibited by major components in the commercial sector.¹ In 1967, restaurants, lunchrooms and catering operations accounted for 69.3 percent of the sales made by, and 52.7 percent of the establishments classified as, eating places. That same year, refreshment places--the Census classification corresponding most closely to fast food places--accounted for 18.1 percent of eating place sales and 23.0 percent of the establishments operated. In 1977, the aggregate share of eating place sales and establishment numbers accounted for by these two major Census sub-classifications within SIC 5812 were 86.3 percent and 77.0 percent,

¹Census provided disaggregated sales and establishment data for 4 major subsegments within SIC 5812 (Eating Places) in 1977. These subsegments were: 1) Restaurants and lunchrooms, 2) cafeterias, 3) refreshment places, and 4) other eating places, including ice cream stands.

respectively.¹ Although these shares are similar to those held in 1967, there was a substantial shift in the individual shares accounted for by the two sub-classes of eating places. Refreshment places garnered 35.1 percent of eating place sales and accounted for 33.7 percent of all establishments in 1977, while the shares accounted for by restaurants and lunchrooms were 51.2 percent and 43.3 percent, respectively. Thus, in an 11 year interval, refreshment place sales increased by over 470 percent; their share of eating place sales nearly doubled and their share of eating place establishments increased by over 45 percent. These data, although still highly aggregated, indicate the increasing relative and absolute importance of fast food-type operations in the commercial foodservice segment.

Structural Change in the Commercial Foodservice Sector

Given the rapid growth in the commercial foodservice segment over the past 15 years, one might expect that major structural changes within the sector would have occurred. Indeed this is the case, although it is unclear whether the structural changes in evidence are more a cause or a consequence of growth. What is clear, however, is that multi-unit restaurants of all types have become more important and, if the present trend continues, will be even more important in the future.

In 1967, sales by multi-unit commercial foodservice operations were slightly over \$6 billion and represented nearly 24 percent of

¹ Both the aggregate share of sales and establishments accounted for by the two sub-classes in SIC 5812 would have been higher if social caterers had not been deleted from the definition including restaurants and lunchrooms in 1977. This change probably biases downward the aggregate share of sales in 1977 by 1-2 percent and establishments by 2-3 percent.

all eating place sales (Table 3.1). That year they accounted for 12 percent of all eating place establishments (Table 3.2). Multi-unit fast food operations were relatively unimportant in 1967; they accounted for only 4.5 percent of sales and 4.2 percent of all establishments (Tables 3.1 and 3.2). More important were other eating places which accounted for 19.2 percent of multi-unit sales and 7.8 percent of establishments. Restaurants, lunchrooms and caterers, the dominant sub-class within the other eating place classification, accounted for about three-fourths of both the sales and the establishments of other eating places in 1967.

Although sales by single establishments still represented more than half of commercial foodservice sales in 1977, the growing dominance of multi-unit operations is clearly evident (Figure 3.1). Census data for that year indicate that multi-unit operations of all types had sales in excess of \$24.4 billion and accounted for 40.5 percent of all eating place sales. Multi-unit establishments represented 22.6 percent of all eating place establishments that year. Multi-unit fast food operations, which had only 4.5 percent of sales in 1967, garnered nearly 19 percent of sales in 1977. Since the share of sales held by other multi-unit foodservice operations rose only a modest 2.5 percentage points over the period, fully 85 percent of the 16.8 percentage point increase in the multi-unit share of sales is attributable to fast food operations.

Within multi-unit operations, the fastest growing size class is that comprised of 11 or more units. Most but not all of these operations

Table 3.1 Single and Multiunit Restaurant Sales
by Type of Establishment,^{a/} Census Years, 1967, 1972 and 1977.

Classification	Sales (\$ million)			Percent		
	1967	1972	1977	1967	1972	1977
Eating Places	17,955.5	28,208.9	52,917.5	100.0	100.0	100.0
Fast Food Places ^{b/}	3,417.6	8,208.9	19,052.1	19.0	29.1	36.0
Single units	2,603.0	4,825.0	9,102.7	14.5	17.1	17.2
Multiunits	814.6	3,383.9	9,949.4	4.5	12.0	18.8
2-5 units	363.8	1,059.3	2,542.8	2.0	3.8	4.8
6-10 units	74.6	265.0	977.6	0.4	0.9	1.8
11 or more units	376.2	2,059.7	6,429.0	2.1	7.3	12.2
Other Eating Places ^{c/}	14,537.9	20,000.0	33,865.4	81.0	70.9	64.0
Single units	11,087.1	14,475.3	22,361.5	61.7	51.3	42.3
Multiunits	3,450.7	5,524.7	11,503.9	19.2	19.6	21.7
2-5 units	981.1	1,567.2	2,563.8	5.5	5.6	4.8
6-10 units	282.9	477.7	862.4	1.6	1.7	1.6
11 or more units	2,186.7	3,479.9	8,077.7	12.2	12.3	15.3

^{a/} Includes only those establishments with payroll that were operating at the end of the year.

^{b/} Fast food places correspond to the Census classification: Refreshment Places.

^{c/} Includes cafeterias, catering places and restaurants.

Source: Bureau of the Census, Census of Business, Retail Trade, selected years.

Table 3.2 Single and Multiunit Restaurant Establishment
Numbers by Type of Establishment,^{a/}
Census Years, 1967, 1972, and 1977.

Classification	Establishments			Percent		
	1967	1972	1977	1967	1972	1977
Eating Places	189,418	208,899	237,728	100.0	100.0	100.0
Fast Food Places ^{b/}	54,492	72,850	92,357	28.8	34.9	38.8
Single units	46,549	55,146	63,097	24.6	26.4	26.5
Multiunits	7,943	17,704	29,260	4.2	8.5	12.3
2-5 units	3,805	6,700	8,844	2.0	3.2	3.7
6-10 units	708	1,549	3,276	0.4	0.8	1.4
11 or more units	3,430	9,455	17,140	1.8	4.5	7.2
Other Eating Places ^{c/}	134,926	136,049	145,371	71.2	65.1	61.2
Single units	120,094	117,761	120,884	63.4	56.4	50.8
Multiunits	14,832	18,288	24,487	7.8	8.8	10.3
2-5 units	5,188	5,995	5,786	2.7	2.9	2.4
6-10 units	1,125	1,503	1,647	0.6	0.7	0.7
11 or more units	8,519	10,790	17,054	4.5	5.2	7.2

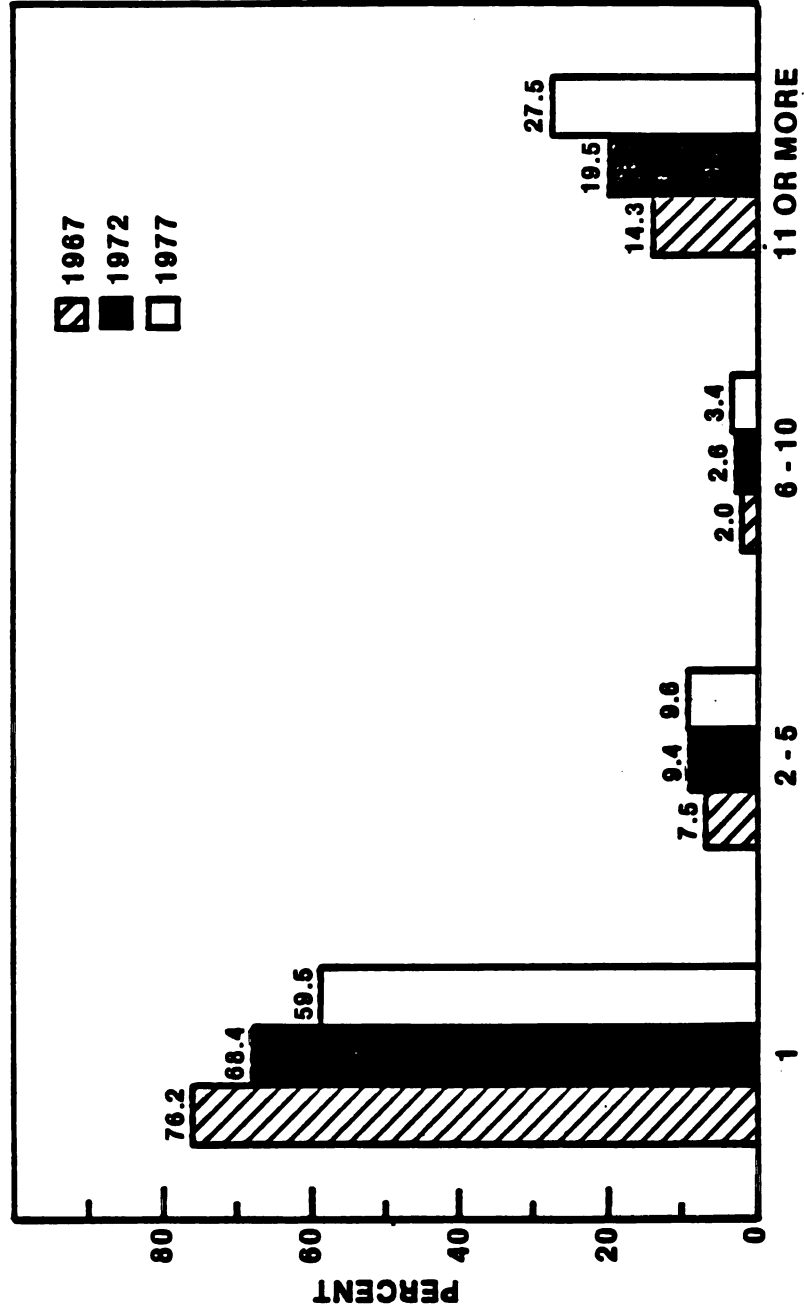
^{a/} Includes only those establishments with payroll that were operating at the end of the year.

^{b/} Fast food places correspond to the Census classification: Refreshment Places (SIC 5812 pt.).

^{c/} Includes cafeterias, catering establishments, lunch rooms and restaurants.

Source: Bureau of the Census, Census of Business, Retail Trade, selected years.

**FIGURE 3.1 DISTRIBUTION OF COMMERCIAL RESTAURANT SALES,
SINGLE AND MULTIPLE UNIT OPERATIONS, 1967, 1972
AND 1977.**



NO. OF FIRM ESTABLISHMENTS

SOURCE: TABLE 3.1

are chains.¹ These operations accounted for 12.2 percent of all eating place sales and 12.3 percent of all establishments in 1977. They controlled only 2.1 percent of sales and 1.8 percent of all establishments in 1967 (Tables 3.1 and 3.2). With total sales of \$6.4 billion, firms in this class accounted for nearly 34 percent of all fast food sales in 1977, compared to only 11 percent in 1967. The rapid expansion of fast food operations over the period contributed significantly to the overall increase from 14.3 percent to 27.5 percent in the share of eating place sales accounted for by firms operating more than 10 commercial foodservice establishments. Clearly, larger foodservice firms are becoming more important within the sector.

Commercial Foodservice Sales by Size of Establishments

Despite the rapid growth in the commercial foodservice segment, sales per establishment are still low relative to other retail establishments. Average sales per eating place establishment were \$202,600 in 1977, compared to average sales of nearly \$390,000 for all retail establishments. Average sales for fast food establishments were \$211,425, or about 4 percent larger than the average sales of all eating places in 1977. This is in marked contrast to the situation in 1967 when the average sales of fast food places were \$62,700, or only about 78 percent of the average sales of all eating places.

Based on sales data, there is a clear trend toward larger foodservice establishments over the 1967-1977 period. In 1967, eating place establishments with annual sales less than \$300,000 accounted for

¹Chain operations are those operations comprised of 11 or more separate units that are controlled by a common ownership or management and operated under a common name or logo.

62.9 percent of the sales and 94.9 percent of all establishments, while those with annual sales in excess of \$500,000 per establishment accounted for 2.0 percent of both sales and establishments. In 1977, eating place establishments with less than \$300,000 in annual sales made only 34 percent of all eating place sales, although they still accounted for over 76 percent of all establishments. Eating places with more than \$500,000 in annual sales made 46.9 percent of all eating place sales in 1977, even though they accounted for only 12 percent of all establishments.

Fast Food Sales by Size of Establishments

A similar trend is in evidence among fast food operations. Over the 1967-1977 period, the percent of fast food sales made by establishments with less than \$300,000 in annual sales declined from 82.8 to 38.2 percent, while the share of those establishments with sales greater than \$500,000 rose from 8.0 to 39.7 percent (Table 3.3). Within narrower size classes, establishments with annual sales between \$100,000 and \$300,000 continue to be very important. These establishments accounted for about 30 percent of all fast food sales and nearly 40 percent of all fast food establishments in 1977. The next most important size group in 1977 encompassed establishments with annual sales between \$500,000 and \$1,000,000. This size group accounted for nearly 29 percent of fast food sales. Although fast food establishments with sales between \$1,000,000 and \$2,000,000 were still fairly rare in 1977 (they represented only 1.6 percent of all fast food establishments), they were the fastest growing size class among fast food operations over the 1967-1977 period. This size class accounted for 8.4 percent of fast food sales in 1977, compared with just 2.0 percent eleven years earlier.

Table 3.3 Distribution of Fast Food Establishment Sales,^{a/}
Census Years, 1967, 1972 and 1977.

Annual Establishment Sales (\$ thousand)	1967		1972		1977	
	Sales (\$ million)	Units	Sales (\$ million)	Units	Sales (\$ million)	Units
Less than 50	751.9	32,260	661.7	24,077	374.0	11,810
50 - 99	747.4	10,714	1,118.0	15,529	1,077.9	14,843
100 - 299	1,152.9	7,181	3,259.7	19,379	5,232.3	28,716
300 - 499	282.3	771	1,345.5	3,561	3,862.0	10,074
500 - 999	140.5	219	987.2	1,562	5,050.8	7,378
1000 - 1999	63.3	48	146.7	115	1,471.2	1,218
2000 or more	66.0	16	82.6	27	415.8	112
TOTAL	3,204.2	51,209	7,601.4	64,250	17,484.0	74,151

^{a/} Establishments with payroll that were operated the entire year. Fast food corresponds to the Census classification: Refreshment Places (SIC 5812 pt.).

Source: Bureau of Census, Census of Business, Retail Trade, Establishment and Firm Size, selected years.

Obviously, inflation has been an important factor influencing the overall trend toward higher sales per establishment and has influenced the size distribution of establishments. But inflation alone cannot account for these trends. Inflation-adjusted sales made by all eating places increased by over 47 percent between 1967 and 1977, while real sales made by fast food establishments rose over 178 percent. The real growth evident over this period is the result of two factors: 1) increases in the total number of eating place establishments, particularly fast food establishments, and 2) increases in average sales per establishment. Eating place establishment numbers increased by over 25 percent and fast food establishment numbers increased by 69 percent between 1967 and 1977. Average sales per eating place increased by over 17 percent and average fast food establishment sales increased by over 64 percent during the same period. Clearly, real sales growth has been an important factor contributing to the trend toward higher sales in commercial foodservice establishments.

Commercial Foodservice Sales by Size of Firm (Establishments)

Commercial foodservice firms also grew larger over the 1967-1977 period. Average sales per firm increased from \$86,600 to \$245,475, or nearly 184 percent, over the 11 year interval. Real sales per firm increased 41.5 percent. Sales by fast food firms, which averaged nearly \$291,000 in 1977, were 106 percent higher in real terms than in 1967.

The fact that real growth rates exhibited by firms were higher than those for establishments is largely due to the increase in multi-unit operations.¹ Each firm operated an average of 1.09 eating place

¹Multi-unit foodservice operations are defined as those operations comprised of 2 or more separate foodservice establishments.

establishments in 1967. By 1977, the average number of establishments per firm had risen to over 1.2. A similar trend is apparent among fast food firms. These firms had an average of 1.36 establishments in 1977, compared to only 1.13 establishments 11 years earlier.

Multi-unit commercial foodservice firms, though they represented only 3 percent of all commercial foodservice firms, made over 39 percent of all eating place sales in 1977. Eleven years earlier they represented 2.0 percent of all firms and made about 26 percent of all sales. Average sales per firm were only slightly over \$1,000,000 and each firm operated an average of 5.4 establishments in 1967. By 1977, average sales per firm had grown to over \$3,100,000 and the average number of establishments operated had reached 7.9.

Among multi-unit operations the largest and fastest growing size class was that comprised of firms operating 101 or more establishments.¹ In 1967, there were 26 firms in this size class. They operated a total of 5,933 establishments and had total eating place sales of \$1.2 billion that year. Although their establishments represented only

¹ It is important for the interested reader to keep in mind that the data collection and aggregation procedures used by the Bureau of Census do not "lump together" franchisor and franchisee sales and establishments. Thus, for example, the sales of fast food restaurants owned outright by McDonald Corporation are aggregated together and reported as originating from one company--McDonald's. McDonald's franchisees' sales are not included in McDonald's corporate total; they report separately to Census. In those instances where a franchisee owns two or more McDonald's restaurants, the Census aggregates the sales from the establishments owned by that franchisee and reports those sales separately from those of McDonald Corporation. Census follows this procedure for each individual franchisee that reports.

2.6 percent of all eating place establishments, these firms' sales accounted for 6.5 percent of eating place sales. In 1977, this class was much more important. The 58 firms in this size class operated a total of 23,276 establishments and had sales of nearly \$9.9 billion. They accounted for 8.4 percent of all establishments and 17.7 percent of all sales that year.

Fast food firms operating 101 or more establishments grew at even a faster rate over the 1967-1977 period than other firms of comparable size in the industry. In 1967, these large fast food firms operated 1,037 establishments with total sales of \$104.7 million. Their sales that year represented only 3 percent of all fast food sales, only 12.8 percent of multi-unit fast food sales and only 8.5 percent of all sales made by firms operating 101 or more establishments. Data for 1977 indicate that the largest class of fast food firms accounted for over 22 percent of fast food sales and about 44 percent of both multi-unit fast food sales and sales by all firms operating 101 or more eating place establishments. Average sales for these firms were slightly over \$128.0 million in 1977, compared to only \$5.8 million in 1967.

Commercial Foodservice Sales by Size of Firm (Sales)

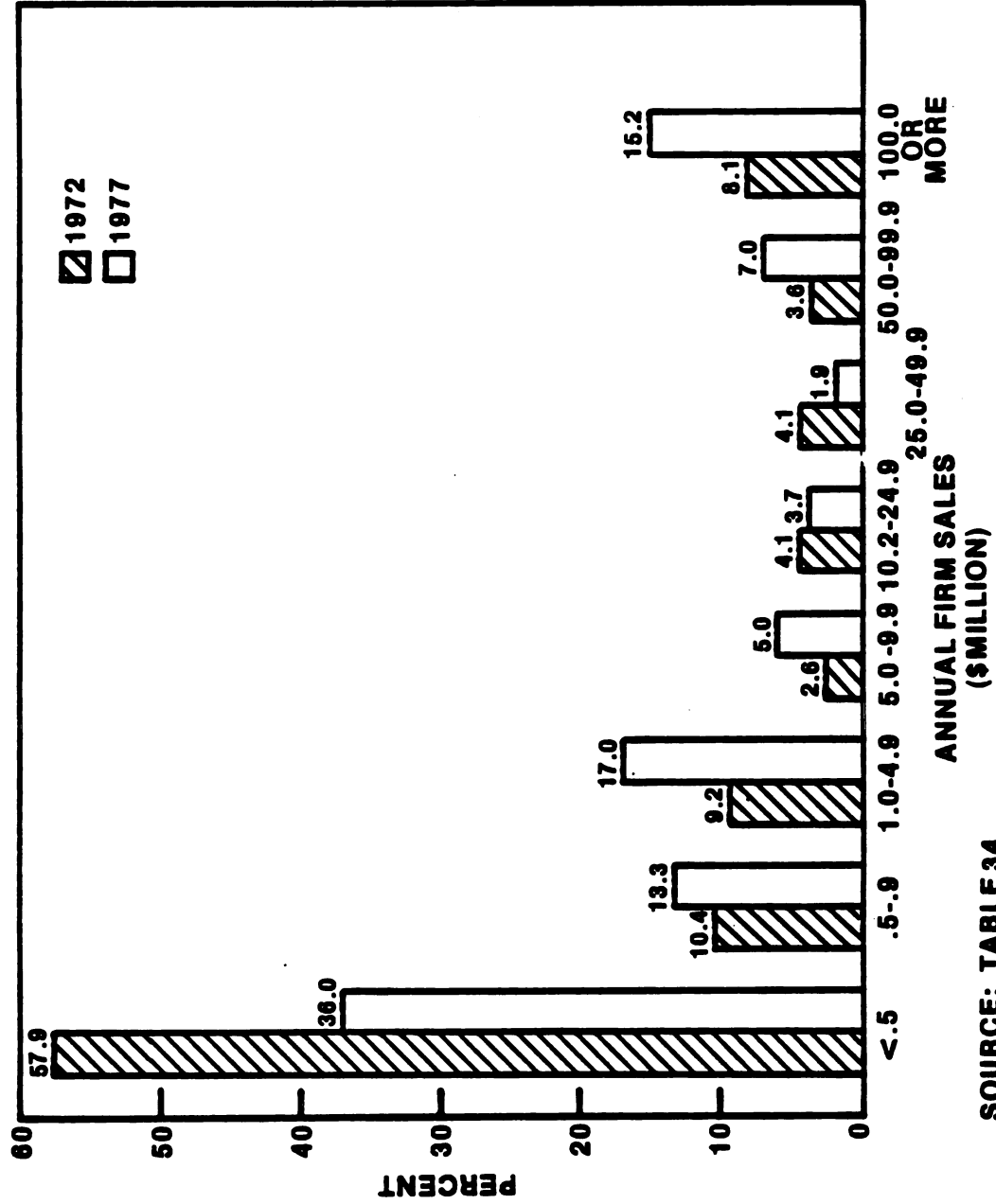
The growing importance of large foodservice firms is also evident when one examines the size distribution of firms based on sales rather than establishments. Firms with annual eating place sales of \$100 million or more accounted for 14.8 percent of total eating place sales in 1977, while those with sales between \$50 million and \$100 million accounted for an additional 4.2 percent. These

same size classes accounted for 6.3 percent and 4.5 percent of sales, respectively, in 1972. Although firms with annual sales less than \$1 million remain an important component within the sector, their share of eating place sales declined from 69.8 percent to 55.4 percent between 1972 and 1977.

Large fast food firms have also become more prominent. Between 1972 and 1977 the share of fast food sales accounted for by firms with annual sales of \$50 million or more rose from 11.7 percent to 22.2 percent (Figure 3.2). The share of fast food sales accounted for by the largest firms, those with sales of \$100 million or more, was 15.2 percent in 1977. This was nearly twice as large as their share in 1972. Large fast food firms also grew at a faster rate than all large firms in the sector. Fast food firms with annual sales of \$50 million or more accounted for 41.6 percent of the sales made by all commercial foodservice firms of this size in 1977. They made only 30.6 percent of those sales in 1972. Aggregate sales for these firms totaled over \$4.3 billion in 1977 and were nearly $4\frac{1}{2}$ times as large as their sales in 1972 (Table 3.4).

The size disparity that exists among fast food firms becomes even more evident when one considers that the 40 largest fast food firms combined for 24.1 percent of fast food sales and operated 12 percent of all fast food establishments in 1977, even though they represented less than 1 percent of all fast food firms that year. The disparity in size is further illustrated by the fact that the largest 3 percent of all fast food firms owned 24.6 percent of all fast food establishments and made 49.7 percent of all fast food sales in 1977. This compares to the 18.5 percent of establishments and 42.1 percent of sales accounted for by the largest 3 percent of fast food firms in

FIGURE 3.2 DISTRIBUTION OF SALES BY FAST FOOD FIRMS, 1972 AND 1977.



SOURCE: TABLE 34

Table 3.4 Size Distribution of Fast Food Firms,^{a/}
1972 and 1977.

Annual Firm Sales (\$ thousand)	1972			1977		
	Number Firms	Sales (\$ million)	Units	Number Firms	Sales (\$ million)	Units
Less than 500	56,313	4,943.1	59,345	61,373	7,222.9	63,653
500 - 999	1,314	888.9	2,814	3,662	2,598.8	5,949
1,000 - 4,999	428	783.2	3,259	1,848	3,313.4	7,367
5,000 - 9,999	31	217.8	943	144	968.3	2,379
10,000 - 24,999	23	353.8	1,784	46	721.2	1,932
25,000 - 49,999	9	352.0	1,239	11	369.9	1,485
50,000 - 99,999	5	307.9	1,249	18	1,363.9	3,360
100,000 or more	4	690.9	2,217	11	2,968.2	6,232
TOTAL	58,127	8,537.6	72,850	67,113	19,526.6	92,357

^{a/} Corresponds to the Census classification: Refreshment Places (SIC 5821 pt.).

Source: Bureau of the Census, Census of Business, Retail Trade,
Establishment and Firm Size, selected years.

1972. Although these data reveal the growing dominance of large fast food firms, they also indicate that small fast food firms, those with sales less than \$1 million in 1977, remain an important element in the fast food sector. Despite the growth exhibited by large fast food firms over the 1972-1977 period, it is significant to note that small fast food firms still made slightly over one half of all fast food sales in 1977.

Concentration Levels in the Foodservice Sector

It is difficult to make precise estimates of the level of concentration in the commercial foodservice sector. The lack of data both at the local market level and within the relevant market segments of the sector, coupled with the extensive use of the franchise method of operation, contribute to the estimation problem. It is clear, however, that in the aggregate, fewer firms are accounting for a larger proportion of total sector sales.

National concentration estimates reported by the Census indicate that 4, 8 and 20 firm concentration levels are relatively low in the foodservice sector. The 4 largest firms accounted for only 3.6 percent of all eating place sales in 1972, and only 4.5 percent of those sales in 1977. The 8 largest firms accounted for 7.3 percent, and the 20 largest firms made 12.4 percent, of all eating place sales in 1977. Within smaller market segments the concentration levels are slightly higher, but still relatively low compared to other industries. For example, the 4 largest fast food firms accounted for an estimated 9.1 percent of all fast food sales in 1977, while the 8 and 20 largest firms accounted for 13.2 and 19.3 percent, respectively.

Concentration at the national level is, of course, not necessarily indicative of local or regional seller concentration. Many food-service firms have multi-market and/or multi-region operations, but few firms' operations are truly national in scope. The extent of an individual firm's operations within a specific local market and/or region is also highly variable. Given these factors, it is reasonable to conclude that national concentration estimates understate, albeit to an unknown degree, the actual seller concentration levels that exist in smaller geographic areas. Unfortunately the paucity of local market sales data precludes a more extended discussion of local market concentration in this study.

The level and trends in concentration at the national level are often useful as indicators of the growth of large firms and the potential market power of these firms in procurement. Although this is the case for many industries or sectors, it is not necessarily true for the foodservice sector because many of the largest firms are franchisors. Excluding franchisee sales from those of the franchising organization, as the Census does, can result in a significant understatement of the actual level of buyer concentration in the sector. Many franchisors secure favorable purchasing arrangements with their suppliers on the basis of their total system-wide product usage, and not solely on the franchisor portion. While franchisors are largely prohibited from forcing their franchisees to participate in such arrangements, the lower prices resulting from these arrangements are often an inducement for franchisee participation in them. When these arrangements are operative, the level of national concentration reported by the Bureau of Census understates actual buyer concentration levels.

A more accurate estimate of buyer concentration would require individual firm data on the extent of franchisee participation in franchisor-negotiated procurement arrangements, however data in this detail are not usually available from public sources. An alternative is to calculate concentration ratios based on system-wide franchise sales. The concentration ratios obtained from this calculation procedure are upper bound estimates of buyer concentration. Based on system-wide sales data, the 4 largest fast food firms accounted for an estimated 41 percent of all fast food sales in 1977. This combined share was about 6 percentage points larger than the share the four largest firms held in 1972, and about twice as large as their share in 1964. Eight-firm concentration was about 51 percent in 1977, compared to 28 percent in 1964. The combined sales of the 20 largest fast food firms represented 71 percent of fast food sales in 1977. In 1964, these firms accounted for 42 percent of total fast food sales.

Given the recent history of sustained growth exhibited by large franchised fast food systems, it seems likely that higher levels of concentration will prevail in the future. These higher levels are likely to result in increased market power in procurement being vested among the largest fast food franchisors.

Vertical Integration in Commercial Foodservice

Vertical integration via ownership is not prevalent throughout the commercial foodservice sector, and there is no clearly identifiable trend toward either vertical integration or disintegration by foodservice firms. Some firms have vertically integrated backward

into the foodservice wholesaler/distributor stage and/or operate commissary facilities. These firms tend to be the largest firms that operate in the coffee shop, family restaurant and foodservice management segments of the sector. Firms that operate fast food facilities and dinner house/theme restaurants are less likely to be vertically integrated. Even the largest firms with these types of foodservice operations are not vertically integrated. For example, only 6 of the 18 fast food operators that ranked among the 50 largest foodservice firms in 1979 operated distribution and/or commissary facilities. By comparison, the 35 largest grocery retailers in 1979 were vertically integrated at least through the wholesale distribution stage.

There are a number of reasons for this pattern of integration. Large firms that operate coffee shops and family restaurants tend to rely less on franchising as a vehicle for expansion than do large fast food firms. Since these restaurant operations are controlled by a single management team, the planning function is simplified. The management can directly control the ordering procedures used by individual restaurants in the system. This creates the potential for a captive market that often can be served efficiently by integrated wholesale facilities operated by the parent organization. In large franchise fast food systems, the individual franchisees maintain considerable autonomy with respect to purchasing decisions. Franchisors cannot be certain that their franchisees will use franchisor-owned distribution facilities if they are available. In many cases, this exposes franchisor-owned distribution facilities to a high degree of uncertainty with respect to anticipated volume. In such situations,

the prospects for efficiently operated distribution facilities are diminished unless the local market volume of franchisor-owned operations is large.

A second reason for the observed pattern is the relatively higher growth rates in the fast food segment compared with those of more traditional foodservice market segments. As long as expected returns are greater in expansion of foodservice outlets than in development and operation of distribution facilities, firms will tend to use available resources for retail outlet expansion. This probably explains in part the lack of backward vertical integration by even large fast food firms. Vertical integration is more common in mature sectors of the economy. As the fast food segment matures, vertical integration may become more commonplace within this segment.

The emergence of multi-market foodservice distributors specialized in the service of fast food restaurants is another reason why large fast food firms have not integrated backward. The development of these distributors, which began in the late 1960s, has simplified the inter-firm coordination process. Instead of dealing with different, non-specialized distributors in each local or regional market area, large fast food firms can now develop distribution agreements with fewer, but more specialized, foodservice wholesalers. This enables fast food operators to concentrate their purchasing among fewer firms and may allow them to negotiate lower margins on purchased items than would be possible if they dealt with individual distributors in each market area.

Although they are relatively unimportant at present, franchisor/franchisee-owned cooperative distribution facilities may become more

common in the future. The commitment by both franchisors and franchisees to utilize such facilities, if they existed, would help assure that available scale economies in wholesale distribution are realized. The development of cooperatively-owned wholesale distribution systems similar to those that exist in grocery retailing are certainly feasible for the foodservice industry.

Franchising in the Commercial Foodservice Sector

Franchising is an important activity within the commercial foodservice sector of the economy and is an activity that has grown rapidly over the past decade. Many of the most visible foodservice operations (e.g., McDonald's, Burger King, Pizza Hut, Ponderosa) are primarily franchise systems. Although franchising is a fairly common activity for firms operating within most segments of the foodservice sector, it is most prevalent in the fast food segment.

The concept of franchising is fairly broad and encompasses two different types of franchise systems. These two systems are often referred to as: 1) product and 2) package franchises. The first type generally involves the distribution of finished, trade-marked manufactured goods by a network of manufacturer-franchised dealerships. New car dealerships are an example of this type of franchise system. The second type of franchise system is basically a trade-name or trademark licensing program. In this type of system, the owner of the trade-name or mark (franchisor) licenses others (franchisees) to conduct a particular type of business under a common business format. Franchised foodservice systems such as McDonald's and Howard Johnson's, and franchised retail gasoline service station operations are examples of trade-name franchise systems.

Although distinguishable on a product-package basis, the two types of franchise systems share some common elements. These elements are: 1) distribution of goods or services associated with a trade-name or trademark, 2) significant control of, or assistance to, the franchisee's method of business operation by the franchisor, and 3) required payments by the franchisee to the franchisor. The distribution of goods or services under a common trade-name or trademark is a highly visible and straightforward activity in franchise operations. The other elements common to all franchise systems are much less visible, however, and require additional explanation.

Elements of Franchisor Control

The specific types of controls and the degree to which they are imposed by franchisors on their franchisees' method of operation vary from firm to firm in the foodservice sector.¹ In general, however, foodservice franchisors place some control over franchisees in the following areas:

- . site approval for unestablished businesses, including building design and/or site appearance requirements.
- . product handling and production techniques, including specification of approved suppliers.
- . advertising and promotion programs.
- . location or sales area restrictions.

Franchisor control over site approval and building design is particularly important within package franchise systems because

¹The following outlines the types of control and/or the types of assistance provided by foodservice franchisors to their franchisees. The typical payments are also outlined. While these are particularly relevant for foodservice franchisors, similar control and payment procedures are often used by franchisors in other business sectors.

the basis of such a system is standardization. Standardization in building format, product offerings and production techniques provides continuity to the system and helps ensure that the value of one franchisee's operation is not lessened by the indiscriminate actions of another franchisee. These types of controls are generally recognized by franchisees as positive contributions to the system's operation, although the approval of suppliers has created problems for some franchisors in certain instances.¹

Another area where franchisors exercise some control over franchisees is in advertising and promotion. Most franchise agreements specify that franchisees must contribute a flat percentage of their gross sales (usually 1 to 3 percent) to a joint advertising fund. Franchisors also contribute to this fund. Monies from these funds are used to develop cooperative advertising programs on a number of different market levels. Franchise systems that operate across large geographic areas usually allocate some monies to national and/or regional advertising programs. These programs generally concentrate their advertising in national or regional magazine publications and network TV.² At the local market level, cooperative advertising programs are usually geared to spot TV and daily and weekly newspapers.

¹An example is the revolt by Kentucky Fried Chicken franchisees against the approved supplier and distributor programs of KFC in early 1976.

²In 1979, the four largest franchise systems (McDonald's, Kentucky Fried Chicken, Burger King and Wendy's) spent an estimated \$238 million (2.8 percent of sales) for advertising in measured media. This represented 54.5 percent of total restaurant media advertising expenditures. These systems spent a total of \$110 million on network TV, which represented over 79 percent of total network advertising by the industry. They also spent \$122.6 million on spot TV (43.4 percent of the industry total). McDonald's alone spent \$138.5 million on TV advertising and accounted for 62.5 percent of industry network TV advertising and 26.6 percent of industry spot TV advertising.

Cooperative advertising programs often offer both franchisors and their franchisees significant advantages over smaller competitors. One advantage stems from the inverse relationship that exists between advertising rates and the amount of advertising purchased. Firms that allocate more dollars to advertising in a particular medium often pay a lower rate per unit of advertising than firms with smaller advertising budgets. As a result, large advertisers can purchase more advertising time (or space) per dollar of advertising expense than smaller advertisers can. Cooperative advertising programs enable franchisors and their franchisees to pool their individual advertising budgets. This makes more advertising dollars available and hence permits cooperative participants to purchase advertising at lower rates than they could as individuals or in smaller groups. Economies that are achieved as a result of large volume purchases are often referred to as pecuniary economies.

Perhaps even more important than the cost per advertising unit is the cost of advertising per dollar of sales. When a given level of advertising expense is spread over larger sales volumes, advertising expense per sales dollar declines and real economies obtain. These economies are often so great that even firms with very large advertising budgets may spend a relatively small proportion of each sales dollar on advertising if their sales are large. This often results in a significant cost advantage for large firms compared to small ones.

In general, real economies of the type noted above are not realized by franchisees because their advertising contributions are a fixed percentage of their gross sales. Under these conditions, the percentage of each dollar of revenue allocated to advertising by franchisees is constant. Increased sales result in larger absolute advertising contributions by franchisees, but not in higher (or lower) advertising contributions per sales dollar.

Franchisor restrictions on the location and/or on the sales area where franchisees may operate businesses are a common component of most franchise agreements. Restrictions of this nature permit the franchisor to sell franchises in specific locales. At the same time, these restrictions assure the franchisee that entry into the sales area by other franchisees in the same system is limited. The size of the delimited area is important in considering the effects of such restrictions. When the geographic market areas are small (e.g., portions of a city or small county), franchisees need less capital to develop the market area because in general, relatively fewer outlet(s) are required. Thus, the business prospects of small, limited-capital franchisees are enhanced in this situation. Conversely, when franchises are sold for a large geographic area (e.g., multi-county or statewide areas), the capital required for development is much greater. Potential franchisees are limited to those individuals or firms with access to relatively large pools of capital. In this case, a major advantage often attributed to franchise systems--namely, the opportunity to own and operate a business--is limited to fewer potential franchisees. Regardless of the size of the area, however, it is clear that by restricting franchisees' operations to specific areas the value of the franchise is enhanced.

Types of Franchisor Assistance

The controls exerted by franchisors over franchisees differ from the assistance provided by franchisors to franchisees. The major distinction between them is that the controls are enforced on the franchisees by the franchisors, while the various forms of assistance provided by franchisors are available to, but are often optional for

franchisees. That is, in general, franchisees may or may not avail themselves of franchisor assistance programs at their discretion.

Franchisors provide assistance to their franchisees in a variety of areas. The most common forms of assistance are:

- . formal sales or business training.
- . management, marketing or personnel training.
- . inventory and accounting programs.
- . site selection advice.

Franchisor assistance programs are directed to the entire operation of franchise businesses, and not simply to the method of selling a specific product or products which may constitute a small portion of the franchisee's operation. Like franchisor controls, franchisor assistance programs are an integral part of standard franchise agreements.

Types of Payments

In a franchise system, the franchisee is usually required to make payments to the franchisor. These payments or fees can be grouped into two general categories: 1) initial or start-up fees and 2) recurring fees. Initial fees are those payments required in order to become a franchisee. Payments made for the right to develop franchise operations in specific geographic areas, security deposits, escrow charges, and payments for franchisor-supplied equipment and/or inventories are examples of initial fees or payments. These payments are required to start the franchise business. They are usually one-time assessments.

Recurring fees are those payments required to continue to operate an existing franchise business. Royalties, advertising fees and

leasehold payments are the most common recurring fees. Unlike initial fees, recurring fees are usually levied as a fixed percentage of franchise sales. Typical royalty fees are in the range of 3 to 5 percent of sales, while advertising fees generally range from 1 to 3 percent of sales. If the franchisor owns the real estate and/or the building housing the franchise business, lease payments are made by the franchisee to the franchisor. Lease agreements often stipulate a minimum or base lease payment, as well as additional lease payments based on a flat percentage of franchise sales. It is not uncommon for total franchisee lease payments to average between 5 and 8 percent of gross sales.

The timing of payment for recurring fees varies by firm and by the type of payment. Royalty fees may be required on either a weekly or monthly basis. Advertising fees and leasehold payments are typically made on a monthly basis.

Regulation of Franchise Agreements

Given the rapid growth of franchising in the economy, it is not surprising that franchise agreements have received close scrutiny from various governmental regulatory agencies. Currently, franchise agreements must conform to one of two existing guidelines. These guidelines are the Uniform Franchise Offering Circular (UFOC), which is a standard format for state registration and disclosure requirements, and the Federal Trade Commission's Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures, which was promulgated in 1979. Although these guidelines differ somewhat in their requirements, the intent of both is to

make available to potential franchisees specific information and disclosures relevant to franchise agreements. Both of these guidelines are designed to delineate the rights, as well as the responsibilities, of both franchisors and potential franchisees.

The purpose of these guidelines is not to standardize all terms of the franchise agreement, but rather to provide for the disclosure of key elements of information pertaining to the operation and performance history of individual franchise systems. Examples of the type of information disclosure required by both these guidelines include:

- . litigation history of the franchisor.
- . bankruptcy information pertaining to the franchisor.
- . refundability of initial and/or recurring payments made by franchisees.
- . the number of cancellations, terminations and nonrenewals of franchises for a pre-determined period.

In addition to the disclosure of information in the areas noted above, franchisor earning claims are also subject to disclosure.

By providing prospective franchisees with information pertaining to past franchisor performance, the guidelines promote an environment where informed choices can be made by potential franchisees prior to the execution of franchise contracts. Guidelines of this type help promote the development of sound franchise systems.

Antitrust Issues in Franchising

Numerous court rulings over the past 15 years have clarified to a great degree the legal relationships that exist between

franchisors and their franchisees in a number of areas. Although these cases involved few foodservice firms directly, they are nonetheless important because they circumscribe the activities of franchisors relative to their franchisees. The courts have clarified these relationships in three primary areas: 1) price fixing activities, 2) purchasing restrictions, and 3) tie-in arrangements.

In Simpson v. Union Oil Co.,¹ the U.S. Supreme Court held that any device designed by franchisors for the purpose of controlling the prices charged by franchisees to their customers is illegal. In rendering this decision, the court reaffirmed its position taken in U.S. v. Parke, Davis and Co.,² and stated, ". . . [that] a supplier may not use coercion on its retail outlets to achieve retail price maintenance." The findings of clear violations of Sections 1 and 2 of the Sherman Act in this case effectively prohibit all franchisors from placing restrictions on the pricing activities of their franchisees.

The courts have also addressed directly the issues of franchisor restrictions on the purchasing activities of their franchisees. In the FTC v. Brown Shoe Co.,³ the U.S. Supreme Court held that agreements or incentives designed to restrict the items sold by franchisees to those manufactured by the franchisor may be an unfair method of competition. In rendering this decision, the court

¹377 U.S. 13, 84 S.Ct. 1051 (1964) .

²362 U.S. 29 (1960) .

³384 U.S. 316, 86 S.Ct. 1501 (1966) .

recognized the potential impact of vertical market foreclosure on both Brown Shoe franchisees and Brown Shoe's competitors in shoe manufacturing. In delivering his decision, Justice Black stated, ". . . [Brown's] program obviously conflicts with the central policy of both Section 1 of the Sherman Act and Section 3 of the Clayton Act against contracts which take away freedom to buy in the open market."

Although the principles enunciated in Brown Shoe were clear in the case where a franchisor-manufacturer was attempting to distribute products through a franchised system, it was not clear whether a franchisor could in fact either coerce franchisees to purchase products from designated third parties or require franchisees to do so as part of the franchise contract. The U.S. Supreme Court decision in FTC v. Texaco¹ clarified the former when it found that dominant franchisors who coerce their dealers to purchase items from designated third parties are engaged in an unfair method of competition. In a subsequent decision in Arthur Murray v. Reserve Plan, the U.S. Court of Appeals extended their earlier interpretations and concluded that franchisors may not require, as part of the franchise contract, that franchisees purchase goods and/or services from designated third parties. Again, as in Brown Shoe, the courts had specifically recognized the overriding importance of maintaining the freedom of franchisees to buy products in the open market.

The U.S. Supreme Court reiterated this position in Fortner Enterprises, Inc. vs. U.S. Steel Corp.,² when it found that franchisors

¹ 393 U.S. 223 (1968).

² 394 U.S. 495 (1969).

could not require franchisees to purchase unwanted items as a condition for purchasing wanted items. In this decision, the court recognized the potential for tie-in sales inherent in many franchise systems and again sought to establish the right for franchisees to purchase products in the open market.

The subsequent decision of the U.S. Court of Appeals in Siegal v. Chicken Delight, Inc.¹ further clarified the court's posture with respect to tie-in sales. In its decision, the court found that a trademark license can be a tying item. The court acknowledged that a trademark reflects the goodwill and quality standards of the enterprise it identifies, but flatly rejected the argument by the defendant that its sale of products to franchisees was necessary for the continued maintenance of that goodwill. In the words of the court,

"The relevant question is not whether the items are essential to the franchise, but whether it is essential to the franchise that the items be purchased from Chicken Delight. This raises not the issue of whether there is a tie-in but rather the issue of whether the tie-in is justifiable . . ."

The court found that the tie-in was not justifiable because it was possible to develop specifications for all the products in question without revealing any trade secrets.

The decision in Chicken Delight did not prohibit tie-in sales by franchisors, but rather demanded that such sales be justifiable for the continuing operation and goodwill of the franchise system. The Federal Trade Commission assumed a similar posture in its Chock Full O'Nuts² decision. In that decision, the Commission held that a

¹448 F.2d 43 (9th Cir. 1971), cert. denied 405 U.S. 955 (1972).

²In the Matter of Chock Full O'Nuts Corporation, Inc., FTC Docket 8884 (Oct. 2, 1973).

franchisor of sit-down, counter service, restaurants which required its franchisees to purchase products manufactured either by or for the franchisor, was engaged in per se violations of Section 5 of the Federal Trade Commission Act. The only defense in such cases is proof by the franchisor that such purchase restrictions are " . . . necessary to ensure the quality of its products, or that no less restrictive means than the tie-in may be used to ensure such quality."

The intent of these two decisions is clear. If franchisees are required to purchase products directly from franchisors, or their designees, then the products so purchased must be necessary to maintain the quality and goodwill inherent in the trade-name or trademark involved. Thus, it appears that the simple act of applying a trade-name or trademark to products that are generally available from alternative sources of supply does not satisfy the conditions that need to exist before tie-ins imposed by franchisors are justified. Tie-in sales are still permitted in those instances where the dissemination of product specifications would require the divulgence of a trade secret.

Future Antitrust Issues

Although the courts have ruled on a number of issues relevant to franchisor-franchisee relationships, there are emerging issues that undoubtedly will have to be dealt with in the future. The issue of what constitutes a trade secret is one of these. Other issues which may have particular relevance for foodservice franchisors and franchisees include: 1) the impact of territorial restrictions on intra-franchise competition, 2) the legality of franchisor restrictions that preclude or severely limit franchisees from participating

directly in alternative business ventures, 3) the nonrenewal of expired franchise licenses for reasons related to the age or physical health of the owner/operator, and 4) the horizontal consequences of franchisor buy-backs from franchisees.

From a somewhat broader perspective, another issue that may become more important in the future relates to conglomerate mergers involving large food processors and large commercial foodservice firms. There have been a substantial number of mergers of this type over the past 15 years, and many of them have involved some of the largest firms in both sectors. The increased propensity for food processors in particular to enter and/or expand their existing foodservice operations via the merger route suggests that closer public scrutiny should be given to the possible anti-competitive consequences of these actions. The enhanced opportunities for vertical market foreclosure presented by some of these mergers are a case in point.

Impact of Franchising on the Structure of the Commercial Foodservice Sector

Franchising has been an important activity contributing to the growth in sales, employment and establishments in the commercial foodservice sector. One indication of the importance of franchise restaurant systems is that these operations had aggregate sales of nearly \$25 billion and accounted for an estimated 37 percent of eating place sales in 1979.¹ Employment in franchise foodservice

¹ "Restaurant Franchising in the Economy." Restaurant Business. March 1, 1980, pp. 138-9.

operations totaled nearly 1.5 million and represented about 40 percent of all persons working in eating places in 1979. With a total of nearly 60,000 restaurants in operation in 1980, franchise systems are clearly an important part of the commercial foodservice sector.

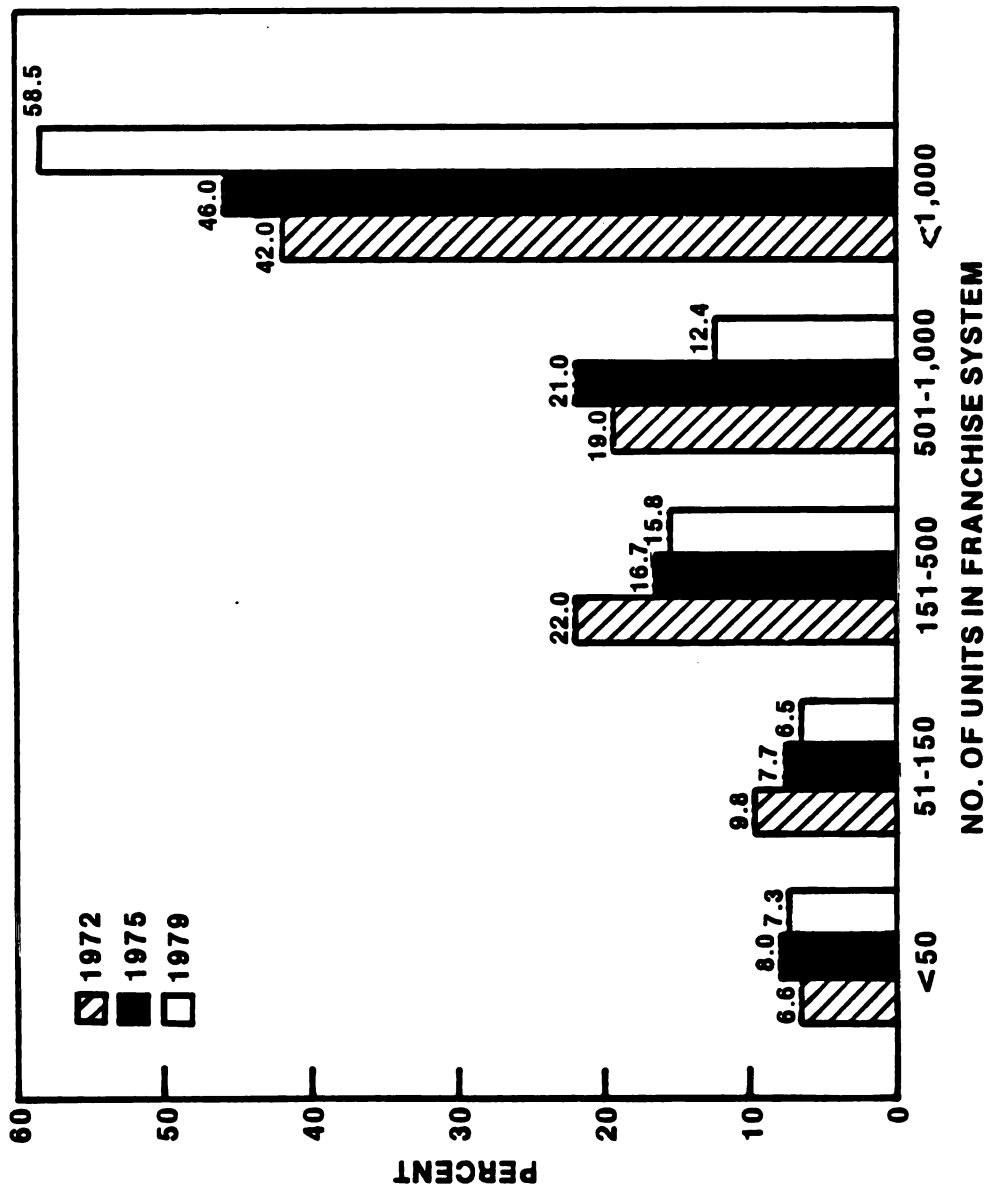
Some insights into the rapid growth of franchise restaurant systems over the past few years can be gained by comparing data on franchise operations to data gathered from the quinquennial Census of Retail Trade. In 1972, total franchise restaurant sales were nearly \$6.8 billion and represented slightly over 22 percent of total eating place sales reported by the Bureau of Census. With over 32,500 establishments, franchise restaurant systems accounted for slightly less than 13 percent of all eating place establishments that year. By 1977 the rapid growth of franchise restaurants was evident; franchise foodservice sales were nearly \$18.2 billion, and establishment numbers had expanded to nearly 52,000 by the end of that year. Franchise foodservice systems' shares of eating place sales and establishments were 33.7 percent and 24.0 percent, respectively, in 1977. The annual growth rate of franchise restaurant sales over this period was 33.5 percent, compared to 16.6 percent for all eating places. Franchise establishments grew at an annualized rate of 11.9 percent, compared to 2.0 percent for all eating places.

Analysis of data covering the period 1972-79 reveals that large franchise restaurant systems accounted for a large share of both franchise sales and establishments. The analysis also reveals that these franchise systems have become a more important element in the

foodservice sector over the past ten years. These facts are demonstrated by the consistent upward trend in the proportion of franchise sales and establishments accounted for by the largest franchise restaurant systems. Between 1972 and 1979, the share of total franchise restaurant sales accounted for by systems with more than 1,000 establishments rose from 42.2 percent to 58.2 percent, while their share of all franchise establishments increased from 43.8 percent to 55 percent (Figure 3.3). Since their share of sales slightly exceeds their share of establishments, it is clear that average sales per establishment are slightly higher in these large franchise systems than in all franchise restaurant systems. Aggregate sales of these franchise systems totaled \$14.4 billion in 1979 and were over 5 times as large as the sales made by firms in this size class in 1972 (Table 3.5). If the sales and establishments of the next largest size class (501 to 1,000 establishments) are included, firms with more than 500 establishments accounted for 70.3 percent of franchise foodservice sales and 65.5 percent of franchise system units in 1979. It is estimated that these operations alone accounted for approximately 25 percent of eating place sales in 1979.

Obviously the rapid growth of some franchise operations, and the attendant movement to larger size classes resulting from that growth, are at least partially responsible for the increased shares in sales and establishment numbers. But that merely serves to illustrate the point that larger systems are indeed becoming more important.

**FIGURE 3.3 DISTRIBUTION OF FRANCHISE SYSTEM RESTAURANT
SALES, 1972, 1975 AND 1979.**



SOURCE: TABLE 3.5

Table 3.5 Size Distribution of Foodservice Franchisors Classified by Number of System-Wide Establishments, 1972, 1975 and 1979.

Year/Item	Size Group (Units)						Total
	0-10	11-50	51-150	151-500	501-1000	1001 +	
1972							
Companies	53	77	45	28	6	5	214
Units	279	1,936	3,775	7,318	4,952	14,278	32,538
Sales ^{a/}	55.5	386.5	668.6	1,487.6	1,331.9	2,867.2	6,797.4
1975							
Companies	82	115	46	32	11	7	293
Units	414	2,881	4,091	8,279	7,672	19,646	42,983
Sales ^{a/}	90.1	875.4	950.4	2,050.0	2,682.0	5,614.0	12,262.0
1979							
Companies	123	157	56	41	8	14	399
Units	657	3,916	5,054	10,690	6,184	32,435	58,936
Sales ^{a/}	272.3	1,526.5	1,644.5	3,905.1	3,009.6	14,407.9	24,765.9

^{a/} Sales are in million dollars. Rows may not add to total due to rounding error.

Source: Franchising in the Economy, selected years.

It should be noted that the data summarized in Table 3.5 are system-wide franchise data. Thus, the restaurant operations of both franchisors as well as their franchisees are consolidated and presented as if they were under common ownership or management. The data are misleading from this standpoint because franchisees maintain considerable autonomy over many of their daily business operations. Operationally, franchisees are largely independent of franchisors. For this reason, it would be erroneous to conclude, solely on the basis of the data summarized in Table 3.5, that individual firms who franchise have increased their share of franchise sales or establishments.

Sub-markets in Foodservice Franchising

Franchised restaurant systems featuring hamburger and roast beef sandwiches represent the single largest sub-group within franchise restaurant operations. In 1979, there were over 27,300 restaurants of this type in operation with aggregate sales of over \$12.7 billion (Table 3.6). These operations accounted for over 51 percent of all franchise restaurant sales and slightly over 46 percent of all franchise restaurant establishments. The second largest sub-group, limited-menu steakhouses and full menu restaurants, accounted for 21.1 percent of the sales and 14.4 percent of the establishments in franchise systems. Thus, the two largest sub-groups within restaurant franchising accounted for over 72 percent of franchise sales and over 60 percent of franchise restaurant establishments in 1979.

Although these two sub-groups remained dominant in 1979, other types of franchised restaurants have expanded their shares of

Table 3.6 Franchise Restaurant Numbers and Sales
Classified by Ownership Status and
Major Menu Offering, Selected Years.

Classification	Units			Sales ^{a/} (\$ million)		
	1972	1975	1979	1972	1975	1979
Franchisor Owned	6,319	11,685	16,884	1,753.3	4,017.9	8,076.4
Chicken	816	1,644	1,990	194.1	461.0	739.4
Hamburger/ Roast Beef	2,399	3,915	5,153	711.9	1,671.4	3,066.9
Pizza	781	2,084	3,285	90.5	375.5	821.0
Mexican	270	518	1,050	40.7	116.1	322.8
Seafood	183	527	965	25.2	113.1	317.6
Steak/Full Menu	1,724	2,703	3,788	656.6	1,196.5	2,575.3
Other ^{b/}	146	294	653	34.4	84.3	233.4

Franchisee Owned	26,219	31,298	42,052	5,044.1	8,244.1	16,689.5
Chicken	3,745	4,062	5,085	819.6	912.9	1,518.7
Hamburger/ Roast Beef	16,925	18,895	22,157	3,055.6	5,088.4	9,673.7
Pizza	1,604	2,927	5,122	209.0	548.9	1,320.6
Mexican	636	944	1,427	72.6	156.5	371.8
Seafood	304	824	1,418	35.3	182.6	456.2
Steak/Full Menu	2,169	2,445	4,699	686.6	1,013.4	2,649.8
Other ^{b/}	836	1,201	2,144	165.3	341.3	698.8

TOTAL	32,538	42,983	58,936	6,797.4	12,262.0	24,765.9

^{a/} Column entries may not add to totals due to rounding error.

^{b/} Includes restaurants specializing in sale of pancakes, waffles, miscellaneous sandwiches and other foods.

Source: Franchising in the Economy, selected years.

franchise sales and establishments over the past 7 or 8 years. The growth exhibited by franchise systems featuring pizza, Mexican-style food and seafood has been significant. In 1979, these operations accounted for 14.6 percent of franchise restaurant sales, compared to only 7.0 percent in 1972.

Fast Food Franchising

Franchising is especially important in fast food operations. Franchised fast food systems featuring chicken, hamburgers and roast beef sandwiches, Mexican-style entrees and seafood items continue to be the predominant types of fast food operations. These systems accounted for 66.5 percent of franchise sales and 66.6 percent of franchise establishments in 1979, compared to 72.9 percent and 77.7 percent, respectively in 1972. The decline in the share of sales held by these fast food franchise operations was primarily the result of the 5.8 percentage point decrease in the sales' share of franchised systems featuring chicken. Strong growth was evident among the other major types of fast food franchise systems over the period.

The growing importance of franchise fast food systems is demonstrated by the fact that over 62 percent of all fast food sales were accounted for by these franchise operations in 1977, compared to 58 percent in 1972. Clearly, these systems are now a significant factor in the foodservice sector and will continue to be so in the near future if past trends continue.

Franchisor-Owned Foodservice Operations

Franchisors owned and operated 6,319 restaurants in 1972. Estimated sales from these restaurants were nearly \$1.8 billion. These operations represented 19.4 percent of all franchised restaurant establishments and nearly 26 percent of franchise restaurant sales (Table 3.6). Comparable data for 1979 indicate that franchisors operated 16,884 establishments and had sales of nearly \$8.1 billion. These figures represented 28.6 percent and 32.6 percent, respectively, of the establishments and sales of all franchise restaurants in 1979. Thus, on a relative basis, franchisor-owned operations have expanded more rapidly over recent years than have those of their franchisees.

Franchisors offering hamburger and roast beef sandwiches as their primary menu items remain the single most dominant sub-group within franchisor-owned restaurants. This sub-group accounted for 38.0 percent of franchisor sales and 30.5 percent of franchisor establishments in 1979. The second largest sub-group, limited-menu steakhouses and full menu restaurants, accounted for 31.9 percent of franchisor sales. Chicken and pizza restaurants accounted for 9.2 percent and 10.2 percent of franchisor-owned restaurant sales, respectively in 1979 (Table 3.6).

Franchisee-Owned Foodservice Operations

Franchisee-owned restaurant operations are, of course, the backbone of most franchise restaurant systems. It is highly unusual for franchisee-owned operations to account for less than 50 percent of the total establishments operated in a given system; and often they

account for over 75 percent of system-wide establishments. Many franchisees operate multiple-establishments, and a few have even branched out and started their own franchise systems (e.g., Rax and Shoney's South). Some of the largest franchisees had sales in excess of \$50 million in 1979.

Like their franchisor counterparts, the largest single sub-group within franchisee-operated restaurants featured hamburger and roast beef sandwiches. In 1979, there were over 22,100 such establishments with sales of over \$9.6 billion. These operations accounted for 52.7 percent of all franchisee-operated establishments and 58 percent of all franchisee sales (Table 3.6). The second largest sub-group, limited-menu steakhouses and full menu restaurants, accounted for 15.9 percent of all franchisee sales and 11.2 percent of franchisee-operated establishments in 1979. The fastest growing sub-groups of franchisee-operated establishments are those specializing in the preparation of pizza and seafood. These operations accounted for 10.6 percent of all franchisee sales in 1979, compared to 4.8 percent in 1972.

Large Franchise Foodservice Systems

Given the prevalence of franchising in the commercial foodservice sector, it is not surprising that the largest franchise systems are among the most well-known restaurant operations in the U.S. Franchise systems such as McDonald's, Kentucky Fried Chicken, Burger King and Wendy's are highly visible operations within the foodservice sector. They were also the 4 largest franchise restaurant systems in the U.S. in 1979. Together, these four systems, all of

which are fast food operations, had nearly \$8.5 billion in sales and over 13,500 establishments in operation during 1979 (Table 3.7). Their sales accounted for 34.2 percent of all franchise restaurant sales, about 40 percent of all fast food sales, and an estimated 12.1 percent of commercial foodservice sales in 1979.

The 10 largest franchise restaurant systems had sales of \$12.9 billion and operated over 26,400 establishments in 1979. Their sales represented 51.9 percent of franchise sales and an estimated 18.6 percent of commercial foodservice sales that year. Seven of the 10 were fast food operations.

The 25 largest franchise restaurant systems had sales slightly in excess of \$17.3 billion and operated nearly 40,000 establishments in 1979 (Table 3.7). They accounted for 70.1 percent of franchise restaurant sales and about 25 percent of commercial foodservice sales that year. Establishments in these systems represented 67.7 percent of all franchise foodservice establishments in 1979.

Sixteen of the largest 25 franchise systems were fast food operations. These systems accounted for \$13.3 billion in sales, over 77 percent of the system-wide sales of the 25 largest franchise systems, and over 52 percent of the sales made by all franchise restaurants in 1979. With over 30,700 establishments operating in 1979, these franchised fast food systems accounted for 52.0 percent of all franchise establishments and an estimated 11 percent of all commercial foodservice establishments.

Among the 25 largest franchise restaurant systems, franchisor-owned restaurants accounted for about 32 percent of the sales and slightly over 26 percent of establishments in operation in 1979. Five

Table 3.7 U.S. Foodservice Sales and Restaurant Units
of the 25 Largest U.S. Franchised Restaurant Systems, 1979.

Franchise System	Franchisor Owned		System ^{a/}	
	Sales (\$ million)	Units	Sales (\$ million)	Units
McDonald's	1,912	1,820	4,448	4,857
KFC	246	783	1,588	4,455
Burger King	289	439	1,460	2,439
Wendy's	238	433	974*	1,765
Int'l. Dairy Queen	9*	47	926	4,860
Pizza Hut	550*	1,940	900*	3,740
Big Boy	140*	180	811*	1,081
Hardee's	220	449	750	1,231
Howard Johnson's	446	793	560	1,054
Arby's	76	138	433	928
Church's	330	876	401*	1,084
Ponderosa	304	450	388*	574
Bonanza	0	0	378	680
Tastee Freez	0	0	350*	2,000
Long John Silver's	175*	515	342*	1,007
Burger Chef	109*	240	340	750
Sonic Drive-Ins	28	137	333	1,182
Taco Bell	166	589	311	1,100
Dunkin Donuts	28	100	269*	953
Western Sizzlin	n.a.	n.a.	263*	475*
A & W Int'l.	0	0	255	1,340
Sizzler	59*	106	250*	402
Arthur Treacher's	n.a.	n.a.	226	777
Perkins Cake n Steak	61*	110*	223	400
Pizza Inn	110	357	190	747
<hr/>				
Total	5,496	10,502	17,369	39,881

*Indicates estimate.

n.a.--not available

^{a/} Includes sales and establishments of both franchisors and franchisees.

Source: Company annual reports and 10K forms; Moody's Investor Service, 1980; Restaurant Business, March 1980, p. 130; Institutions, July 15, 1980, pp. 89-187.

of the franchisors had company sales in excess of \$250 million and two firms (McDonald's and Pizza Hut) had more than \$500 million in company sales. Average company sales were \$220 million, compared with system-wide average sales of \$695 million for the largest 25 foodservice franchisors (Table 3.7). (If those franchisors not operating company-owned restaurants (Bonanza, Tastee Freez and A & W) are excluded, average company sales for the remaining 22 largest foodservice franchisors were \$250 million in 1979.) The largest 25 franchisors operated an average of 420 company-owned establishments in 1979 (the average is 477 if the three completely franchised systems are excluded), compared to a systems' average of 1,595 establishments.

The 200 Largest Commercial Foodservice Systems

As noted earlier, the commercial foodservice sector is comprised of many different market segments. These segments cover a broad spectrum of activities that range from fast food restaurants to dinner house/theme restaurant operations. A comprehensive analysis of the structure of the commercial foodservice sector would normally include a detailed analysis of these segments. Unfortunately, such an analysis is not possible at this time. Neither Census data nor data published periodically in various foodservice trade journals provide a sufficiently detailed disaggregation of data that would enable a comprehensive analysis of the sector's structure along the lines that were outlined earlier in this chapter. Clearly, the lack of such data limits the scope of the analysis. But some insights into the structure of the sector can be gained by examining the types

of foodservice operations that are prevalent among the largest firms in the sector and the ownership status of these operations.¹

An analysis of the 200 largest commercial foodservice systems, which had aggregate sales of about \$45 billion in 1979, reveals that firms primarily engaged in fast food operations represented a large percentage of the total. Sixty-four such operations (32 percent) were included in this group (Table 3.8). Most of these (48) were fast food franchisors; four were fast food operations that were not franchise systems, and the remaining 12 were fast food operations owned by large franchisees. Each of the franchisee-operated systems were affiliated with at least one of the 48 fast food franchisors included in the group. Five of the franchisee-operated systems were affiliated with more than one of these franchise systems.

The number of fast food franchisors and franchisees included among the 200 largest commercial foodservice firms is actually greater than 60 firms. There are other firms who are either fast food franchisors or franchisees but because these operations are small relative to their other foodservice activities, they are not classified as fast food operators. For example, although 6 of the 10 largest foodservice firms are primarily fast food operators, there are two other firms among the 10 (Pillsbury and Marriott) who are fast food franchisors and who also operate some of their own fast food restaurants. Both of these firms have diverse foodservice operations and are classified as such in Table 3.8, but they are also important

¹ Although it must be recognized that these firms are not necessarily representative of all industry participants, nonetheless they are important forces shaping trends in the commercial foodservice sector.

Table 3.8 Distribution of the 200 Largest U.S. Foodservice Firms
by Type of Foodservice Operation, 1979^{a/}.

Firm Sales Rank	Type of Foodservice Operation						
	Coffee Shop	Dinner House	Family Restaurant	Fast Food	Foodservice Management .	Diverse ^{b/}	Other ^{c/}
	-----No. of Firms-----						
1-10	-0-	-0-	-0-	6	1	2	1
11-20	2	1	1	1	2	1	2
21-50	1	1	5	11	4	0	8
51-100	0	7	10	11	13	3	6
101-150	0	9	4	21	1	2	13
151-200	1	4	13	14	2	2	14
TOTAL	4	22	33	64	23	10	44

^{a/} Includes only those firms whose foodservice operations are available to the public-at-large. Airlines, in-plant foodservice contractors and those foodservice contractors providing services to hospitals, public and private schools, etc. are excluded. Firm rankings are based on total U.S. foodservice sales in 1979.

^{b/} Includes firms whose foodservice operations encompass more than one market segment. For these firms it was not possible to identify a primary or dominant type of foodservice operation.

^{c/} Includes the foodservice operations of firms engaged primarily in the operation of hotels, motels and general retailing.

SOURCE: Company annual reports and 10K forms; Institutions, July 15, 1980, pp. 89-153; Moody's Industrial Manual, 1980; Restaurant Business, May 1978, pp. 147-169.

fast food franchisors.

Among the 200 largest foodservice firms, 71 firms were either franchisors or franchisees who were actively involved in some type of fast food operation in 1979. Sixty of these firms were classified as fast food firms. The fast food operations of the 11 remaining firms were not the primary foodservice activity for these firms. Accordingly, these firms have been categorized in other market segments. Five of the 10 firms with secondary fast food operations are included in the diverse foodservice category. The rest are classified in either the coffee shop, family restaurant or dinner house categories.

The second largest category includes the foodservice operations of hotels, motels and general merchandise retailers. There were 44 of these firms included among the 200 largest commercial foodservice firms in 1979 (Table 3.8). Although they represented 22 percent of the 200 largest foodservice operators in 1979, these operations were more prevalent among the second hundred firms than among the 100 largest firms. Twenty-seven of these operations (61 percent) were included in the former group, while only 17 were included in the latter group. In general, these foodservice activities are operated as complementary enterprises to the major business activity of these firms. These foodservice operations are important from a foodservice standpoint, as their ranking indicates, but they generally account for less than 25 percent of hotel and motel revenues and usually less than 5 percent of general merchandise retailers' revenues.

Family restaurants were the third most common type of foodservice operations. Firms operating family restaurants represented 16.5 percent of the 200 largest commercial foodservice firms in 1979. They were followed by foodservice management firms (23), dinner

house operators (22), diversified foodservice firms (10) and coffee shop operations (4). Except for coffee shops, firms operating in these broad market segments were fairly well represented within each size group shown in Table 3.8.

Franchising Activity

Franchising was an important activity for the 200 largest commercial foodservice firms in 1979. One hundred seven of those firms were involved to some extent in franchise foodservice systems. Eighty-one of these firms were primarily franchisors, while 26 were franchisee operations. A few of the franchisee operations also franchised some foodservice operations, but these firms derived most of their income from the foodservice establishments they operated as franchisees.

Forty-eight of the 81 franchisors were primarily fast food franchisors. Fourteen firms were franchisors of family restaurants, and 14 firms were hotel or motel franchisors. Three of the 5 remaining franchisors were classified in the diverse foodservice category, while the 2 remaining firms franchised coffee shops and foodservice management operations, respectively. A few firms (e.g., PepsiCo, Denny's, Marriott, and Howard Johnson's) franchised more than one type of restaurant operation, but these firms were an exception. Most firms were single system franchisors.

Twenty-six franchisee-operated systems were ranked among the 200 largest foodservice firms in 1979. None of these firms ranked among the 20 largest foodservice firms, but 4 systems operated by franchisees did rank among the 50 largest foodservice firms. Most

of the franchisee operations (15) were ranked among the second hundred largest firms. Fourteen of the franchisees were primarily fast food firms, 11 firms operated family restaurant franchises and one firm was highly diverse in its foodservice operations.

Unlike franchisors, franchisee operations often encompass more than one foodservice market segment. In fact, 23 of the 26 franchisees operated foodservice establishments that were independent of their own franchise operations. Although this situation exists among large franchisees, it is clearly not the case for franchisees in general.

Ownership Patterns in Commercial Foodservice

The ownership patterns that exist within an industry or sector are an important element in the sector's overall structural configuration. These patterns often provide some insight into the linkages that exist between firms that operate in different sectors of the economy. These linkages are often important because they may influence the growth opportunities of particular firms. Foodservice firms that are owned or controlled by firms whose primary source of revenue is not derived from foodservice operations may benefit from cross subsidization by the parent organization. Foodservice firms subsidized in this manner can often expand their operations more rapidly than those firms that must rely solely on foodservice revenues for expansion. While some capacity for cross subsidization exists within any firm that has multi-unit and/or multi-market activities, the potential for such activity is particularly strong when firms operate in different sectors of the economy.

Although a comprehensive analysis of the cross subsidization activities involving foodservice firms and their parent organizations is beyond the scope of this study, the ownership status of large foodservice firms is itself enlightening. An analysis of the ownership patterns exhibited by the 200 largest commercial foodservice firms in 1979 reveals that 94 of them (47 percent) were owned or controlled by firms that derived most of their revenue and income from non-foodservice sources (Table 3.9). Thirty-four of these firms had substantial food-related business activities; 29 of these firms were primarily food processors; 3 firms were food retailers and 2 firms were conglomerates with extensive food processing activities. The 60 remaining firms operated primarily in non-food business sectors. Hotel and motel operators (27) comprised the largest single category in this group.

The penetration of food processors into the commercial foodservice sector is particularly interesting. Food processors and conglomerates with extensive food processing activities owned or controlled 17 of the 50 largest foodservice firms in 1979. Four of the 10 largest foodservice firms and 8 of the 20 largest foodservice firms were owned by firms with substantial food processing activities.

Most of this penetration by food processors has occurred since 1965 and has been the direct result of mergers and acquisitions. Without these mergers, the participation of food processors in the foodservice sector would be minimal. Although the reasons underlying this merger activity are not well documented, the relatively higher growth rates of foodservice firms compared to food processors and the temporary depression of foodservice stock prices relative to earnings potential have certainly been important factors.

Table 3.9 Ownership Patterns for the 200 Largest U.S. Foodservice Firms, 1979^{a/}.

Firm Sales Rank	Owned by Foodservice Firms	Food-Related			Non-Food Related			
		Processors	Grocery Retailers	Conglomerates	Lodgers	Retailers	Conglomerates	Other
1-10	5	4	-	-	1	-	-	-
11-20	3	3	-	1	1	-	1	1
21-50	12	9	-	-	3	1	1	4
51-100	31	5	2	1	1	3	3	4
101-150	28	5	-	-	8	4	2	3
151-200	27	3	1	-	13	2	-	4
TOTAL	106	29	3	2	27	10	7	16

^{a/} Includes only those firms whose foodservice operations are available to the public-at-large. Airlines, in-plant foodservice contractors and those foodservice contractors providing services to hospitals, public and private schools, etc. are excluded. Firm rankings are based on total U.S. foodservice sales in 1979.

^{b/} Firms deriving substantially all their income from the operation and/or franchising of on-going foodservice operations.

SOURCE: Company annual reports and 10K forms; Directory of the 200 Largest U.S. Food and Tobacco Processing Firms, 1975; Institutions, July 15, 1980, pp. 89-153; Moody's Industrial Manual, 1980; and Restaurant Business, May 1978, pp. 147-169.

Mergers and Acquisitions in Commercial Foodservice

Mergers and acquisitions involving large foodservice firms have become fairly common in the past 15 years. The rapid growth evident throughout the commercial foodservice sector and the concomitant increase in the demand for capital to sustain individual firm growth have made foodservice firms, particularly large ones, prime merger targets. As mentioned earlier, firms with substantial food processing activities have been among the most active and successful suitors of foodservice firms. But these are not the only firms that have consummated mergers with large foodservice firms. There have also been mergers between foodservice firms and firms with business activities outside the agribusiness complex (Table 3.10), as well as mergers between foodservice firms themselves. In the latter case, many of the transactions have involved franchisor buy-backs from franchisees.

Mergers Involving Large Foodservice Firms

Some indication of the amount of merger activity that has taken place recently is revealed by examining mergers involving the 100 largest commercial foodservice firms in 1979. Between 1976 and 1980, 32 of these firms were involved in at least one merger or acquisition; this included 9 of the 10 largest firms and 24 of the 50 largest firms (Table 3.11). Some of the firms ranked among the 100 largest foodservice firms were involved in more than one type of merger, and at least one firm (PepsiCo) was involved in all three types of mergers during the 1976-1980 period.

Table 3.10 Major Mergers and Acquisitions of U.S. Foodservice Firms
Made by Large Firms Other Than Food Processors, 1967-1980.

Parent Company	Foodservice Operation	Year Acquired	1979 ^{a/}	
			Sales (\$ million)	Units
Carlson Co.	Country Kitchen	1977	159.0	335
	T.G.I. Friday's	1975	44.0 ^{c/}	33
GDV, Inc.	Red Barn ^{b/}	1979	57.7*	197
	Servomation	1979	418.0 ^{c/}	6,300
	Sambo's (34%)	1980	543.8 ^{c/}	1,117
Holiday Inns, Inc.	Perkin's Cafe & Steak	1980	240.0	364
K Mart Corp	Furr's Cafeterias	1980	96.9 ^{c/}	79
Lucky Stores	Sirloin Stockade	1974	98.5	216
Moxie Industries	Frostie Enterprises	1979	32.5	176
Oakbrook Consolidated	Szabo Food Service	1978	112.0	430
Ogden Corp	ABC Consolidated	1967	181.3 ^{c/}	2,500
	Chef's Orchid	1968		
	Doggie Dinner	1969		
	Wometco	1980	60.0	3,200*
Red River Resources	Swensen Ice Cream	1979	59.0	260
Roxbury of America	Uncle John's Restaurants	1978	36.0 ^{c/}	34
Trans World Corp	Canteen Corp	1973	631.7 ^{c/}	970
	Spartan Food Systems	1980	163.5 ^{c/}	275

*Estimated.

^{a/} System-wide sales and units unless otherwise noted.

^{b/} Originally acquired by Servomation in 1966. Subsequently acquired as part of GDV, Inc. acquisition of Servomation.

^{c/} Company owned sales and units only.

Source: Company annual reports and 10K forms; Institutions, selected issues; Moody's Industrial Manual, selected years; Nation's Restaurant News, selected issues; Restaurant Business, selected issues.

Table 3.11 Mergers and Acquisitions Involving the 100 Largest U.S. Foodservice Firms of 1979 by Type of Merger or Acquisition, 1976-1980.^{a/}

Firm Sales Rank	No. Firms Making Acquisitions	Type of Merger of Acquisition ^{b/}			Market Extension ^{d/}
		Conglomerate	Horizontal ^{c/}		
-----No. of Firms-----					
1-10	9	2	6		4
11-20	4	2	2		1
21-50	11	4	4		4
51-100	8	3	0		5
Total	32	11	12		14

^{a/} Excludes the foodservice operations of airlines, in-plant foodservice contractors and foodservice contractors providing services to hospitals, public and private schools, etc. Firm rankings are based on total U.S. foodservice sales in 1979.

^{b/} Column entries are the number of firms in a given size group who were involved in at least one merger or acquisition of the reported type over the period 1976-1980.

^{c/} Primarily acquisitions of franchisee operations by the franchising company.

^{d/} Mergers and acquisitions of foodservice firms made by other foodservice firms operating in different segments of the industry than the acquired firm.

Source: Company annual reports and 10K forms; Institutions, selected issues; Moody's Industrial Manual, selected years; Nation's Restaurant News, selected issues; Restaurant Business, selected issues.

There were 11 conglomerate mergers over the period, 7 of which involved food processors. Market extension mergers, those involving mergers between firms that operated in different market segments within the foodservice sector, were also fairly common, as were horizontal mergers.

Although precise figures are not available on the value of each of the 11 conglomerate mergers, a conservative estimate of the total value of these mergers is \$1.6 billion. Over 6,100 foodservice establishments with total sales in excess of \$2.75 billion were acquired as a result of these mergers. Six of the 11 mergers involved franchisor systems. If franchisee sales and establishments are added to those directly under company control, over 9,600 establishments with sales of about \$3.6 billion were acquired.

Fast food operations were the most frequent merger targets; 4 fast food firms were acquired as a result of conglomerate mergers. Foodservice firms operating family restaurants (3), coffee shops (2), and foodservice management firms (2) were also part of conglomerate mergers over the period.

Market-extension Mergers

Although only 14 firms in the group made market extension-type mergers, there were 21 such mergers over the period. Eleven firms made one acquisition each, while 3 firms made multiple acquisitions. In general, these mergers were smaller than conglomerate mergers, although there was considerable variation in the size of individual market extension mergers. These mergers ranged in size from

Weinerwald's acquisition of IHOP, which involved 561 restaurants and sales of \$253 million, to Quaker Oats' acquisition of Engine House Pizza, which involved only one restaurant and estimated sales of less than \$1 million. In total, there were about 1,750 foodservice establishments with sales of over \$820 million acquired as a result of market extension mergers.

As in the case of conglomerate mergers, some of these acquisitions involved franchise systems. If franchisee establishments and sales are included, about 2,500 establishments with sales of \$1.16 billion were acquired. Market-extension acquisitions of dinner house/theme restaurants (8) and family restaurant operations (6) were most common over the period; however, there were 3 mergers of this type that involved fast food firms, one of which was a large franchisee operation.

Horizontal Mergers

Horizontal mergers, most of which were between franchisors and their franchisees, were fairly common over the 1976-1980 period. Unfortunately, data available from public sources and company annual reports regarding these mergers is somewhat limited. Some firms do not report these transactions, particularly small ones, and those that do, usually report only the total number of establishments acquired and not the number of individual firms involved or the sales of those firms. It is clear, however, that both buy-backs and divestitures are fairly common occurrences in many franchise systems. For example, between 1976 and 1980, McDonald's acquired 320 operating restaurants from franchisees for a total purchase value of \$113.2

million and sold 322 operating restaurants to either new or established franchisees. Over the same period, Bonanza International acquired 126 restaurants operated by its franchisees (for an undisclosed sum) and sold 288 company-owned restaurants. Similar transactions were made by other large franchisors over the period (e.g., Wendy's, Ponderosa, Arby's and Church's); however, the number of restaurants acquired varied considerably across firms.

At the present time, there is no solid evidence that would indicate a general trend toward franchisor buy-backs. It is possible, however, that in the next five years they will become more frequent. Many of the franchise agreements signed in the early and mid 1960s will be subject to renewal by then, and franchisors whose systems have matured may look to franchisee acquisitions as a means of firm growth in a slow growth industry.

Mergers Between Large Food and Tobacco Processors and Foodservice Firms

Mergers and acquisitions have been the primary vehicles used by food and tobacco processors to enter the commercial foodservice sector. Large food and tobacco processors--those ranked among the 200 largest U.S. food and tobacco processing firms in 1975--have been very aggressive in the acquisition of foodservice firms. Between 1965 and 1980, 38 of these firms made a total of 70 separate acquisitions of foodservice firms (Table 3.12).¹ The total value

¹ Only conglomerate and market extension mergers are included in this total. Some of the processors also made an undisclosed number of horizontal acquisitions, most of which involved the acquisition of franchisee operations by the franchisor organization.

Table 3.12 Major Mergers and Acquisitions of U.S. Foodservice Firms Made by the
200 Largest U.S. Food and Tobacco Processors of 1975, 1965-1980.

Year	Acquired Firm	Acquiring Firm	Acquisition			
			Value ^{a/} (\$ million)	Franchisor/ Company Owned		System ^{b/}
				Sales (\$ million)	Units	Sales (\$ million)
1965	Chicken Delight ^{c/}	Consolidated Foods	2.2 - 4.8	0	0	50.1
1966	A & W International ^{d/}	United Brands	n.a.	1.4*	25	147.4*
	Lyons Restaurants	Consolidated Foods	3.5	6.0*	20	6.0*
	Uncle John's Restaurants ^{e/}	General Host	3.5	20.5*	52	20.5*
1967	Baskin Robbins	United Brands	n.a.	0	0	28.0
	Burger Chef	General Foods	15.0	21.6	120	129.6*
	Burger King	Pillsbury	18.0	5.5	20*	77.4*
1968	Calico Kitchens	Kane-Miller ^{f/}	0.9	3.0	3	3.0
	Canteen ^{g/}	IT & T	229.9*	245.6	250	245.6
	Dobb's House ^{h/}	Squibb Corp.	n.a.	78.6	475	475
	Fred Harvey, Inc.	Arafac	25.0	34.9*	98	34.9*
	National Air Catering	Greyhound	10.0	n.a.	n.a.	n.a.
	Jack-in-the-Box	Ralston Purina	54.2	36.1	275	36.1
	Mayflower Restaurants	Kane-Miller ^{f/}	7.3	10.0*	60	10.0*
	Schrafft's Restaurants ^{i/}	Pet, Inc. ^{j/}	23.6	10.0	50	10.0
	Service Systems	Del Monte ^{k/}	10.0	35.5	703	35.5
	Shakey's Pizza	Hunt International Resources	14.0	6.0*	30	59.7*
	Zuider Zee	Ward Foods ^{l/}	7.0	13.5*	18	13.5*
	BBF, Inc.	Borden ^{m/}	10.2*	5.0*	51	5.0*
1969	Dutch Pantry	CPC International	n.a.	23.2	40	30.2
	Jacques' French Restaurants	IT & T	2.5	6.1	10	6.1
	L & K Restaurants ^{n/}	Consolidated Foods	4.0 - 7.9	7.6	50	7.6
	Magic Pan	Quaker Oats	n.a.	1.0*	2	1.0*
	Rix Systems ^{o/}	General Foods	n.a.	2.0*	10	2.0*
	Tijuana Taco	Ward Foods ^{k/}	1.6	4.0*	40	4.0*
	Trini's Restaurants	Riviana Foods ^{o/}	1.3*	1.0*	3	1.0*
	Clark's Restaurants ^{p/}	Campbell Soups	4.4	9.7*	20	9.7*
	Far West Services	W.R. Grace	27.0	25.2*	47	25.2*
	Herfy's	Campbell Soup	2.7	2.2*	11	2.2*
1970	Mr. Donut	International Multifoods	6.0	1.5	14	30.0
	Red Lobster	General Mills	1.0	1.0*	3	1.0*
	Sveden House	International Multifoods	1.0	2.2*	6	17.0
	Clark's Restaurants ^{p/}	Campbell Soups	4.4	9.7*	20	9.7*
	Far West Services	W.R. Grace	27.0	25.2*	47	25.2*
1971	Continental Restaurants ^{q/}	Ralston Purina	7.6	2.5	7	2.5
	KFC Corp.	Heublein	267.6	192.8	901*	700.0
	Lums (franchise)	Riviana Foods ^{o/}	n.a.	11.0*	54	11.0*
	Henricl's	Green Giant ^{r/}	9.4	20.0*	56	20.0*
1972	Henricl's	Green Giant ^{r/}	9.4	20.0*	56	20.0*

Table 3.12 (Cont'd.)

Year	Acquired Firm	Acquiring Firm	Acquisition				
			Value (\$ million)	Franchisor/ Company Owned Sales (\$ million)	Units	Sales (\$ million)	System ^{b/} Units
1973	Davis Bros. Hot Sam Pietro's Ranch House Stouffer's	Heublein General Host Campbell Soup Riviana Foodsg/ Nestle	45.2 2.2 3.3 8.0 n.a.	30.3 5.0* 1.0* 9.0* 97.4	141 100 5 29 152	---	---
1974	Baskin Robbins Mass Feeding Corp. TFI Co. (Tastee Freeze) Zantigo's ^{u/}	J. Lyons & Co. Jewel Cos. J. Lyons & Co. s/ Heublein	37.6 5.0* 15.0 3.0	0 15.0 0 3.0*	0 500 0 9	120.0 15.0 276.9* 3.0*	1408 500 2215 9
1975	None	None	---	---	---	---	---
1976	Arby's International El Torito/La Fiesta Hardee's Hoffman House Steak & Ale	Royal Crown Cola W.R. Grace Imasco, Ltd. u/ Green Giant ^{r/} Pillsbury	18.0 12.5 115.0 6.2 96.3	21.8* 24.0 102.4* 24.0* 102.8	65 22 328 12 113	190.1* 24.0 297.5* 24.0* 102.8	568 22 953 12 113
1977	Del Taco El Chico Engine House Landshire Food System Le Chateau Pizza Hut Taco Plaza ^{w/} York Steak House	W.R. Grace ^{v/} Campbell Taggart Quaker Oats Southland Green Giant ^{r/} PepsiCo Con Agra General Mills	n.a. 20.4 n.a. 2.4 4.9 314.2 2.8 19.2	1.0* 38.2 1.0* 46.0 10.0* 382.0* 6.0 40.0	21 86 1 31 19 1760 26 47	1.0* 38.2 1.0* 46.0 10.0* 560.0* 6.0 40.0	21 86 1 31 19 3200 26 47
1978	Beef Corral Gilbert-Robinson Interstate United Taco Bell	Chock Full O' Nuts W.R. Grace Hanson Trust Pepsico	n.a. 20.9 n.a. 130.1	3.6* 46.0 321.4 108.2*	12 27 800 450	3.6* 46.0 321.4 216.3*	12 27 800 900
1979	Casa Galardo Friendly Ice Cream Lavicio's Sandwich Shops Mexican Foods of America	General Mills Hershey Foods Southland General Foods	n.a. 164.0 n.a. 2.4	1.0* 209.0* 3.2* 4.0*	1 587 32 4	1.0* 209.0* 3.2* 4.0*	1 587 32 4
1980	Howard Johnson Jojo's Restaurants The Good Earth Darryl's	Imperial Group, Ltd. W.R. Grace General Mills General Mills	630.0 n.a. n.a. n.a.	446.0 84.5* 20.0* 15.0*	793 145 20 10	560.0 84.5* 20.0* 15.0*	1054 145 20 10
TOTAL			2449.0-2455.5	3068.0	9872	5232.5	24,673

Table 3.12 (Cont'd.)

n.a.--not available.

*Indicates estimate.

a/ In those instances where franchisors were acquired, the acquisition involved only the assets directly under the control of the franchisor. Franchisee assets are excluded.

b/ Includes sales and establishments of both franchisors and franchisees.

c/ Divested by Consolidated Foods in 1972.

d/ Formerly owned by J. Hungerford Smith which was acquired by United Brands in 1966.

e/ Divested by General Host in 1968.

f/ Kane-Miller completed divestiture of its restaurant operations in 1974.

g/ Canteen Corp. and Jacques' French Restaurants, which had been merged into ITT's Canteen Division, were divested by ITT in 1973 as part of the agreement reached between ITT and the Justice Department in the ITT-Hartford antitrust case. Canteen was subsequently acquired by Trans World Corp.

h/ Formerly owned by Beech Nut-Life Saver which merged with Squibb in 1968. Dobbs House was divested by Squibb in 1980.

i/ Sold by Pet in 1973.

j/ Del Monte was acquired by R.J. Reynolds in 1977.

k/ Ward Foods divested its restaurant operations in 1974.

l/ Borden discontinued its restaurant operations in 1977.

m/ Divested by Consolidated Foods in 1977.

n/ Discontinued operation in 1974.

o/ In 1976 Riviana Foods was acquired by Colgate-Palmolive for \$179.6 million. Colgate-Palmolive announced plans to divest its restaurant operations in 1980.

p/ Discontinued operation in 1977.

q/ Indicates the acquisition of 7 separately owned restaurants which were subsequently combined into the Continental Restaurant Division of Ralston Purina.

Table 3.12 (Cont'd.)

r/ In 1979 Pillsbury acquired Green Giant for \$148.0 million. Henrici's was sold in 1980.

s/ J. Lyons and Co. owns 47 percent of TFI Co., the parent company of Tastee Freez.

t/ Formerly Zapata's.

u/ Imasco, Ltd. owns 44.3 percent of Hardee's.

v/ A joint venture between Del Taco and W. R. Grace.

w/ Formerly Taco Patio.

Source: Company annual reports and 10K forms; Directory of the 200 Largest U.S. Food and Tobacco Processing Firms, 1975; Food Service Today, November 1976; Institutions, selected issues; Moody's Industrial Manual, selected years; Nation's Restaurant News, selected issues; Restaurant Business, selected issues.

of these transactions is estimated to be between \$3.2 and \$3.4 billion. Slightly over \$3 billion in foodservice sales and nearly 9,900 foodservice establishments were acquired in these mergers (Table 3.12). Eighteen of the 70 acquisitions involved franchise foodservice systems. If the sales and establishments of franchisees are included, a total of about \$5.2 billion in sales and nearly 24,700 foodservice establishments were acquired over the period.

There was considerable variability in the size of individual mergers. They ranged from Imperial Group Ltd's \$630 million acquisition of Howard Johnson's to General Mills' acquisition of Casa Galardo, which operated only one restaurant. The average value of each acquisition for which data are available was \$46.2 million. Seven mergers exceeded \$100 million in value. On average, the 70 transactions resulted in the acquisition of \$43.8 million in foodservice sales and 141 foodservice establishments that were directly under the control of the acquiring firm. In 9 of these mergers, sales of the acquired foodservice firm were in excess of \$100 million in the fiscal year preceding the year of acquisition. In 14 of these mergers, total system-wide franchise sales exceeded \$100 million.

Despite the relatively large average sales acquired in these mergers, not all mergers involved large foodservice firms. Using an admittedly arbitrary standard of \$3.0 million in acquired sales as an upper bound in delimiting toehold mergers, there were a total of 12 toehold mergers over the 1965-1980 period. Total acquired sales resulting from these mergers were \$19.7 million, or an average of about \$1.6 million per merger. On average, only 6.3 establishments were acquired in each of these mergers. The difference between the

average size of toehold mergers and the average size of all mergers highlights the relatively wide range in the absolute size of food processor/foodservice mergers.

Mergers in Major Market Segments

Mergers between large food and tobacco processors and foodservice firms spanned not only a wide range in firm size, but also the major market segments in the foodservice sector. Within the major market segments, merger activity was greatest in the limited-menu segment, which is comprised primarily of fast food operations. This segment accounted for 29 (41 percent) of the mergers. Total acquired sales were slightly less than \$1.02 billion, or about 1/3 of the sales acquired in all mergers (Table 3.13). Over 4,400 establishments were acquired, which represented 45 percent of all acquired establishments over the 1965-1980 period. Fifteen of the 29 mergers were acquisitions of franchisors. If the sales and establishments operated by their franchisees are included in the total, then mergers in this market segment accounted for 57.9 percent of system-wide acquired sales and 76.6 percent of system-wide acquired establishments. Within the limited-menu segment, merger activity was greatest (in sales terms) among firms specializing in the preparation of pizza, chicken, hamburgers and Mexican-style food. In each of these sub-market segments, total acquired sales exceeded \$130 million.

Although merger activity was strongest in the limited-menu segment, firms operating in the other major market segments were also merger targets. Mergers involving firms operating in the caterer/vending segment and the coffee shop segment accounted for

Table 3.13 Major Mergers and Acquisitions of U.S. Foodservice Firms Made by the 200 Largest U.S. Food and Tobacco Processors of 1975, Classified by Type of Restaurant Operation, 1965-1980.

Restaurant Operation	Number of Acquiring Firms	Acquisitions				System ^a /	
		Number of Acquisitions	Franchisor/Company Owned		Units	Sales (\$ Million)	Units
			Sales (\$ Million)	Units			
Catering/Vending	6	6	663.5*	2,248*	663.5*	2,248*	2,248*
Coffee Shop	5	5	654.0	1,571*	768.0*	1,832	1,832
Dinner House/Theme Restaurants	13	20	430.2*	566	430.2*	566	566
Family Restaurants	8	9	295.5*	871	336.5*	985	985
Limited Menu:							
Chicken	2	3	223.1	1,042*	750.1*	4,362	4,362
Donuts	1	1	1.5*	14	30.0	275	275
Hamburger	4	4	134.5*	519*	509.5*	2,004	2,004
Ice Cream	2	3	-0-	-0-	424.9	4,148	4,148
Mexican	6	6	160.4	632	268.5	1,082	1,082
Pizza	4	4	390.0*	1,796	621.7*	3,506	3,506
Roast Beef	4	4	29.6*	98*	197.9*	601*	601*
Steak	1	1	40.0	47	40.0	47	47
Varied	3	3	40.7	332	186.7	2,881	2,881
Other	1	1	5.0*	100	5.0*	100	100
TOTAL	60	70	3,068.0	9,872	5,232.5	24,673	24,673

* Indicates estimate.

^a/ Includes sales and establishments of both franchisors and franchisees.

SOURCE: Company annual reports and 10K forms; Directory of the 200 Largest U.S. Food and Tobacco Processing Firms, 1975; Food Service Today, November 1976; Institutions, selected issues; Moody's Industrial Manual, selected years; Nation's Restaurant News, selected issues; Restaurant Business, selected issues.

21.6 percent and 21.3 percent of acquired foodservice sales, respectively. Operators of dinner houses and family restaurants that were acquired represented 14.0 percent and 9.6 percent, respectively, of acquired sales. Taken as a whole, these data suggest that food processors have not concentrated their merger efforts within any individual sub-market segment in the foodservice sector.

Mergers by Size of Processor

A somewhat different perspective on these mergers is gained when the processors are ranked on the basis of their food and tobacco processing sales. It is apparent from such a ranking that the very largest food and tobacco processors were also the most active merger partners for foodservice firms. There were 17 firms ranked among the 50 largest food and tobacco processors in 1975 that were involved in at least one merger with a foodservice firm during the 1965-1980 period. Those 17 firms made exactly one half of the 70 foodservice mergers made by the 200 largest food and tobacco processors and accounted for 46.3 percent of the sales and 53.4 percent of the establishments acquired over the period (Table 3.14). These mergers ranged in size from PepsiCo's \$314.2 million acquisition of Pizza Hut to Quaker Oats' acquisition of Engine House Pizza, which operated only one restaurant. Nine of the 35 mergers were toehold mergers. Seventeen of the mergers involved limited-menu foodservice operations; the remaining 18 mergers were distributed among firms that operated in the other major segments of the foodservice sector. Mergers involving limited-menu restaurants, 11 of which were franchise systems, accounted for 58 percent of the foodservice sales acquired by firms

Table 3.14 Major Mergers and Acquisitions of U.S. Foodservice Firms Made by the
200 Largest U.S. Food and Tobacco Processors of 1975,
Ranked by Size of Processor, ^{a/} 1965-1980.

Firm Sales Rank	Number Of Acquiring Firms	Acquisition					System ^{b/}	
		Number	Value (\$ Million)	Franchisor/Company Owned		Units		Sales (\$ Million)
				Sales (\$ Million)	Units			
1-10	4	7	99.4	71.2	467	179.2	1,067	
11-20	5	13	263.0	440.4	554	614.4	3,628	
21-50	8	15	917.7-924.2	908.9	4,260	1,800.9	9,742	
51-100	12	21	262.9	764.5	2,058	880.7	2,691	
101-200	9	14	906.0	883.0	2,533	1,757.3	7,545	
TOTAL	38	70	2,449.0-2,455.5	3,068.0	9,872	5,232.5	24,673	

^{a/}Ranking is based on estimated company sales in food and tobacco processing; it does not include foreign food processing sales of these firms.

^{b/}Includes sales and establishments of both franchisors and franchisees.

SOURCE: Company annual reports and 10K forms; Directory of the 200 Largest U.S. Food and Tobacco Processing Firms, 1975; Food Service Today, November 1976; Institutions, selected issues; Moody's Industrial Manual, selected years; Nation's Restaurant News, selected issues; Restaurant Business, selected issues.

ranked among the 50 largest food and tobacco processors. Multiple acquisitions were common for these processors: 11 of the 17 firms made more than one acquisition, and 5 of the processors made 3 or more separate acquisitions.

If the size grouping of food and tobacco processors is expanded to include the 100 largest firms, one finds that 29 firms in the size group made at least one merger over the 1965-1980 period that involved a foodservice firm. The 56 separate mergers consummated by these firms accounted for 71.2 percent of the sales and 74.2 percent of the establishments acquired by the 200 largest food and tobacco processors.

Foodservice firms operating limited-menu restaurants were the most common merger targets; 22 of the 56 mergers involved firms operating in this market segment. These mergers accounted for 40.2 percent of the foodservice sales acquired by the 100 largest food and tobacco processors. The remaining 34 mergers were distributed more or less uniformly across the other major market segments in the foodservice sector.

Although it is clear that some large food and tobacco processors have actively and successfully pursued foodservice firms, there is not as yet any strong evidence that indicates any systematic pattern linking the firms' primary food processing activities and their acquired foodservice operations. The 38 processors that made at least one foodservice acquisition over the 1965-1980 period were highly divergent in their primary food processing activities. In fact, those processors were categorized into 22 separate 4-digit food industries and 4 separate 2 or 3-digit groups based on their

primary food or tobacco processing activities (Table 3.15). No single industry accounted for more than 16 percent of franchisor/company acquired sales or more than 15 percent of system sales.

Despite the relative diversity apparent among these food processors, it must be noted that many of these processors are highly diversified within their own food processing activities. For this reason, the data presented in Table 3.15 must be interpreted with caution. They do not capture the organizational diversity that is characteristic of these processors.

It is clear, however, that the potential for partial vertical market foreclosure is enhanced when a firm acquires another firm that is either an actual or potential user of some of its products. Food processor/foodservice mergers are no exception. The data presented in Table 3.15 illustrate this potential. They also indicate the increased potential for reciprocity between food processors that have foodservice operations.

Food Processor/Foodservice Operations (1979)

In 1979, 46 of the 200 largest food and tobacco processors of 1975 operated over 14,700 foodservice establishments and had foodservice sales of nearly \$6.4 billion in the U.S. (Table 3.16). Their aggregate foodservice sales accounted for an estimated 10.6 percent of separate eating place sales in 1979.

The amount of foodservice sales varied widely among these food processors: 13 of these processors had less than \$20 million in foodservice sales; 25 companies had more than \$50 million in foodservice sales; 16 firms had sales in excess of \$100 million and 3

Table 3.15 Major Mergers and Acquisitions of U.S. Foodservice Firms Made
by the 200 Largest U.S. Food and Tobacco Processing Companies
of 1975, Classified by Principal Four-Digit Industry, 1965-1980.

Principal Food Industry ^{a/} (SIC)	Number of Acquiring Firms	Acquisitions					
		Number ^{b/}	Value of Transaction (\$ Million)	Franchisor/Company Owned		System ^{c/}	
				Sales (\$ Million)	Units	Sales (\$ Million)	Units
2011	4	7	23.9 ^{d/}	39.9*	240	213.9*	3,314
2013	1	1	^{d/}	321.4	800	321.4	800
2026	1	2	2.4 ^{d/}	49.2*	63	49.2*	63
202X	2	2	33.8	15.0*	101	15.0*	101
2033	2	4	30.5	89.5*	790	89.5*	790
2038	1	1	115.0	102.4*	328	297.5*	953
203X	2	4	35.4	47.8*	134	47.8*	134
2041	2	3	9.8	9.7*	46	53.0	347
2043	2	7	20.2 ^{d/}	79.0*	84	79.0*	84
2044	1	3	9.3 ^{d/}	21.0*	86	40.2*	148
2045	1	2	114.3	108.3*	133*	180.2*	393
2045	1	1	^{d/}	23.2*	40	30.2	52
2048	1	2	61.8	38.6*	282	38.6*	282
2051	4	6	266.4	322.4*	904*	322.4*	904*
2063	1	1	14.0	6.0*	30*	59.7*	300
2066	1	1	164.0	209.0	587	209.0	587
2067	1	1	^{d/}	78.6	475	78.6	475
2082	1	1	^{d/}	3.6*	12	3.6*	12
2085	1	3	315.8	226.1*	1,051*	703.0	3,731*
2086	1	1	18.0	21.8*	65*	190.1*	568
2087	1	2	444.3	490.2*	2,210*	776.3*	4,100*
2092	1	5	60.4 ^{d/}	180.7*	262	180.7*	262
2095	2	4	17.4 ^{d/}	125.0*	286*	233.0*	886*
2099	1	2	52.6	-0-	-0-	396.9*	3,623*
20XX	1	3	9.7-16.2	13.6*	70*	63.7*	710*
21XX	1	1	630.0	446.0	793	560.0	1,054
TOTAL	38	68	2,449.0-2,455.5	3,068.0	9,873	5,232.5	24,673

*Indicates estimate.

Table 3.15 (Cont'd.)

a/ Industry accounting for largest proportion of company food sales. In those cases where no four-digit industry accounted for at least 20 percent of food sales, then the primary three-digit (e.g., 201X) or two-digit (e.g., 20XX) industry is noted instead.

A description of the relevant two, three and four-digit industries is contained in Appendix A.

b/ Includes only those acquisitions where the acquired firm was involved primarily in the foodservice industry. Thus, for example, Green Giant's separate acquisitions of Hoffman House, Le Chateau and Henrici's are included; however, the subsequent acquisition of Green Giant and its restaurant operations by Pillsbury is not.

c/ Includes sales and establishments of both franchisors and franchisees.

d/ Value of acquisitions is not reported in all cases. Where possible, estimates have been made based on stock transfers and stock prices at the time of the transaction. In a few instances it was not possible to estimate the value of the merger or acquisition because either the acquisition involved assets other than those directly related to foodservice operations or the acquisition was small and not reported separately from other acquisitions made during the same year by the acquiring firm.

The relatively small acquisitions whose values are not reported include: 2026 (Southland: Lavicio's Sandwich Shops); 2043 (General Mills: Casa Galardo and Quaker Oats: Magic Pan and Engine House); 2044 (Riviana Foods: Lums franchise); 2046 (CPC International: Dutch Pantry); 2082 (Chock Full O'Nuts: Beef Corral); 2092 (W.R. Grace: Del Taco); and 2095 (General Foods: Rix System). Total estimated value of these acquisitions is believed to be less than \$25 million.

The larger acquisitions whose acquisition values are not reported include: 2011 (United Brands: A & W International and Baskin Robbins); 2013 (Hanson Industries: Interstate United Corp.); 2043 (General Mills: The Good Earth and Creative Dining Systems, Inc.); 2067 (Squibb: Dobbs House); 2092 (W.R. Grace: Jojo's) and 2095 (Nestlé: Stouffer's). Total estimated value of these acquisitions is believed to be \$200 million.

SOURCE: Company annual reports and 10K forms; Directory of the 200 Largest U.S. Food and Tobacco Processing Firms, 1975; Food Service Today, November 1976; Institutions, selected issues; Moody's Industrial Manual, selected years; Nation's Restaurant News, selected issues; Restaurant Business, selected issues.

Table 3.16 U.S. Foodservice Operations and Estimated Foodservice Sales
Made by the 200 Largest U.S. Food and Tobacco Processing Companies of 1975, 1979.

Company	U.S. Foodservice Operations	Franchisor/Company Owned		Systems ^{a/}	
		Sales (\$ million)	Units	Sales (\$ million)	Units
Pillsbury	Bennigan's, Burger King, Granny's Attic, Henrici's, Hoffman House, Holloway House, Hungry Jack, Hungry Lion, Le Chateau, Ontra Cafeteria, Orville Beans, Poppin Fresh Pie Shops, Rafter's	846.0	850*	2017.0*	2850
PepsiCo	Applegate's Landing, Pizza Hut, Taco Bell	716.1*	2529	1210.7*	4840
Ralston Purina	Barclay Jack's, Boar's Head, Hungry Hunter, Jack-in-the-Box, Monterey Jack's, Mountain Jack's, Stag & Hound, Taco Jack, The Boat House, The Dry Dock, Tortilla Flats, Whaling Station	544.4	869	544.4	869
Imperial Group, Ltd. ^{c/}	Ground Round, Howard Johnson, Lucky Lil's, New Edition, Red Coach Grill, The Choice is Yours	446.0	793	560.0	1054
General Mills	Betty Crocker Pie Shops, Casa Galardo, Fenimores, Hannahan's, Red Lobster, York Steak House	436.3	345	436.3	345
Hanson Trust	Interstate United	322.1	800*	322.1	800*

Table 3.16 (Cont'd.)

W.R. Grace^{d/}

	Annie's Santa Fe, Baxter Street, Cano's, Chantclair, Coco's Coffee Shop, Del Taco, El Torito-La Fiesta, Gorda Liz, Houlihan's Old Place, Moonraker, Plank- house, Reuben's, Reuben E. Lee, Sam Wilson's Meat Market, Sandpiper, Sunday's	320.0	430	320.0	430
ITT	Sheraton Inns and Hotels	295.7*	471*	630.0	1004
Squibb ^{e/}	Dobbs House, Steak & Egg Kitchens	269.0	476	269.0	476
Heublein	H. Salt Seafood, Kentucky Fried Chicken, Zantigo Mexican-American	246.1	783	1582.8*	4455
Hershey Foods	Friendly Ice Cream	245.0	600	245.0	600
Imasco	Hardee's Food System	220.0	449	750.0	1231
Nestle	Stouffer's	171.7*	60	171.7*	60
Greyhound	Burger King (franchisee), National Air Catering Service, Post House, Prophet Co.	170.7*	450	170.7*	450
R.J. Reynolds	Del Monte Service System	122.8	1026	122.8	1026
General Foods	Burger Chef, GuadalaHARRY'S, Meriwether's	113.8*	245	245.0*	755

Table 3.16 (Cont'd.)

Quaker Oats	Engine House Pizza, Magic Pan, Proud Popover	84.0	95	84.0	95
Royal Crown	Arby's	75.5	138	433.0	928
Amfac	Fred Harvey, Island Holidays	74.9	85	74.9	85
Southland	Charles and Co. Sandwich, Landshire Food Systems, Lavicio's Sandwich Shops	70.8*	82*	70.8*	82*
Jewel Cos.	Brighams Ice Cream, Mass Feeding Corp.	67.4*	1148*	67.4*	1148
Loew's Corp.	Leow's Hotels	61.6	59	61.6	59
Rapid American	Holland House, Wm. Talley House	57.0*	480	57.0*	480
Campbell Taggart	El Chico	51.3*	98	56.0	107
Colgate-Palmolive ^{f/}	Ranch House, Lum's (franchisee)	50.0*	79*	50.0*	79*
Campbell Soup	Hanover Trail, Herfy's, Pietro's	46.6*	38	58.0	81
Consolidated Foods	Lyon'et, Lyon Inn, Lyons Restaurants	43.7	42	43.7	42
American Stores	Alphy's, Hardee's (franchisee)	33.0	58	33.0	58
International Multifoods	Boston Sea Party, Mr. Donut, T. Butcherblock	30.2	20	144.6*	508*

Table 3.16 (Cont'd.)

Dean Foods ^{g/}	Baskin Robbins (franchisee)	30.0*	292	30.0*	292
Chock Full O' Nuts	Beef Corral, Chock Full O' Nut Fairs	27.6*	48	35.6*	62
IC Industries ^{h/}	Stuckey's	27.0*	295	27.0*	295
Anheuser Busch	Busch Entertainment Corp.	20.4	48	20.4	48
CPC International	Dutch Pantry, Keg and Kettle	19.0*	31	47.2*	77
Beatrice	Krispy Kreme Donuts	12.4*	124	12.4*	124
Hunt Inter- national Resources	Shakey's Pizza	11.6*	35*	153.5	465
Federal	Holly Farms Chicken	7.5*	100*	7.5*	100*
Con Agra	Taco Plaza	6.0*	30	8.6*	43
General Host	Hot Sam	4.8*	120*	4.8*	120*
J. Lyons	Baskin Robbins Ice Cream, TFI Companies	0	0	658.9*	4422*
United Brands	A & W International	0	0	255.0	1340

Table 3.16 (Cont'd.)

Esmark	Dipper Dan	n.a.	n.a.	30.6*	340
Dibrell Bros.	Briarpatch Kentucky Rib-Eye	n.a.	n.a.	n.a.	n.a.
Hubbard Milling	Henry's Drive-In (franchisee)	n.a.	n.a.	n.a.	n.a.
Smithfield Foods	Smithfield Inn	n.a.	n.a.	n.a.	n.a.
United Biscuit	Carry Out Bars	n.a.	n.a.	n.a.	n.a.

Total		6,398.0	14,721	12,223.0	32,725

Table 3.16 (Cont'd.)

n.a.--not available.

*Indicates estimate.

a/ Includes sales and establishments of both franchisors and franchisees.

b/ Pillsbury attempted to sell its Henrici operations in 1980.

c/ The proposed acquisition of Howard Johnson's by Imperial Group, Ltd. was announced in late 1979; the merger was completed in 1980.

d/ W.R. Grace announced plans to acquire Jojo's Restaurants, a chain of 145 coffee shops, in early 1980. Grace expects Jojo's to contribute approximately \$50 million in additional foodservice sales to its existing foodservice operations.

e/ In its 1979 annual report, Squibb revealed plans to divest itself of its foodservice operations during 1980.

f/ Colgate-Palmolive was not originally included among the 200 largest food and tobacco processing companies of 1975. However, its 1976 acquisition of Riviana Foods, who was included among that group, would have placed Colgate in that select group.

In its 1979 annual report Colgate revealed plans to divest itself of its foodservice operations.

g/ Baskin Robbins is owned by J. Lyons and Co. Dean Foods has a franchise to operate Baskin Robbins stores in parts of the U.S.

h/ Pet, Inc., who originally acquired Stuckey's in 1964, was acquired by IC Industries in 1976.

Source: Company annual reports and 10k forms; Directory of the 200 Largest U.S. Food and Tobacco Processing Firms, 1975; Food Service Today, November 1976; Institutions, July 15, 1980; Moody's Industrial Manual, 1980; Nation's Restaurant News, selected issues; Restaurant Business, May 1980.

firms made over \$500 million in foodservice sales in 1979 (Table 3.16). Foodservice operations were an important source of revenue for some of these firms. Sales from foodservice operations accounted for over 39 percent of Pillsbury's total revenues, about 14 percent of Heublein's and PepsiCo's revenues and about 12 percent of the total sales made by General Mills and Ralston Purina in 1979. The profit contributions of foodservice operations were of similar magnitudes for these firms.

Foodservice operations owned by food processors spanned the major market segments within the foodservice sector; however, activity was greatest in the limited-menu and dinner house segments. Twenty-seven of the 46 processors operated and/or franchised limited-menu operations, and 15 firms operated dinner house restaurants in 1979 (Table 3.17). In total, 34 of the 46 firms operated and/or franchised foodservice establishments in at least one of these two broad market segments, and 8 firms had at least one operation in both segments. Food processor sales in each of these market segments exceeded \$2.1 billion in 1979. Together these segments accounted for 68 percent of foodservice sales and 58 percent of the foodservice establishments operated by food processors in 1979 (Table 3.18).

Most food processors have restricted their foodservice operations to a single broad market segment. Only 11 of the 46 companies had foodservice operations in more than one market segment, and only one of the firms operated in more than 2 market segments in 1979. It is not uncommon, however, for these firms to operate more than one distinct foodservice operation within a given market segment. This is particularly true of firms operating in the dinner house

Table 3.17 Major Foodservice Market Segment Participation by the 200 Largest U.S. Food and Tobacco Processors of 1975, 1979.^{a/}

Firm Sales Rank	Number Firms	Foodservice Market Segment					Other ^{b/}
		Coffee Shop	Dinner Houses	Family Restaurants	Food Management	Limited Menu	
1-10	6	1	2	-0-	1	5	-0-
11-20	6	-0-	4	-0-	-0-	3	1
21-50	6	-0-	2	2	-0-	4	-0-
51-100	11	1	2	1	1	7	-0-
101-200	17	4	5	2	1	8	1
<hr/>							
Total	46	6	15	5	3	27	2

^{a/} Column entries are the number of firms in a given size class with at least one foodservice operation in the relevant market segment.

^{b/} Includes foodservice operations in amusement parks and other recreational areas.

Source: Company annual reports and 10K forms; Directory of the 200 Largest U.S. Food and Tobacco Processing Firms, 1975; Institutions, July 15, 1980; Moody's Industrial Manual, 1980.

Table 3.18 U.S. Foodservice Operations and Foodservice Sales of the
200 Largest Food and Tobacco Processing Companies of 1975,
Classified by Type of Foodservice Operations, 1979.

Restaurant Operation	Number of Firms	Franchisor/Company Owned		System ^{a/}	
		Sales (\$ Million)	Units	Sales (\$ Million)	Units
Cafeteria/Caterers/ Vending	6	730.8	3,767	730.8	3,767
Coffee Shop	3	725.8	1,487	828.9	1,723
Dinner House/ Theme Restaurants	15	2,105.1	1,918	2,450.3	2,474
Family Restaurants	4	341.0	756	369.2	802
Limited Menu:	32	2,443.0	6,583	7,784.2	23,735
Chicken	2	249.0	843	1,562.8	4,354
Donuts	2	13.6	130	128.0	618
Hamburger	5	665.7	1,210	2,598.0	4,502
Ice Cream	5	57.2	390	746.7	5,152
Mexican	5	250.3	908	406.1	1,478
Pizza	4	590.8	2,000	1,083.0	4,230
Roast Beef	3	81.6	158	451.2	993
Steak	1	60.8	90	60.8	90
Varied	5	474.0	854	747.6	2,318
Other	6	52.3	212	59.6	224
TOTAL	66	6,398.0	14,721	12,223.0	32,725

^{a/} Includes sales and establishments of both franchisors and franchisees.

SOURCE: Company annual reports and 10K forms; Directory of the 200
Largest U.S. Food and Tobacco Processing Firms, 1975; Institutions, July
15, 1980; Moody's Industrial Manual, 1980; Restaurant Business, May 1980.

segment. Variations in restaurant decor and menu offerings are common in this segment, and firms often experiment with different restaurant concepts in an effort to find an unfilled market niche.

Multiple foodservice operations are less common within the other market segments. For example, only 2 of the 27 firms with limited-menu operations owned and/or franchised more than one type of limited-menu foodservice outlet, and neither of these firms operated or franchised more than one type of operation in any individual sub-segment within the limited-menu segment.

Food Processor/Franchise Foodservice Operations

In 1979, 18 food processors owned foodservice firms that sold franchises. Fourteen of these firms owned one foodservice franchisor; 3 firms owned or had controlling interest in 2 separate foodservice franchisors and one firm (Heublein) controlled 3 separate franchisors. Total sales from these franchisor-owned establishments slightly exceeded \$2.5 billion in 1979 and represented nearly 40 percent of the foodservice sales made by large food and tobacco manufacturers (Table 3.19). Total sales generated by these franchise systems were about \$8.3 billion. Limited-menu operations accounted for most of these sales. Slightly less than 70 percent of franchisor sales and nearly 85 percent of system-wide sales were generated by limited-menu operations.

The penetration of food processors into franchise foodservice operations is significant. Franchisors owned or controlled by food processors accounted for an estimated 31 percent of total franchisor foodservice sales and 36 percent of franchisor-owned establishments

U.S. Food and Tobacco Processors of 1975, Classified by Type of Foodservice Operations, 1979^{a/}

Table 3.19 Foodservice Franchising Operations of the 200 Largest

Restaurant Operation	Franchising Companies				Companies Operating as Franchisees		
	No.	Franchisor Owned		System ^{b/}	No.	Sales (\$ million)	Units
		Sales (\$ million)	Units				
Coffee Shop	1	354.9	631	458.0	867	0	0
Dinner House/Theme Restaurant	2	386.8	633	732.0	1,191	0	0
Family Restaurant	1	19.0	31	47.2	77	0	0
Limited Menu:	18	1,731.6	4,767	7,072.7	17,169	4	374
Chicken	1	241.5	743	1,555.3	4,254	0	0
Donuts	1	1.2	6	115.6	494	0	0
Hamburger	3	617.7	1,128	2,549.9	4,420	2	82
Ice Cream	2	0	0	689.5	4,762	1	30.0
Mexican	4	228.3	757	384.1	1,327	0	0
Pizza	2	561.3	1,975	1,053.5	4,205	0	0
Roast Beef	3	81.6	158	451.2	993	0	0
Varied	2	0	0	273.6	1,464	1	n.a.
Other	1	24.1	38	31.4	50	0	0
Total	23 ^{a/}	2,516.4	6,100	8,341.3	24,104	4	374

n.a.--not available.

^{a/} The number of food processors offering foodservice franchises is 18. The difference between that figure and the total number of franchising companies (23) is due to the fact that some food processors offer franchises under more than one franchise system.

^{b/} Includes sales and establishments of both franchisors and franchisees.

Source: Company annual reports and 10K forms; Directory of the 200 Largest U.S. Food and Tobacco Processing Firms, 1975; Institutions, July 15, 1980; Moody's Industrial Manual, 1980.

in 1979. Franchise systems sponsored by food processor-owned franchisors accounted for nearly 34 percent of all franchise sales and nearly 41 percent of all franchise establishments in 1979. Ten of the 25 largest foodservice franchisors (including 6 of the 10 largest) were owned or controlled by large food processors in 1979.

Some food processor-owned franchisors are very important in the sub-markets within the limited-menu segment. Franchise systems sponsored by these processors accounted for over 68 percent of the sales made by firms specializing in preparation of chicken, over 49 percent of the sales made by firms specializing in pizza and over 20 percent of the sales made by franchise hamburger operations. These processors also accounted for over 55 percent of the franchise sales made by firms specializing in Mexican-style foods, which is one of the fastest growing sub-markets within the limited-menu segment.

Foodservice Sales/Size of Food Processors

As was the case with mergers, firms ranked among the 50 largest food and tobacco processors in 1975 accounted for a large share of the foodservice sales and establishments operated by large food and tobacco processors. Eighteen of those 50 largest companies had foodservice operations in 1979. Their average foodservice sales were about \$210 million. These firms jointly accounted for nearly 61 percent of the foodservice sales made by large food processors and about 55 percent of the foodservice establishments operated by those processors in 1979 (Table 3.20). It is estimated that

Table 3.20 U.S. Foodservice Operations of the 200 Largest U.S. Food and Tobacco Processing Companies of 1975, Ranked by Size of Processor^{a/}, 1979.

Firm Sales Rank	Foodservice Operations				
	Firms	Franchisor/Company Owned		System ^{b/}	
		Sales (\$ Million)	Units	Sales (\$ Million)	Units
1-10	6	964.1	2,714	1,225.9	3,564
11-20	6	970.7	962	1,571.4	2,878
21-50	6	1,954.9	4,330	4,985.4	12,359
51-100	11	672.9	1,903	936.5	2,843
101-200	17	1,835.4	4,812	3,503.8	11,081
TOTAL	46	6,398.0	14,721	12,223.0	32,725

^{a/} Ranking is based on estimated company sales in U.S. food and tobacco processing; it does not include any foreign food processing sales of these firms.

^{b/} Includes sales and establishments of both franchisors and franchisees.

SOURCE: Company annual reports and 10K forms; Directory of the 200 Largest U.S. Food and Tobacco Processing Firms, 1975; Institutions, July 15, 1980; Moody's Industrial Manual, 1980; Nation's Restaurant News, selected issues; Restaurant Business, May 1980.

those 18 firms alone accounted for about 6.5 percent of all separate eating place sales in 1979.

The foodservice operations of these firms were also more diverse than those of other large food processors. Seven of the 18 firms owned and/or franchised at least one foodservice operation in two separate market segments within the commercial foodservice sector in 1979. Only 4 of the remaining 28 large food processors operated in more than one major foodservice market segment in 1979. Eight of the 18 companies were limited-menu franchisors, and 5 of the 8 firms owned and/or controlled 6 of the 25 largest U.S. foodservice franchisors in 1979. The franchise systems sponsored by those 5 companies accounted for nearly 20 percent of all franchise foodservice sales in 1979.

The 28 remaining large food and tobacco processors had average foodservice sales of about \$90 million in 1979. Ten of these firms were franchisors; however, on average their franchise systems were smaller on both a sales and establishment basis than those systems sponsored by larger processors. System-wide franchise sales averaged about \$276 million for these franchisors in 1979, compared to average system-wide sales of \$618 million for larger processor/franchisors. Systems sponsored by smaller processors had 878 establishments on average, compared to an average of 1,770 establishments for larger processors.

Limited-menu operations and dinner house restaurants were the most common types of foodservice outlets owned and/or franchised by second tier processors. Fifteen companies had at least one limited-menu operation, and 7 firms had dinner house operations in 1979.

Most of the processors confined their foodservice activities to a single market segment. Only 4 of the 28 processors in the group had foodservice operations in more than one major market segment, and only one firm had more than one type of limited-menu outlet.

Four-Digit Classification of Food Processors

The 46 food and tobacco processing companies with foodservice operations in 1979 had very different primary processing activities. This diversity is evident when the firms are classified on a 4-digit (industry) basis, using value of shipments as the classification criterion (Table 3.21). It is also apparent from such a classification that there is no readily observable pattern linking foodservice operations with the primary industry of the manufacturer/owner. In general, there were only one or two processors with foodservice activities within any given primary industry classification. This diversity would seem to suggest that the ownership of foodservice operations is not necessarily conditional upon the specific food processing activities of the parent organization.

In reaching such a conclusion, however, it is important to recognize that many of these food processors are highly diversified within their food processing activities. A relatively simple classification such as that used above does not indicate the extent of this diversity. Inferences drawn from such a classification format must be tempered by a realization of the limitations of that format. Without a more detailed analysis of the processing activities of these large processors, it is not possible to make any definitive statements regarding any systematic linkages between their processing and foodservice operations.

Table 3.21. U.S. Foodservice Operations and Estimated Foodservice Sales of the 200 Largest U.S. Food and Tobacco Processors of 1975, Classified by Principal Four-Digit Industry, 1979.

Principal Food Industry ^{a/} (SIC)	Number of Firms	Foodservice Operations			
		Franchisor/Company Owned		System ^{b/}	
		Sales (\$ million)	Units	Sales (\$ million)	Units
2011 ^{c/}	5	208.5*	628*	494.1*	2,308*
2013 ^{c/}	2	322.1	800	322.1	800
2016	1	7.5*	100*	7.5*	100*
2026	2	100.8*	374*	100.8*	374*
202X	1	12.4*	124	12.4*	124
2038	1	220.0	449	750.0	1,231
203X	2	121.5*	123	132.9	166
2041 ^{c/}	3	36.2*	50	153.2*	551*
2043	2	520.3	440	520.3	440
2044	1	50.0*	79*	50.0*	79*
2045	1	846.0	850*	2,017.0*	2,850
2046	1	19.0*	31	47.2*	77
2048	1	544.4	869	544.4	869
2051	3	414.4*	1,717*	753.4*	2,259
2052	1	n.a.	n.a.	n.a.	n.a.
2063	1	11.6*	35*	153.5	465
2066	1	245.0	600	245.0	600
2067	1	269.0	476	269.0	476
2082	2	48.0*	96	56.0*	110
2085	2	303.1*	1,263	1,639.8*	4,935
2086	2	102.5	433	460.0	1,223
2087	1	716.1	2,529	1,210.7*	4,840
2092	1	320.0	430	320.0	430
2095	2	285.5*	305	516.7*	815
2099	1	-0-	-0-	658.9*	4,422*
20XX	1	43.7	42	43.7	42
2111	2	184.4	1,085	184.4	1,085
2141	1	n.a.	n.a.	n.a.	n.a.
21XX	1	446.0	793	560.0	1,054
TOTAL	46	6,398.0	14,721	12,223.0	32,725

Table 3.21 (Cont'd.)

n.a.--not available.

*Indicates estimate.

a/ Industry accounting for largest proportion of company food and tobacco sales. In those cases where no four-digit industry accounted for at least 20 percent of food or tobacco sales, then the primary three-digit (e.g., 201X) or two-digit (e.g., 20XX) industry is noted instead.

A description of the relevant two, three and four-digit industries is contained in Appendix A.

b/ Includes sales and establishments of both franchisors and franchisees.

c/ Reported sales and units, both company and system-wide, for these four digit industries do not include all foodservice sales and units of the firms classified in these industries. The unreported sales and unit numbers are relatively small and are believed to total less than \$15.0 million and 40 units across all affected industries.

Source: Company annual reports and 10K forms; Directory of the 200 Largest U.S. Food and Tobacco Processing Firms, 1975; Institutions, July 15, 1980; Moody's Industrial Manual, 1980.

Merger Effects in 1979

As noted earlier, mergers between food and tobacco processors and foodservice firms were fairly common between 1965 and 1980. It is important to note, however, that not all of these mergers proved to be successful. Nineteen of the 70 foodservice firms acquired over this period either discontinued operation or were divested by their parent organization prior to 1980. In all but five of these cases, the elimination of these foodservice operations resulted in the total withdrawal of the food processor from direct participation in the foodservice sector.

While some acquisitions have not proven to be fruitful, many others have, and these are largely responsible for food processor ownership of foodservice operations in 1979. In fact, the holdings of 36 of the 46 food processors with foodservice operations in 1979 can be traced directly to mergers. An example of the extent and effect of these mergers can be seen by noting that each of the 23 franchise systems sponsored by food processors in 1979 was acquired via merger sometime between 1965 and 1979. Only one of these was a toehold merger; the rest were mergers that involved established foodservice franchisors, some of which were among the largest and most successful firms in their respective market segments. As a result of these mergers, food processors currently own and/or control the largest franchisors specializing in the preparation of chicken, roast beef sandwiches, pizza and Mexican-style food and two of the four largest hamburger franchisors. They also own

franchisors that hold leading positions in the coffee shop, family restaurant and dinner house segments within the foodservice sector. Without these mergers, the ownership of foodservice firms, especially large firms, by food processors would be limited.

Future acquisitions of foodservice firms by food processors seem assured if the pronouncements of some food processing executives are taken at face value.¹ It also seems likely that future acquisitions will both widen food processor participation by bringing those currently without foodservice operations into the sector, and deepen it by fortifying the position of firms currently with foodservice holdings.² Either result increases the potential for vertical foreclosure in the industry and hence raises serious antitrust questions. Future mergers should be closely scrutinized for their competitive consequences, particularly in those instances where the acquiring firm already has foodservice holdings or where the acquisition involves a strong foodservice firm with an established name.

¹ See, for example, the statements made by various food processor executives in Restaurant Business, May 1, 1980.

² An example was the proposed December 1980 acquisition of Bob Evans' Restaurants by Beatrice Foods (for an estimated \$200 million), which collapsed during final negotiations.

Chapter Summary

This chapter has examined some of the major factors that have influenced growth in the commercial foodservice sector over the past two decades. This sector, which includes foodservice operations that are generally available to the public-at-large, currently accounts for approximately 70 percent of all foodservice sales. The major types of commercial foodservice operations are limited-menu restaurants (primarily fast food operations), coffee shops, dinner houses, family restaurants and the foodservice operations in hotels and motels. Commercial foodservice sales were approximately \$70 billion in 1979, an increase of 220 percent over their sales in 1967.

Significant shifts have occurred in the proportion of sales accounted for by various types of commercial foodservice operations during the past 15 years. Fast food operations have become relatively more important. Census data for 1977 reveal that these operations accounted for 35.1 percent of all eating place sales and 33.7 percent of all eating place establishments. They accounted for only 18.1 percent of sales and 23 percent of the establishments in 1967.

Multi-unit foodservice operations have also become relatively more important over the past 15 years. In 1977, multi-unit operations accounted for 40.5 percent of all eating place sales and about 23 percent of all establishments. They accounted for only 23.7 percent of sales and 12 percent of all establishments in 1967. Approximately 85 percent of the 16.8 percentage point increase in the share of sales made by multi-unit foodservice operations resulted from the

expansion of fast food operations. Growth was particularly strong among fast food firms operating 11 or more units. These operations alone accounted for 60 percent of the increase in the share of sales made by all multi-unit foodservice operations.

Firms with \$50 million or more in sales have become more important within the commercial foodservice sector. In 1977, firms of this size accounted for 19 percent of commercial sales, compared to only 10.8 percent in 1972. About 22 percent of all fast food sales were made by fast food firms with sales of \$50 million or more in 1977. This was approximately twice their share in 1972.

National concentration estimates provided by the Bureau of Census are of limited usefulness in assessing either seller or buyer concentration levels in the commercial foodservice sector. Rivalry between foodservice firms, like that between grocery retailers, tends to be at a local (or at most, regional) market level. Relatively few firms' operations are truly national in scope. Therefore, in general, national concentration estimates will understate local market concentration levels, albeit to an unknown degree. In addition, the classification scheme used by Census does not effectively isolate some of the important market segments within the sector. The joint effect of these data limitations makes the national concentration estimates provided by the Bureau of Census virtually useless as indices of seller concentration in the sector.

National concentration estimates also significantly understate the level of buyer concentration in the sector. This understatement

occurs because Census does not take into account the effect of franchise system purchase programs. Many of the largest firms in the sector are franchisors. These firms often provide some type of purchasing program to assist their franchisees in procuring needed inputs. When such programs are operational, the franchisor can bring to bear the purchasing power of the system. In these instances the size of the franchise system, and not merely that of the franchisor, must be taken into account when considering potential market power in procurement.

The difference between the concentration estimates provided by the Census and those obtained by using system-wide franchise sales can be substantial. For example, the 1977 Census estimate of four firm concentration in the fast food segment of the sector was only 9.1 percent. By comparison, the aggregate sales of the four largest franchise fast food systems accounted for about 40 percent of all fast food sales that year. While the latter estimate may overstate buyer concentration levels because all franchisees do not participate in franchisor purchasing programs, it is clear that the potential market power in procurement is greater than Census estimates would indicate.

Franchising is an important activity for many foodservice firms, but is particularly important for fast food firms. Franchise restaurant systems had aggregate sales of nearly \$25 billion in 1979 and accounted for approximately 37 percent of eating place sales. In 1972, franchise restaurants accounted for only about 22 percent of eating place sales. Large franchise systems--those with more than 500 establishments--are particularly important;

they accounted for about 70 percent of all franchise foodservice sales and about 24 percent of all eating place sales in 1977. Sales made by fast food restaurants that were part of a franchise system represented about 69 percent of all franchise foodservice sales and approximately 62 percent of all fast food sales in 1977.

Franchisor-owned foodservice establishments accounted for 32.6 percent of all franchise foodservice sales in 1979, an increase of about 4 percentage points over their share in 1972. About 38 percent of these sales were made by firms specializing in the preparation of hamburger and roast beef sandwiches. Franchisee operations featuring these types of sandwiches were also very important. It is estimated that these operations accounted for 58 percent of all franchisee sales in 1979.

The four largest franchise foodservice systems--all of which were fast food systems--made approximately 40 percent of all fast food sales and an estimated 12.1 percent of commercial foodservice sales in 1979. System-wide sales averaged \$2.1 billion for these firms that year. The 25 largest franchise systems had aggregate sales in excess of \$17.3 billion in 1979. They accounted for about 70 percent of franchise sales and nearly 25 percent of commercial foodservice sales.

The 200 largest commercial foodservice systems had sales of approximately \$45 billion in 1979 and accounted for about 60 percent of sector sales. Sixty-four of these firms were primarily fast food firms and a total of 107 firms were involved to some extent in franchising. Of the 107 firms, 81 firms were franchisors and 26 were large franchisees. Forty-eight of the franchisors were primarily fast food

franchisors, 14 firms were franchisors of family restaurants and 14 firms were hotel or motel franchisors. Nearly all the firms were single system franchisors.

Ninety-four of the 200 largest commercial foodservice firms were owned and/or controlled by firms that derive most of their revenue from non-foodservice sources. Thirty-four of these firms had substantial food-related business activities; the remaining 60 firms operated primarily in non-food business sectors. Thirty-one of the firms with food-related business activities were food processors. These processors owned or controlled 4 of the 10 largest and 17 of the 50 largest commercial foodservice firms in 1979.

Mergers have been an important factor influencing ownership patterns in the commercial foodservice sector. Between 1976 and 1980, 32 of the 100 largest foodservice firms in 1979 were involved in at least one merger or acquisition; this included 9 of the 10 largest and 24 of the 50 largest firms. There were 11 conglomerate mergers, 7 of which involved food processors, and 14 firms made market-extension mergers during the period. Total foodservice sales acquired in these mergers were approximately \$3.57 billion.

Large food processors have been particularly active and successful suitors of foodservice firms. Thirty-eight of the 200 largest U.S. food and tobacco processors made a total of 70 separate mergers with foodservice firms between 1965 and 1980. Slightly over \$3 billion in sales and nearly 9,900 foodservice establishments were acquired in these mergers. In 9 of these mergers, sales of the acquired foodservice firm exceeded \$100 million in the year prior to acquisition. Merger activity was greatest among firms with limited-menu operations; approximately

1/3 of the acquired sales and 45 percent of the acquired establishments were in the limited-menu segment.

The very largest food processors were the most active merger partners for foodservice firms over the 1965-80 period. Exactly 1/2 of these mergers were made by 17 food processors, all of which ranked among the 50 largest food processors in 1975. Mergers consummated by these firms accounted for 46 percent of the sales and 53 percent of the establishments acquired by the 200 largest food processors. Eleven of the 17 processors made more than one acquisition and 5 of the firms made three or more separate acquisitions. Seventeen of the mergers made by these firms involved limited-menu operations.

In 1979, 46 of the 200 largest food and tobacco processors of 1975 operated over 14,700 foodservice establishments and had foodservice sales of nearly \$6.4 billion. Twenty-five of these firms had more than \$50 million in foodservice sales; 16 firms had sales in excess of \$100 million and 3 firms made over \$500 million in foodservice sales. Limited-menu and dinner house operations were the most common types of food processor/foodservice operations. Aggregate sales in these segments represented approximately 68 percent of all food processor/foodservice sales in 1979.

Eighteen food processors owned foodservice firms that sold franchises in 1979. Total sales of these franchisor-owned outlets exceeded \$2.5 billion in 1979 and represented nearly 40 percent of the foodservice sales made by the 200 largest food processors. About 70 percent of these sales were generated by limited-menu

operations. It is estimated that approximately 31 percent of all franchisor foodservice sales were made by franchisors owned and/or controlled by food processors in 1979. Franchise systems sponsored by food processor-owned franchisors accounted for about 34 percent of all franchise foodservice sales in 1979. Ten of the 25 largest foodservice franchisors (including 6 of the 10 largest firms) were owned by food processors in 1979.

Mergers were largely responsible for the foodservice operations owned by food processors in 1979. In fact, the holdings of 36 of the 46 processors with foodservice operations in 1979 were directly attributable to mergers. This includes each of the 23 franchise systems sponsored by food processors.

Within specific market segments, food processors owned and/or controlled the largest franchisors specializing in the preparation of chicken, roast beef sandwiches, pizza and Mexican-style food and two of the four largest hamburger franchisors in 1979. Food processors also controlled foodservice firms that held leading positions in the coffee shop, family restaurant and dinner house segments of the commercial foodservice sector.

CHAPTER IV

BEEF AND POULTRY PROCUREMENT PROCEDURES EMPLOYED BY LIMITED-MENU FOODSERVICE FIRMS

Introduction

The primary emphasis of this study is to delineate the standard operating procedures used by limited-menu foodservice firms in the procurement of beef and poultry (i.e., chicken) products for their retail operations. This chapter examines these procedures in detail. Both primary and secondary data sources are used to develop an overview of relevant procurement procedures, although primary sources are relied upon most heavily. Structural differences in firm organization are used as control variables to allow comparisons and contrasts in procurement procedures to be drawn. Interactions between processors, foodservice distributors and limited-menu firms are examined, particularly as they relate to the functional division of procurement and distribution activities.

The Role of the Purchasing Agent

The theoretical constructs summarized in Chapter II suggest that the SOPs utilized by firms directly impact on firm decision processes, and further that these procedures also have spillover effects on the external relationships between vertically adjacent firms that affect coordination processes. The agent within the foodservice firm that implements and often develops these procedures is the purchasing agent.

Thus, in order to understand how procurement SOPs influence vertical coordination processes, it is important to examine the role of the purchasing agent.¹ Perhaps the most straightforward way to gain this insight is to briefly outline some of the general responsibilities of purchasing agents. These responsibilities would normally include the following:²

Task Performance Activities:

Purchase Activities:

- . Purchase products at lowest possible cost subject to quality standards and specifications.
- . Institute search procedures for alternative sources of supply; select suppliers and establish working relationship with same. Negotiate prices and delivery arrangements as required.
- . Establish and maintain distributor network. Negotiate inventory requirements, establish preliminary inventory reorder points and negotiate delivery and inventory handling costs.
- . Establish product standards and specifications (in conjunction with quality assurance department, if separate).

Control Activities:

- . Monitor quality control reports to evaluate supplier performance.
- . Monitor inventory levels of distributors for compliance with established levels.
- . Monitor distributor price levels (monthly), check accuracy, forward to accounting department for payment.

¹In this context the term "purchasing agent" refers to those individuals within the foodservice firm that are directly involved in both the purchase and distribution of food and paper items.

²Developed from data collected during personal interviews and from information contained in selected trade journal articles.

Price Analysis and Demand Activities:

- . Forecast food prices quarterly and for fiscal year.
- . Modify forecasts as need be in light of significant price changes.
- . Evaluate strategies for locking-in food costs.
- . Estimate product requirements (yearly) with assistance from Marketing Department.

Report Activities:

- . Forward quarterly and yearly food price forecasts to Operations Department for use in budget process.
- . Provide performance evaluation reports to suppliers and distributors as required.
- . Quarterly and year-end comparisons of actual and forecasted food costs (post-budget evaluation).

The above is a generalized job description for a purchasing agent and would need to be modified slightly to reflect differences in firm organizational structures. It is apparent, however, that the specific procedures operationalized by purchasing agents have implications for vertical coordination processes. It remains to examine these procedures in detail and to analyze their impact on vertical coordination processes.

Procurement and Distribution Practices: A Perspective

Before any detailed discussion of beef and poultry procurement practices can begin, it is important to have some understanding of the general procurement and distribution practices used by limited-menu foodservice firms. These general procedures influence not only the procurement but also the distribution practices employed for beef and poultry products. Many of these procedures are standardized across similarly structured firms in the sector and thus can be viewed

generally as standard industry practices. Where any significant deviations from these practices occur they will be treated separately.

As noted in Chapter III, the preponderance of large firms operating in this sector are either franchisors or large franchisees. These firms are not usually vertically integrated into either commissary or foodservice distribution activities.¹ Since non-vertically integrated, franchise firms are most typical of large firms in the sector, the discussion of general procurement and distribution practices begins with this type of firm.

The general procurement procedures used by limited-menu franchisors result in a situation where the purchasing agent is largely removed from daily purchase and distribution decisions. The agent's primary role is that of a monitoring and control agent who oversees the purchase, but does not actually purchase commodities or products on a continuous basis. To understand this process, we must examine the linkages that exist between food processors, foodservice distributors (wholesalers), retail level store operators and the purchasing agent because each of these is involved in purchase and distribution activities.

For many products (primarily processed food and paper products), the franchisor's purchasing agent negotiates directly with food and paper processor/suppliers. The agent provides processor/suppliers with estimates of anticipated product requirements for a fixed future period (usually 6 months to a year) and requests bids covering those quantities. Based on these bids, the purchasing agent selects a supplier(s) and enters into a contractual agreement. These master supply agreements

¹Commissaries are food processing facilities. Distribution activities encompass storage and delivery functions, but do not include physical transformation processes.

are open-ended purchase agreements that permit any designated distributor to order and draw products against the master agreement under the terms set forth in the agreement. The master supply agreement allows the agent to secure a known quantity and quality of product at a fixed price per unit for a definite time period. Contracts of this type are typically used for canned and/or frozen food products (except frozen meat) and paper items.

The link between the food processor and the retail level is completed by the foodservice distributor. These distributors perform functions for foodservice operators that are similar to the functions grocery wholesalers perform for grocery retailers. These functions include: 1) inventory ordering and control activities, 2) storage activities, and 3) order taking, consolidation, and delivery to retail units. The functions performed by these distributors are critical to the physical flow of products through the foodservice sector.

Purchasing agents secure the services of foodservice distributors by entering into written contracts with them (some may be less formal agreements). These contracts normally specify the services to be provided by the distributor, the area(s) to be serviced, the duration of the contract, and the terms under which payment is to be made. Where both the franchisor and distributor are multi-market or multi-region operators, the agreement may cover either single markets or span multiple markets. The duration of these contracts vary somewhat, however, most are written for one year. Clauses written into the agreements normally provide for termination by either party with 60 to 90 days written notice. Pricing arrangements also vary across firms depending on the size of the account and the frequency of

product turnover in the distribution facility. As a general rule, however, the contracts specify some type of cost plus pricing arrangement. These pricing arrangements remain fixed for the duration of the contract, but are subject to renegotiation during contract renewal periods.

Franchisor-owned retail outlets are assigned a particular food-service distributor by the purchasing agent and must purchase available food and paper products from that source.¹ By controlling retail level input purchases this way, the franchisor organization consolidates the aggregate product flows generated by its retail outlets and directs them toward specific distributors. This maximizes the firm's product turnover at a distributor's facility and may ultimately result in lower distributor handling costs. In those instances where turnover increases substantially, subsequent distributor contracts with franchisors may reflect the higher product turnover rates through lower distributor margins.

Once a distributor has been selected it is a relatively simple process to establish delivery schedules for retail outlets. These schedules are developed based on the needs of individual units. Since the in-store storage capacity of limited-menu restaurants is restricted, most retail outlets require deliveries of canned and frozen food products and paper goods at least once per week. High traffic stores often require deliveries more frequently and may receive products two or even three times per week.² To facilitate deliveries the distributor and

¹Bakery and dairy products are purchased locally and often are not purchased from foodservice distributors.

²Deliveries of fresh products (e.g., dairy and bakery products) are required more frequently than once per week. These products are often purchased from local firms and are not usually delivered by foodservice distributors.

retail store manager establish a standardized delivery schedule which establishes the day and approximate hour when deliveries are to be made. Since deliveries usually lag order placement by one or two days, the retail unit manager knows when he must evaluate his inventory position and place his order with the distributor if product is to be received during the next distributor delivery.

The coordination between the retail level and the distributor level is facilitated by the relatively small number of products that are handled in the exchange. Most limited-menu restaurants require fewer than 250 food and paper items in their operations, and some of these firms (primarily fast food) may require as few as 50 products. The relative stability of retail sales and the tendency for limited-menu firms to maintain their menu structure over long periods of time contribute to the overall stability of product demand at the distributor level. This greatly facilitates the planning and inventory control activities that are required at the distributor level.

When franchise limited-menu firms contract with foodservice distributors for distribution services, the franchisor's purchasing agent is largely removed from direct involvement in day-to-day buying and distribution activities. The purchasing agent organizes the buying and distribution functions, but usually does not physically place orders or establish delivery schedules either at the wholesale or retail levels. In most cases these activities are performed by personnel who work at the appropriate level in the marketing system. The separate supplier and distributor contract systems allow the purchasing agent to separate the physical flow of products within the system from the price-making process. Since many product prices are negotiated

and fixed in advance of product shipment, as are distribution costs, the purchasing agent need not be involved in daily buying activities. This type of purchasing system economizes greatly on personnel costs and is the primary reason why even very large firms may have only two or three people directly involved in procurement activities.

Franchisor/Franchisee Procurement Arrangements

In Chapter III it was noted that franchisors are prohibited from requiring that their franchisees purchase products from either the franchisor organization or designated third parties as a condition of their franchise agreement. The only exception is where it can be shown that a tied-product is required for the continued maintenance and goodwill of the franchise system. Under current court interpretations the only food products that might justify a tie-in are those where it is not possible to develop product specifications without revealing trade secrets. The distribution of most food products is not restricted by tie-in arrangements. The few products that are tied tend to be syrups, special seasonings and flours.

Franchisors cannot unilaterally restrict franchisee food purchases to a single designated supplier or distributor. However, they apparently can, and often do, limit the number of both suppliers (food processors) and distributors (wholesalers) that are available to franchisees. This is accomplished by franchisors through the use of approved lists of suppliers and/or distributors. These lists designate those processors and/or distributors that have met the franchisor's established product and/or service standards. Although, as a general rule, franchisors approve more than one product supplier and more than one foodservice distributor in a given market area, the number of

processors and/or distributors whose products and/or services are available to a given franchisee is smaller than the number of processors and/or distributors who are potential suppliers in that market. Franchisees have some choice in the selection of their distributors but they must often choose from a group approved by their franchisor.

Franchisor approval procedures typically provide some mechanism to accommodate changes in suppliers and/or distributors. Approval of new suppliers is often made at the request of franchisees and is usually conditional upon the proven ability of the supplier to meet the quality and service standards established by the franchisor.¹ In those instances where laboratory testing is required to assure compliance with product standards, the costs of such testing are normally borne by the supplier. Most franchise agreements contain clauses that specify the franchisor's right to approve sources of supply.² Some agreements specify the right of distributor approval as well, although distributor approval is less common than supplier approval.

The supplier approval system employed by most franchisors serves a dual purpose. First, it provides a means for more direct control over the quality of food and paper products used by participants in the franchise system. Standardization of product quality is essential to package franchise systems. By maintaining some control over the quality of purchased inputs, the franchisor essentially guarantees the quality of inputs used by franchisees, which is the first step toward

¹This is particularly true in the procurement of fresh products such as bakery items, dairy items, produce and, in some cases, beef or poultry items.

²See Appendix B for examples.

standardizing the quality of outputs.¹ Second, approval systems strengthen the position of the franchisors in negotiating contracts with product suppliers. Total franchise system product purchases, rather than just those generated by franchisor-owned facilities, can be brought to bear during negotiations with suppliers. This may result in lower product costs than either the franchisor or its franchisees could negotiate if they acted alone or in smaller groups. Since it is uncommon for franchisor-owned units to account for more than one half of total systems units, these procedures may increase the quantities being negotiated by a factor of two or more.

This strategy is particularly effective when products can be purchased in national or large regional markets. Canned and frozen food items and paper products are especially well suited to this type of procurement control. Fresh products, which are typically purchased in local markets, are not well suited to this process because the procurement power of the entire franchise system cannot be brought to bear directly. Franchisors also approve fresh product supply sources, but primarily for quality control rather than for procurement leverage purposes.

Approved foodservice distributor networks are common among franchise systems, but are not used as extensively as supplier approval programs. The data in Table 4.1 illustrate this fact. Of the 20 largest franchise systems that used beef and/or poultry products in 1979, 13 approved distributors for their franchisees. However, all

¹Quality of output is also a function of the production techniques used at the retail level. Specific storage and cooking procedures coupled with random quality checks by both in-store and district or regional supervisors are controls on this process.

Table 4.1 Methods Used by Franchisors to Control Quality and/or Source of Food Products Purchased by their Franchisees, 1979.

Firm Sales Rank ^a	Specifications/ Standards ^b	Private Label Programs	Approved Beef or Poultry Fabricator	Approved Foodservice Distributor	Direct Sales ^c to Franchisees	Require Purchases ^d by Franchisees
-----No. of Firms using-----						
1-10	10	9	10	8 ^e	5	3
11-20	10	6	10	5 ^f	5	3
Total	20	15	20	13	10	6

^a/Ranking is based on system-wide sales in 1979. Includes only those limited-menu franchise systems which use significant quantities of beef and/or poultry (chicken) products.

^b/Standards for beef and poultry only.

^c/Franchisee food product purchases from franchisors. Includes a broad range of food products.

^d/Franchisee food product purchases required as part of franchise agreements. These purchases are primarily for special seasonings and blended flours. They may be purchased from either the franchisor or designated third parties.

^e/Does not include one franchisor that approves products but not distributors.

^f/Does not include one franchisor that approves products but not distributors, and one franchisor that withholds the right to disapprove distributors.

Source: Company annual reports and 10K reports; FTC A & W International file data; selected industry reports.

20 franchisors had some type of approval program for their beef and/or poultry suppliers. One reason for this difference is that while franchisees may accept some limitations on their procurement options at the processor level, they see no reason for that limitation to extend to the distribution level. In addition, the way most master supply arrangements are set up virtually any distributor can draw products against the agreement at a fixed price. Under these circumstances, franchisees feel they should have the right to choose their own distributor. Franchisors concede this point, and the approval of distributors is often nothing more than a formality for most of them.

Despite relatively fewer franchisor constraints on distributor activity, there remains a strong economic incentive for franchisors to consolidate the number of distributors servicing both franchisor-owned and franchised retail units in a given market. Inventory costs can be reduced at the distributor level by increasing the rate of product turnover, other factors assumed constant. If franchisee purchases are consolidated with those of the franchisor, the prospects for higher turnover levels are enhanced. Ultimately, these lower costs may be reflected in reduced markups or margins negotiated with the distributor. When distributor margins are lowered both franchisor-owned and franchised retail outlets benefit.

Distributor consolidation is more difficult for franchisors to achieve when a large proportion of purchased inputs are national brand products. In a given market area there may be many distributors who have access to national brand suppliers. Each is a potential distributor for franchisees because they often carry national brand products as standard inventory items. When this is the case, the distributor

need not stock new items, but rather can service retail outlets from its standard inventory format.

Distributor consolidation is much easier to achieve when franchisors specify either distributor label products or their own private label products. In the former case, only distributors with approved labels are available to franchisees. Although franchisors are careful to make sure there is more than one local distributor available to franchisees, the number of approved distributors tends to be smaller than the total number of distributors in the market and distributor consolidation results.

When distributor labels are specified or approved for use, the purchasing agent normally negotiates directly with the distributor over the unit prices of the products the franchise system requires. Fixed price agreements of six months to a year's duration are relatively common. The unit prices negotiated may include delivery costs or these costs may be negotiated separately.

Private label products packaged specifically for use in franchise systems restrict franchisees' choice of distributors perhaps even more so than the use of distributor label products. The reason for this is simply that while many distributors in a given market may be able to purchase franchise label products, these products can only be used in franchise system outlets. Thus, unlike either national brand or distributor label products, which potentially can be sold to a wide range of foodservice operations, the market for private label products is highly specialized. The relatively limited market for these items, coupled with distributor preference for an adequate volume and high turnover of inventory items, results in a situation where it is often

prohibitively costly for a large number of distributors in a given market to handle these items. Distributor consolidation may be a consequence, even though the primary purpose of such programs may be standardization of product quality.

Limited-menu firms using private label items typically negotiate fixed price contracts with either national brand or packer label processors that cover anticipated system-wide product requirements over a specified time period, usually a calendar or pack year. Approved distributors draw product against these supply contracts in the manner described earlier.

Non-Franchised Firms

Non-franchised, limited-menu foodservice firms tend to use procurement and distribution procedures very similar to those used by franchisors for their own retail outlets. Canned and frozen food products (except frozen meat) and paper items are contracted for in the same manner. Distribution services are also contracted in most instances. The functional distribution of activity is also similar. The foodservice firm's purchasing agent establishes both the supplier and distributor network, negotiates prices, and monitors inventory levels and product flows from the distribution level. The agent is not normally involved in day-to-day buying activities for contracted products. In most cases the retail unit manager is responsible for inventory control and ordering at the store level. The distributor deals directly with the store manager to coordinate deliveries and

control inventory at the distributor level.¹

The primary difference between the franchisor procurement system and that used by non-franchised firms is in control over the number of suppliers and distributors used to service retail foodservice operations. Control is unilaterally imposed by the purchasing agent in the non-franchised firm. Franchisors are restricted in this control aspect by the prevailing case law as it pertains to franchise agreements.

Vertically Integrated Firms

So far the discussion of general purchase procedures has been confined to foodservice firms that are not vertically integrated into either distribution or supply (processing) activities. This situation is most typical of limited-menu firms. There are, however, a few firms that are vertically integrated into distribution and/or processing activities. Some of these firms are franchisors; others are non-franchised firms.

In Chapter III it was noted that there is no identifiable trend toward either vertical integration or disintegration in the commercial foodservice sector. This generalization also applies to the limited-menu segment of the sector. In fact, there are two distinctly different views held by sector participants on the issue of self-distribution and supply. The proponents of vertical integration hold the general

¹In a few instances, the retail manager may send orders either via telephone or mail, to the firm's purchasing department where orders are consolidated and forwarded to the distributor. Even in these cases, however, the purchasing department merely acts in a consolidation capacity; the distributor orders and inventories the products.

view that these support activities are important from a quality control and service standpoint and that vertical integration is the best way to achieve the desired level of quality and service. This is definitely a minority viewpoint.

Most firms in the sector view product quality and service as important to the continued success of their operations, but reject the notion that the only way to achieve desired quality and service levels is to "do it themselves." As a defense for their position, non-integrated firms point to the fact that their quality assurance programs and distributor review programs are sufficient to insure stable supply and distribution practices. They also generally agree that in some instances owning their own production facilities may actually reduce product quality. In the words of one foodservice executive,

"On the contrary, processing your own meat gives you less control. If you have a company-run processing operation and it makes a mistake, your stores end up paying for it because the only alternative to throwing the mistake out is passing it on to the stores."¹

Relatively low returns to the distribution activity compared to returns from retail level operations are also a factor influencing vertical integration decisions. High growth firms are often in need of capital for expansion and cannot justify the expenditure of relatively large amounts of capital on distribution and/or processing facilities when expected returns from these operations are less than anticipated returns from expansion of retail operations.

¹"McD runs its units, leaves distribution to professionals", Nation's Restaurant News, July 4, 1977, p. 26.

Franchisor relations with their franchisees are another concern when firms consider vertical integration projects. Many franchisees consider franchisor-owned distribution and/or production facilities as threats to their own purchase options. Franchisee complaints of "rip-offs" and "rake-offs" on franchisor-supplied products have sensitized franchisors and have raised the expected costs of vertical integration.¹ Even when franchisors are aboveboard in their dealings with franchisees, there is always a threat of "bad publicity" stemming from franchisee distrust of the franchisor. Such publicity is damaging to the franchise system and many franchisors have opted to forego vertical integration in order to avoid these problems.

Where franchisors have vertically integrated into distribution activities they have followed one of two strategies in dealing with their franchisees. Either they restrict their distribution activity to only franchisor-owned retail outlets or they offer their distribution services to franchisees on a purely voluntary basis. Taco Bell currently uses the former system, while Burger King uses the latter system. In either case, however, the effect of the vertical integration activity is to substitute franchisor-owned facilities for distributor facilities. From a functional standpoint, there are few discernable differences between these distribution systems. The only major difference is that the franchisor takes title to products at the distributor level rather than at the retail level when the franchisor is vertically integrated.

The few non-franchised firms that are vertically integrated through the distribution level are in a situation similar to that of the

¹The revolt by KFC franchisees against KFC's distribution program in the mid 1970s is a case in point.

franchisor who restricts service to its own outlets. They are merely substituting their own distribution facilities for those of specialized distributors. Purchasing agents negotiate with suppliers for quantities at fixed prices, but instead of distributors ordering and inventorying the products, the foodservice firm's warehouse manager is usually responsible for drawing products against the master supply agreement. Title is, of course, transferred to the foodservice firm when products are delivered to their distribution facility.

No physical transformations take place at the distributor level. Hence, vertical integration into that stage by limited-menu foodservice firms tends to be for service and/or cost reasons, rather than for quality assurance reasons. Integration into processing activities, however, may be prompted by any or all of these reasons. Vertical integration into processing or commissary activities is not common among limited-menu foodservice firms. Where it does occur, the procurement procedures used to purchase inputs tend to be product-specific. This makes it difficult to generalize about the purchase procedures used and their effect on coordination. Since it is difficult to make meaningful generalizations about these procedures, a discussion of these activities, particularly as they relate to beef, will be deferred until later.

Beef Procurement Procedures: An Overview

Beef procurement is an important activity for many limited-menu foodservice firms. The menu offerings and marketing strategies of these firms are often built around beef items. Without a continuous flow of beef that meets or exceeds established quality standards, it would not be possible for limited-menu firms to operate successfully.

Standardization of quality is essential. It is important for all limited-menu firms, but is particularly important for franchise systems and other multi-market, limited-menu foodservice operations because customers expect consistent quality in the food items they purchase.

In the limited-menu segment of the foodservice industry, beef products are used in a variety of forms. Many firms in the sector use beef in ground form as hamburger. Some of this beef is pattied for use in hamburger sandwiches, while some is bulk prepared for use in Mexican-style entrees or chili. Other firms in the sector use sliced beef for roast beef sandwiches. Beef is also used for steaks and chopped beef sandwiches in budget steakhouse operations. These different end uses imply that different degrees of processing are required for beef products. Since most limited-menu firms are not vertically integrated into beef processing activities, these specialized activities are performed by independent processor/fabricators. Most of these firms are not slaughtering operations, but instead are firms that purchase fresh or frozen boxed beef and transform those inputs into the desired beef product. Most beef purchases are boxed cow meat.

Product quality is controlled through the use of product specifications.¹ Foodservice firms provide detailed, written product specifications to their fabricators. These specifications describe the type and quality of beef to be used in the fabrication process. They

¹ USDA establishes minimum standards for hamburger. The current USDA specification sets the minimum lean content at 70% and the maximum fat content at 30% per unit weight. All foodservice firms interviewed maintained standards well within these tolerances, but there were substantial differences between firms. Most firms interviewed had lean/fat specifications in the range of 78/22 to 80/20; these might be considered the industry norm.

may specify, for example, that only domestically-produced beef may be utilized. This is standard policy for many firms in the sector. They also specify the portion size of final product, the package and handling procedures, and the quality control procedures to be used.¹ Specifications for beef products are used by all large firms in the sector (Table 4.1).

Franchisor organizations impose restrictions on their franchisee beef procurement options through the use of approved supplier programs. These restrictions are similar to those imposed by franchisors on other food suppliers. Non-franchised firms, of course, have direct control and oversight over the selection of fabricators. The number of fabricators approved by franchisors and the number of fabricators selected by non-franchise firms is primarily a function of the physical characteristics of the beef product being utilized. In general, when the beef product is frozen there are fewer fabricators approved or selected than there are when the product is used in fresh form by the foodservice firm. Frozen product has a longer shelf life under normal storage conditions than fresh product. With an extended shelf life, frozen product can be transported longer distances without any effect on quality, if storage conditions are maintained at adequate levels. This is not the case with fresh product, which must be moved through the distribution system much more rapidly to prevent product spoilage.

The storage and transportation advantages of frozen product over that of fresh product allows the purchasing agent of firms using frozen product to reduce the number of fabricators needed to service

¹See Appendix C for an example of the type of product specification used by firms in the sector.

a given distribution area. Using fewer fabricators, given the level of product demand by the foodservice firm, results in higher average levels of output per fabricator, other factors constant. If processing costs are inversely related to the level of output, fabricator consolidation may result in lower processing costs per unit of output.

The number of fabricators supplying beef products to limited-menu firms varies across firms. In those instances where the firm utilizes frozen hamburger, for example, even the very largest firms in the sector often have as few as 10 separate processing plants supplying most of their product needs. McDonald's is reported to have only four major beef fabricators that operate a total of 9 separate processing facilities.¹ It is not uncommon for a single fabricator to supply anywhere from one third to one half of the frozen hamburger requirements of a large limited-menu firm. This is in sharp contrast to the number of fabricators supplying fresh beef products to limited-menu firms. Wendy's, for example, as recently as 1978 had approximately 175 local fabricators supplying its system-wide hamburger needs.²

From a control and performance audit standpoint, frozen product has distinct advantages over its fresh counterpart. One significant advantage stems from its longer shelf life. Unlike fresh product, frozen product can be stored for up to three months, and in some cases even longer. Firms using frozen product also have the option to "buy-in" in situations where it appears that the price of raw material inputs will be rising in the near future. This option is not open to

¹Hayenga, M., 1978, p. 22.

²"Why Wendy's Way Works," Restaurant Business, February 1978.

fresh product users. When "buy-ins" occur the fabricator purchases and stores additional quantities of raw materials at the specific request of the purchasing agent.¹ Payments are usually made for the stored product immediately (within 10 days), even though some of that product may not be used for 60 to 90 days. Storage charges are also levied on unshipped raw materials held by the fabricator and usually average about one percent of the value of the stored material on a monthly basis.²

Product loss due to spoilage is reduced when frozen product is used by the foodservice firm. Again, the key factor is the longer shelf life of frozen product. Firms using frozen product have less concern over product loss resulting from an inability to deliver and/or use beef products. Fresh product firms incur some product losses when, for example, bad winter weather prohibits the delivery of fabricated product to their retail operations. They may also incur losses on product already at retail units if customer counts are significantly reduced as a result of bad weather. Frozen product firms generally do not incur these losses because of the longer shelf life of their product. Given the advantages of frozen over fresh product, it is not surprising that most firms in the limited-menu segment currently use only frozen beef products.

The procurement process for beef products differs from that used for most other food products. For many food products, primarily those that have extended shelf lives, the purchasing agent negotiates

¹"Buy-ins" are discussed in detail in Chapter V.

²In many instances the first 30 days of storage are free to the foodservice firms.

fixed-price agreements with processors based on some estimate of future quantity needs. For beef products, even frozen beef products, there are no fixed-price contracts. Instead, most firms use some type of formula pricing for beef items. This is particularly true of firms which purchase large quantities of hamburger.

Firms that are not vertically integrated into beef processing activities, as standard practice, negotiate with beef fabricators only over processing, handling, storage and freight costs. These costs are negotiated only infrequently and on a somewhat random basis. Negotiations may be initiated by either party to the transaction. The reasons most often cited by the buyer for renegotiating these informal arrangements are usually related to increased product purchases from a given supplier. Where buyers expect that a fabricator's average processing costs have decreased as a result of larger product purchases by the buyer, the buyer may attempt to establish lower unit processing fees. Fabricators, on the other hand, often request higher processing fees to offset higher labor costs or other increases in direct operating expenses (e.g., utility, packaging costs, etc.)

Infrequent requests by fabricators for higher processing fees to cover higher costs are generally viewed by foodservice purchasing agents as part of normal business activity. However, frequent requests for increased processing fees are viewed in negative terms by purchasing agents. Such requests signal lax management controls at the fabricator level and may trigger buyer search procedures for alternative sources of fabricated beef products.

Search procedures for new beef processor/fabricators generally specify that only USDA inspected operations are to be considered.

This is standard policy for limited-menu foodservice firms. When a set of potential suppliers meeting this criterion is identified in the relevant marketing area, the foodservice firm's purchasing and quality assurance personnel undertake an in-depth investigation of each potential supplier. These investigations typically include the following types of information on each firm:¹

- . an assessment of the firm's performance history with emphasis on recent performance with respect to reliability and product quality.
- . an assessment of the quality and conditions of the physical processing and support facilities.
- . an assessment of the strengths and/or weaknesses of top management personnel.
- . an assessment of the firm's financial position.

Firms are usually ranked in order of their overall strength across these criteria, and one firm selected as a new supplier, subject to negotiations over specific working relationships. Although all four of the above criteria are considered important, the greatest weight is usually given to the firm's performance history and the quality of its facilities.

Procurement Relationships and Pricing Arrangements

The relationships between limited-menu foodservice firms and their primary beef suppliers are generally very stable. A number of factors contribute to this stability. Large limited-menu foodservice firms require a continuous flow of consistent quality beef products. When they find fabricators who can maintain those quality standards

¹The identification and ranking of supplier search criteria were consistent across all purchasing agents interviewed.

the foodservice firm is reluctant to change. Suppliers are also reluctant to change their working relationships with these foodservice firms once they are established because the continuous and relatively stable demand for their output generated by these accounts facilitates fabricator planning and procurement activities and helps maintain efficient levels of plant utilization.

Perhaps the most important factor contributing to this stability from both the buyer and seller viewpoint, however, is the transfer pricing mechanism used for many beef items. With processing, storage and handling costs fixed in the short run, the only significant cost factor not known in advance of fabrication is the cost of raw material inputs (e.g., lean beef and trimmings). The formula pricing arrangements used by most limited-menu foodservice firms and their beef fabricators reduce the uncertainty surrounding a "going market price" for those beef inputs. These pricing arrangements also benefit the transaction parties in other ways. For example, such arrangements reduce the need for foodservice firm purchasing agents to constantly monitor the prices of alternative sources of supply, thereby conserving firm resources. In addition, they reduce incentives for foodservice firms to change fabricators because base input prices do not vary between fabricators at a given point in time. Third, to the extent that such arrangements are widespread throughout the industry, purchasing agents are assured that they are not paying higher prices for raw materials than are their competitors who purchase similar inputs. From the fabricator's standpoint, the advantage of such arrangements is that their customers have less incentive to switch fabricators. Fabricator planning is enhanced by the increased stability. The

transactional and operating efficiencies that result from the use of formula pricing arrangements are strong factors reinforcing their widespread use.

Formula pricing arrangements, although widely used by limited-menu firms and their beef fabricators, are not necessarily standardized across firms. For example, some arrangements specify that the relevant transfer price for raw material inputs is the price reported for that input on the day the finished product is shipped by the fabricator. Other arrangements specify that the relevant base price is a weighted average of the raw material price over the five or ten day reporting period immediately preceding the day the order was placed with the fabricator. Still other arrangements use a price reported on a particular day of the week as a base price for products to be processed and shipped over some definite future period (e.g., within seven days). In all cases, however, the prices of raw materials are tied to either past or current price quotations; the formula is not based on a future price quotation.

The "Yellow Sheet" provides the price information on which most formula pricing arrangements are based.¹ The relevant beef price quotations reported in the "Sheet" on the appropriate day(s) are used to determine the base input price. Previously negotiated processing, storage, handling and transportation costs are simply added to the base price to arrive at the final product price.

¹The "Yellow Sheet" is the trade name for The National Provisioner Daily Market Service.

Vertically Integrated Beef Operations

There are a few limited-menu firms that are vertically integrated into beef fabrication operations. These firms generally use frozen product exclusively in their retail operations. Most use both domestically-produced and imported boxed boneless cow meat in their fabrication operation. They purchase beef under private treaty with slaughter/fabricators, rather than under formula pricing arrangements.

Vertically integrated franchisors compete against other beef fabricators for sales to their franchisees' operations. Franchisor-owned retail units are usually supplied exclusively by the integrated facility as long as it is economical to do so from a transportation cost standpoint. In a few instances, the integrated operations make product sales to other foodservice operations, but these sales are typically only a very small share of total output. When such sales are made the products may either be sold on a price list/quotation basis or may sometimes be sold on a formula basis similar to those described earlier.

Hamburger Pricing Arrangements

Limited-menu firms buying significant quantities of hamburger from beef fabricators are most likely to use formula pricing in their beef purchases. A simple example will demonstrate how the pricing system for hamburger functions.

Suppose the purchaser has established hamburger specifications which require that the final product shall consist of 80 percent lean meat and 20 percent fat by weight with a one percent tolerance for

error in either direction.¹ Further, the purchaser specifies that only 90 percent chemically lean boneless beef and 50/50 beef trimmings are to be used as inputs for its hamburger products. Using the specification and the daily price quotations for these beef inputs, it is a relatively simple process to calculate the raw material cost of the final product.

The first step is to find the appropriate weights to be applied to the price of the raw material inputs. Let X_1 be the proportion of 90 percent lean beef required to produce one pound of hamburger at the specified quality levels and X_2 equal the corresponding proportion of the trim input. Since the final product is to be 80 percent lean and 20 percent fat by weight, the proportions of lean beef and trimmings required is found by solving the following set of equations:

$$(a) \ .9X_1 + .5X_2 = .80$$

$$(b) \ .1X_1 + .5X_2 = .20$$

In this example X_1 equals .75 and X_2 equals .25. Thus, in order to produce one pound of hamburger at exactly the 80/20 specification, it requires .75 pounds of 90 percent chemical lean beef and .25 pounds of 50/50 trimmings, on average. The raw material price for the 80/20 final product is found by multiplying the proportions of lean beef and trimmings needed to produce one pound of final product by the price per pound of the corresponding input and then summing the resulting prices.

¹There are a variety of chemical tests used to determine a product's fat content. Among the most common tests are the modified Babcock and the ether extract method.

An example will clarify this process.

Suppose that the appropriate Yellow Sheet quote is \$1.30 per pound for 90 percent chemical lean boneless beef and \$.60 per pound for choice 50/50 trimmings. The raw material price for the final product is then $.75 (\$1.30) + .25 (\$.60) = \$1.125$ per pound. This figure represents raw material costs to the fabricator before processing charges, shrink adjustments, storage fees and transportation costs have been added. Shrink allowances and storage fees together average between 2-1/2 and 2-3/4 percent of the value of the raw material.¹ Assuming these changes are 2-1/2 percent, they would add approximately 2.8 cents per pound to the raw material price in the example. Processing fees are fixed charges negotiated between fabricator and buyer. A range of 10 to 12 cents per pound is common with the exact charge a function of the number of patties per pound and the amount of product processed for the particular buyer. In general, the greater the quantity processed on a continuing basis the lower the per pound processing fee.

Under the terms of most formula pricing arrangements, limited-menu firms purchasing fabricated hamburger products base their payments to the fabricator on the average of their specifications. These specifications have error tolerances because the grinding and mixing technologies used by fabricators are accurate only within two or three percent in terms of the actual lean/fat composition of the ground product. Thus, while the specification may call for an 80/20 ratio of lean to fat, the acceptable range of product quality may vary from

¹Storage fees are not usually levied on products that are stored for less than 30 days by the fabricator.

79 to 81 percent lean. Fabricators are paid for an 80/20 product, however, regardless of the actual lean/fat content so long as the quality control tests indicate that the product quality is within acceptable tolerances. This creates an incentive for the fabricator to provide product that is within but at the lower boundary of the product specification. The lower boundary is represented by the highest level of fat content allowed by the specification.

The incentive for fabricators to maintain the lower boundary of the product specification results from the difference in price between lean beef and trim inputs. Under normal circumstances the price per pound of lean beef is about twice that of trim. If fabricators can monitor their production process closely enough to allow greater use of the lower cost input, they will save money on input costs. The wider the difference between input costs, the greater the potential savings. A difference of one percent fat content in the final product, using the prices from the example above, would result in a 1.75 cents per pound change in the fabricator's cost. While this may not appear to be a significant savings, it is when one considers that some fabricators process between 100,000 and 1,000,000 pounds of finished product per week.

The current state of technology in hamburger processing will not allow even the most technologically efficient fabricator to consistently maintain the lower boundary of a product specification. With stringent quality control techniques, however, some processors are capable of producing products whose average lean/fat content is below the mid-point of the specification. Where fabricators are able to implement such controls, they achieve lower product costs and realize

higher returns per unit than other less efficient fabricators.

Formula pricing may reduce the incentives for both fabricators and their limited-menu customers to seek alternative working relationships, but it does nothing to stabilize the price of raw material inputs.¹ The way most formula pricing arrangements are instituted, both parties to the transaction still bear substantial price risks. To the extent that the formula is tied to a price series that is a reliable indicator of underlying supply and demand conditions, limited-menu firms are only exposed to normal price fluctuations inherent in most markets.

The risk exposure of fabricators differs from that of the food-service firm. Relatively few fabricators purchase raw material inputs under formula pricing arrangements with their suppliers. Rather, they purchase beef inputs under private treaty. That is, they negotiate prices with their suppliers on an individual trade basis. Some of these trades may be at the reported Yellow Sheet price for a particular day, but they need not be. In those cases where the fabricator purchases raw materials below the reported "Sheet" price, he captures the difference between his purchase price and the "Sheet" price used in the formula pricing arrangement with his customer. When the fabricator's purchase price exceeds the "Sheet" price, he takes a loss on that volume of product.

The combination of formula pricing outputs to limited-menu firms and securing beef inputs via private trades places the fabricator in a high risk situation relative to the spread between Yellow Sheet prices and those prices established in private trades. Fabricators

¹The effects of formula pricing on price stability and adjustment are discussed in Chapter V.

who can, on average, purchase raw materials below the Yellow Sheet find themselves in an advantageous position because the price they pay for inputs is below the price on which the formula is based. Those that cannot are often squeezed by the higher prices for raw material inputs they purchase and the ceiling imposed by the Yellow Sheet price. Technologically efficient fabricators can at least partially offset any procurement price disadvantage by maintaining the lower boundary of the product specification.

Although formula pricing is the predominant method used by limited-menu firms to establish prices for fresh or frozen hamburger, it is not the only pricing method used for hamburger products. There are at least two alternative pricing and procurement procedures that are also used by firms in this market segment. One of these is used by a small number of firms that purchase only fresh product for their retail units. These firms use a bid procedure to price their hamburger purchases and select fabricators. Once each week the purchasing agent contacts two or three approved local market beef fabricators, provides them estimates of the firm's local product requirements for the following week, and requests bids based on the quantity estimates. Low bidder receives the order. Firms that use the weekly bid system to price product generally believe that the procedure helps assure that "prices are right" and fabricators remain competitive in both price and service.

The other major exception to formula pricing is the procurement and pricing system reportedly used by McDonald's.¹ This system is unique in the limited-menu sector from the standpoint of the

¹See M. Hayenga, 1978, p. 17-24.

buyer-seller relationship. Unlike other limited-menu firms, McDonald's negotiates a profit target with each of its hamburger fabricators which essentially guarantees the fabricator the targeted rate of return. This type of procurement system is workable for two interrelated reasons. First, McDonald's hamburger fabricators supply McDonald's restaurants exclusively. Most other beef fabricators are not exclusive suppliers to individual limited-menu firms. Second, McDonald's requires that its fabricators allow McDonald personnel access to the firm's accounting records. This "open book" arrangement enables McDonald's to monitor both overhead and raw material costs directly, while the exclusive supply arrangement allows McDonald's to largely avoid any problems concerning the allocation of overhead expense that could arise if the fabricators supplied more than one firm. From the fabricator's point of view, the primary advantage of this arrangement is the guaranteed rate of return and the risk protection it affords. The primary advantage that accrues to McDonald's is in the area of quality control, where the fabricator no longer has an incentive to formulate product at the lower boundary of the product specification. However, unlike other large limited-menu firms that use formula pricing, McDonald's apparently assumes the risks associated with bad fabricator purchase decisions. In formula arrangements, those risks are borne by the fabricator.

Pricing Arrangements for Other Beef Items

Although hamburger is the predominant beef item used by limited-menu foodservice firms, other beef items are also used by firms in this market segment. Most notable among these items are roasts and steaks. Sliced roast beef sandwiches have long been an important

menu item for some limited-menu firms and have recently been introduced by other firms that had previously featured hamburger items. In the limited-menu segment, steaks are used predominantly by budget steak-houses.

Firms featuring these beef items employ a variety of pricing arrangements. Some firms, primarily those purchasing roasts for their operations, use a formula method to price product from their fabricators. Most of these purchases are for frozen product, often cow meat, and are prices using the Yellow Sheet as a base. Supplementary charges for any further processing done by the fabricator are usually negotiated and remain fixed for some future period. These pricing arrangements are very similar to those used by most firms for hamburger procurement.

Other firms may employ an "open book" pricing method similar to that reportedly used by McDonald's. Processing fees are negotiated with the fabricator, but rather than base product price on the Yellow Sheet or another market reporting service's quotation the price is based on the fabricator's actual purchase cost. Since nearly all purchases made by fabricators are made under private treaty, invoices from slaughterers are used to establish the prices actually paid by the fabricator.

The few non-vertically integrated firms utilizing imported frozen boneless beef in their retail operations do not use formula pricing arrangements to purchase this input. Rather, these firms make purchase decisions based on price quotes supplied either by brokers or by fabricators that regularly use imported beef in their operations. Firms purchasing imported product negotiate with fabricators over processing,

storage and delivery costs in the same manner as firms purchasing only domestic product.

Physical Product Flows

Once the network of fabricators has been established, the purchasing agent's role is primarily one of maintaining product flows through the distribution network and monitoring quality and price levels. In most cases, the purchasing agent is not directly involved in day-to-day buying activities. Thus, from an operations and coordination standpoint, the physical flow of beef products between the fabrication stage and the retail level is very similar to that used for other food and paper items. This is particularly true of firms which utilize frozen beef products, although fresh beef products may also be delivered by distributors.

Firms using frozen beef products often use their established distributor systems to coordinate ordering and delivery functions between fabricator and retail levels. As was the case with other food products, the distributor is responsible for maintaining adequate beef inventory levels and for servicing the retail unit. When beef products are handled by the distributor, a cost plus pricing arrangement is used to control distribution costs. These cost plus arrangements are not usually negotiated with the distributor separately from those for other food and paper items. Instead, the purchasing agent negotiates a fixed percentage markup over delivered costs to the distributor warehouse for all food and paper products handled by the distributor.

Fresh beef products often do not flow through the distributor

network. Instead, deliveries are usually handled by the fabricator.

Fabricator delivery is used for fresh product for two primary reasons. First, firms using fresh product typically must receive beef deliveries every other day, but distributor deliveries to retail units are normally scheduled only once, or at most twice, per week. The difference in delivery cycles makes it difficult in most instances for distributors to deliver fresh beef products. Second, in many cases the market area served by the fresh beef fabricator is more limited than the market area served by the distributor. If the area served by the distributor overlaps the areas serviced by two or more different fresh beef fabricators, it is often more costly for the distributor to deliver these products than it is for the fabricator. When fabricators deliver fresh beef products, they invoice the receiving unit directly. In the case where deliveries are made to franchisor-owned units or to multi-unit franchisees, the invoice may be sent to a central accounting unit. Payment terms are typically net, 7-10 days from date of delivery.

When beef products are inventoried and delivered by foodservice distributors, the distributor assumes the responsibility for ordering beef products from designated fabricators and establishing the delivery schedules with fabricators. Under normal circumstances a fabricator would only deliver frozen beef products to distributors once each week. Distributors also in many cases assume the responsibility for making payments to fabricators. In these cases, the purchasing agent is normally responsible for informing the distributor of the weekly price to be paid for beef products received from a specific fabricator. That price plus freight cost becomes the

delivered price to the distributor's facility. Standard payment terms are net, 7-10 days from date of delivery, which in many cases is the same as date of shipment. Distributors are reimbursed by the food-service firm but only after product is delivered to the retail level. Specific payment terms vary across firms. Some firms are paid every 15 days for deliveries made during that period; others are paid every 30 days.

Beef inventories held at the distributor level are determined jointly by the distributor and the purchasing agent. Frozen product inventory rules normally require that distributors maintain at least a 7 to 10 day supply of product at all times. This is a safety stock level to guard against product outages if fabricators cannot deliver product to the distributor on schedule. Distributor personnel are responsible for rotating inventories on a first-in, first-out basis according to the production date imprinted on the product container.

The rules that govern beef product inventories held at the distributor level are adjusted on an infrequent basis. Under normal circumstances, distributor inventory levels are adequate to accommodate any short-run surges in demand that might be caused by such factors as new retail store openings or special promotions at the retail level. Thus, there is only minimal interaction between the purchasing agent and the distributor in the short run once the decision rules governing inventories have been established.

Distributors and purchasing agents do interact when establishing inventory rules for new products. Initially, there is some uncertainty regarding the level of demand for new products offered at the retail level. Data on product usage from test markets provide

some basis for establishing preliminary inventory levels, but these estimates are subject to a relatively high degree of variability in the short run. Since retail units must have product to meet demand, there is a bias toward overstocking new products at the distributor level. Normally after a three to six month period, retail demand can be evaluated with greater accuracy and inventories adjusted accordingly.

Franchisee Beef Procurement Procedures

As was noted earlier in this chapter, most large limited-menu franchisors impose some restrictions on their franchisees' procurement activities. Franchisor-developed standards and specifications are one type of restriction imposed on franchisee beef procurement activities by all large franchisors. Franchisors also impose constraints on franchisee procurement activities by reserving the right to approve (or disapprove) beef fabricators supplying their franchisees (Table 4.1). Procurement restrictions of this nature are standard procedures for franchisor organizations. However, despite these restrictions, franchisees often have some latitude in selecting their own beef supplier. Many franchisors apparently will approve any beef fabricator that a franchisee requests so long as that fabricator can demonstrate an ability to maintain the required product specification. Where laboratory testing is involved to ascertain product quality, the prospective supplier and/or the franchisee bears the cost of testing.

Most franchisors, as standard practice, make available to their franchisees the same procurement arrangements and prices that the franchisor negotiates with beef suppliers and foodservice distributors.¹

¹This was found to be the case in all personnel interviews.

Franchisees may avail themselves of these arrangements or may opt to use alternative, approved sources of supply. Many purchasing agents interviewed suggested that franchisor-organized procurement and distribution systems were favored by a high percentage of their franchisees. Voluntary participation rates above 75 percent were commonly noted for these programs. Since many of these distribution programs include frozen beef items, it seems likely that at least some franchisees are being supplied by the same fabricator(s) supplying franchisor-owned retail units.

The participation rates of franchisees in fresh beef procurement programs organized by franchisors are less clear. Some purchasing agents indicated that franchisee participation was high; others were not sure. Since most fresh beef products are purchased in local, rather than regional, markets and are usually not delivered by food-service distributors, franchisees might very well opt to use a local beef fabricator other than the one used by franchisor-owned units. In some cases it is possible for a franchisee, especially a multi-unit operator, to procure locally fabricated beef items at prices competitive with those of fabricators supplying franchisor-owned units.

Poultry Procurement: An Overview

Like beef procurement, poultry procurement is an important activity for many limited-menu foodservice firms. For firms like Kentucky Fried Chicken (KFC), chicken procurement has always been a critical activity because of the prominence of chicken products on their menus. However, with the expansion of menu-offerings to include chicken sandwiches, chicken procurement has become an important activity for firms which had previously specialized in beef product offerings. Firms such as

McDonald's, Wendy's, Burger King and Burger Chef have recently added chicken sandwiches to their menus.

Chicken is used in two different basic forms by limited-menu restaurants; it is used either as parts or as patties for sandwiches. Parts are obtained by cutting up whole birds into 8 or 9 separate pieces as required by the foodservice firm. These cut-up procedures are normally referred to as "fast food" cuts. Pattied chicken may consist of either whole pieces of boned chicken taken from the breast or meat taken from various portions of the bird that is compressed and re-formed into a standard weight patty. In the latter case, a Formax or similar machine shapes the patty.

In general, the firms performing the slaughtering function are also the firms involved in any additional processing of chicken products used by limited-menu operations. Most of these processors are vertically integrated backward through the hatchery supply flock stage and directly control the hatchery, grow-out and slaughter/processing operations. In most instances, supply flock and grow-out operations are vertically integrated via contractual arrangements with producers. The hatchery and processing operations are usually owned by the processor/integrator.¹

Currently, there are no large limited-menu foodservice operations that are vertically integrated backward into the processor stage.² There are a few processors, however, that have integrated forward into

¹For details see Marion and Arthur, 1973; and Benson and Witzig, 1977.

²KFC owned and operated chicken processing facilities (Spring Valley) between 1968 and 1976. This facility supplied between 5 and 10 percent of KFC's system-wide needs during the latter part of this period.

retail foodservice operations.¹ These retail operations are not extensive and are highly localized at present.

Specifications are used by large limited-menu firms to control the quality of products used in their retail operations. It is standard practice to require that only U.S. grade A chicken be used in these products. All large chicken processors are federally inspected and most, if not all, of their output is federally graded.² Thus, the grade requirement places no additional demands on processor quality control systems. In addition to the grade requirement, limited-menu firms also impose weight restrictions in their specifications. These specifications usually establish minimum and maximum weights for birds used in the foodservice operation. The acceptable weight range for birds varies across retail firms. However, dressed birds weighing less than 2½ pounds or more than 2-¾ pounds are not usually acceptable. In some instances there may be less than ¼ pound difference between the maximum and minimum weight.

Weight restrictions serve a dual purpose. First, by restricting the size of bird to a relatively narrow range, the foodservice firm can standardize to a large extent both the size and weight of the chicken parts they sell.³ Thus, weight restrictions provide some control over the variance in the size of individual chicken parts sold over time. This standardization is important from a marketing and

¹Examples are Holly Farms and Perdue.

²Approximately 98 percent of commercial broiler slaughter was federally inspected in 1975. Benson and Witzig, 1977.

³The weight and size of cut parts are proportional to the weight of the dressed bird.

consumer franchise standpoint. Second, the weight restriction serves a cost control function. Firms sell prepared chicken to final consumers on a piece, or multiple piece, basis. But they purchase chicken on a weight basis. If they did not control the weight of the dressed birds they purchase from processors within a narrow range, it would be most difficult to control the average cost of chicken they sell in prepared form.

Limited-menu firms that sell prepared chicken parts normally purchase only shell birds from processors.¹ In some cases the processor performs the cut-up operation. In other cases, this function is performed at the retail level. Most large firms selling parts use only fresh chicken in their retail operations. Most of this product is ice packed by the processor, though in some instances CO₂ pack is used as well. Packaging specifications normally require a certain number of birds to be packed in each box. These specifications vary across foodservice firms.

Foodservice firms that use portion controlled chicken patties buy the product in either fresh or frozen form. In general, firms that use frozen beef products in their operations will purchase frozen chicken products, while firms emphasizing fresh beef in their operations normally use fresh chicken patties. The primary reason for the similarities between the type of beef and chicken products used by an individual firm is consistency with the overall marketing, storage and distribution practices of the particular foodservice firm.

¹ Shell birds are whole birds, except for neck and giblets. They are also referred to as WOG birds (without giblets.)

Procurement Relationships

Processor/foodservice firm relationships tend to be stable both in the short and long run. A number of factors contribute to this stability. One factor is the relatively stable demand for broilers, especially shell birds, generated by the foodservice firm's retail operations. While demand at the processing level may fluctuate on a seasonal basis with fluctuations in retail demand, the within-season demand for product is relatively stable at the retail level.¹ From an individual processor standpoint, the relatively stable demand for its output generated by a foodservice account is an attractive stabilizing force on processing activities. Processors that have working relationships with large limited-menu foodservice firms can rely on the fact that those accounts will be "in the market" each week. This is particularly true of firms that specialize in chicken menu items because these firms do not have the flexibility to adjust their menu offerings in the short run. They must procure a certain quantity of product each week to meet retail demand. In this regard, specialized firms are different than both foodservice firms with more diversified menus and retail grocery operations because the latter have some capacity to adjust their broiler purchases in the short run.

The relative inflexibility of the specialized foodservice firm is a demand side factor which promotes close ties with processors. Foodservice firms require a standardized product on a continuous basis. Relatively stable working relationships with processors are one means the foodservice firm can use to promote continuity and facilitate

¹ Retail sales are generally higher during the months of April through September than they are during the remainder of the year.

processor planning activities. To the extent these relationships achieve that end, they also stabilize product supply.

Another factor that contributes to these stable relationships is the quality control program of the foodservice firm. Large limited-menu foodservice firms often place their own quality control personnel in processor-owned facilities. These inspectors train cutters, monitor bird sizes and oversee cutting operations at the foodservice firm's expense. When in-processor quality control personnel are used by foodservice firms, it is a cumbersome process to change processors on short notice because of the sunk costs involved in the quality control program. It is an even more cumbersome procedure if processors have organized special processing lines to accommodate the foodservice firm's product requirements.

Despite their emphasis on stable supplier relationships, most large limited-menu firms are reluctant to concentrate their chicken procurement activities among only a few large processors.¹ By diversifying suppliers, foodservice firms can at least partially reduce the risk associated with spot product shortages. A diversified, but stable, supplier base affords more flexibility in product procurement to accommodate isolated shortages. If one processor for some reason cannot meet the foodservice firm's demand for product at a given point in time, the remaining suppliers can be used to offset the product shortfall. When procurement is highly concentrated it becomes much more difficult for the foodservice firm to make any necessary short-run

¹ For example, in its 1979 10K report to the Security and Exchange Commission, Church's Fried Chicken, Inc. reported that poultry used in company-owned stores was purchased from 48 different processors.

adjustments that might be required.

Foodservice firms also diversify their chicken suppliers to help minimize transportation costs. Large limited-menu firms often operate across wide geographic areas. By diversifying suppliers both within and across regional production areas, foodservice firms can reduce transportation costs associated with delivering chicken products to designated foodservice distributors. In a period where energy costs are rapidly rising, the potential savings associated with supplier diversification are even more attractive.¹

Pricing Arrangements: Shell and Pre-cut Birds

Broiler processors and large limited-menu foodservice firms that purchase shell broilers use formula pricing exclusively in their transactions. This practice is used both in regional and local broiler purchases. Typically, there are three components in the formula. Two of these components are negotiated prior to the exchange and are fixed in the short run. The third component--a base price--fluctuates from week to week.

The fixed components of the formula cover processing charges and yield loss. These fees are negotiated separately between the processor and the foodservice firm's purchasing department. The fees are usually negotiated on a per pound basis and thus are independent of the level of the base price. One of these fixed components covers the basic processing costs related to transforming the live broiler into a dressed

¹Benson and Witzig (1977) reported that weighted average transportation costs for ready-to-cook broilers were approximately 1.4 cents per pound in 1975. (p. 22) However, since that time the wholesale price of gasoline and diesel fuel has increased substantially. Transportation costs today are probably between 3.0 and 4.0 cents per pound.

bird. The second fixed charge is levied on any additional processing activity, such as a cut-up operation, that the processor performs.¹ During calendar year 1980, typical processing charges were about 5-1/2 to 5-3/4 cents per pound, while cut-up costs averaged about 3-1/2 cents per pound. Transportation charges are handled separately and are also negotiated.

Fixed component charges are negotiated on a relatively infrequent basis (usually once a year). Either the processor or the purchasing agent may initiate negotiations. Processor requests for increased processing fees usually result from increases in direct operating expenses such as labor costs. Purchasing agents, on the other hand, may attempt to negotiate lower unit processing charges with a processor if they believe that their purchases from that source have resulted in lower unit processing costs. Whether the charges actually increase or decrease as a result of negotiation is primarily a function of the interaction between processors and their foodservice clients and is situation-specific. Thus, no broad generalizations can be made regarding the outcome of these negotiations.

The negotiated processing charges are added to a base price to determine the exchange price for the trade. The base price may be obtained from a variety of market quotations. The particular market used for the price base is agreed upon between the processor and its foodservice client and remains fixed for an indefinite period. In general, foodservice firms are flexible with regard to the market chosen,

¹In some instances, the cut-up operation is performed at the retail level. In these cases there is only one processing charge at the processor stage.

and under normal circumstances will use any market the processor prefers. Processor preferences for a particular market tend to be associated with their marketing patterns. Processors that sell a high proportion of their output within one region of the country often prefer a market in that region. Those that sell product across a broader geographic area usually prefer a broader-based market quote. Some of the markets used to provide base prices include the Georgia Primary, issued by the Georgia Department of Agriculture, the USDA Poultry Market News 9-city market report and the Los Angeles market report. These market reports provide data on weekly, weighted average prices of ice-packed-equivalent whole birds, f.o.b. processor's dock.¹

The typical pricing arrangement between large limited-menu food-service firms and their processors establishes the exchange price for products up to one week in advance of shipment.² Few pricing arrangements are for a longer duration. The usual procedure is to select a particular day of the week (normally Friday) and use the appropriate market price quotation for that day as a base price. Since the market quote used is normally for whole birds, there is an allowance made for the value of necks and giblets. This allowance may be based on either a quoted market price for these items³ or calculated as a fixed percentage of the value of the whole bird. The particular method used to estimate these allowances is established through processor/foodservice

¹A concise review of the methods used to develop these prices is contained in Schrader, 1981.

²This practice is also common in processor sales to grocery retailers. Schrader, 1981.

³Both Urner Barry and USDA Market News report daily market prices for necks and livers in the New York market.

firm negotiations.

The establishment of the exchange price is a straightforward process. The foodservice firm's purchasing agent merely takes the relevant base market price, subtracts the allowance for necks and giblets, adds the negotiated processing fees, and arrives at an f.o.b. processor's dock product price. This price plus negotiated freight charges becomes the delivered price to a destination point. The destination point may be either a food distribution facility or a retail store depending on whether the product was bought on a regional or local market basis. In either case, however, the price covers the total quantity of product shipped by the processor to the foodservice firm or its designated distributor during the next 7 calendar days. At the end of the 7 day period the price cycle begins again.

The formula pricing method used for shell birds, like that used for most transactions between limited-menu firms and hamburger fabricators, establishes the price of the product prior to the time the product is shipped by the processor, but does not establish the quantity to be shipped. This type of formula pricing arrangement differs from that used by many large retail grocery chains in their beef procurement activities. In the latter case, the typical formula agreement establishes the quantities to be delivered during a specified future period (e.g., one week hence) but does not establish the exchange price prior to product shipment. The exchange price is established by taking the market quotation for the day prior to product shipment and applying a negotiated price differential to the reported price.¹

¹See statement by L. Haverkamp in Pricing Problems in the Food Industry, 1979.

Although these formula pricing methods are different in the way they are instituted, they are similar in the sense that the transaction participants are not directly involved in the price-making process. Instead, they rely on other market participants to establish market prices, thereby avoiding the costs associated with participation in the price-making process. The transactional efficiencies associated with formula pricing methods largely account for their widespread use.¹ Smaller purchasing department staffs and the associated lower personnel costs are often cited as major benefits of formula trading.

Chicken Patty Pricing Arrangements

The use of portion-controlled chicken patties by limited-menu foodservice firms is a relatively recent phenomenon. Although many firms test marketed products of this type throughout the 1970s, they were not introduced on a broad scale until the latter years of the decade. Because of their recent introduction, many of the formalized pricing arrangements that characterize the procurement of shell birds had not been developed for pattied products at the time interviews were conducted. In fact, most of the firms interviewed were still in the process of identifying suppliers and establishing supplier linkages, and had given only cursory attention to the establishment of formula pricing arrangements. However, based on purchasing agent responses, and their expressed preference for formula pricing, it seems likely that such arrangements will be developed in the future.

At the time interviews were conducted, most limited-menu firms were purchasing pattied chicken product based on processor list

¹Haverkamp, L., 1979.

prices or price quotations. These prices are normally established at the beginning of a month and remain fixed throughout the month. To facilitate processor planning and production activities, the purchasing agent usually provides an estimate of the foodservice firm's product requirements for the month. Prices are quoted based on these quantities.

The purchasing agent can elect to place an order at the time the quote is made, or may solicit additional quotes from competing processors before placing an order. Since there is no cash market price reported for chicken patties, purchasing agents have encountered some difficulty in pinpointing the prevailing market price. In order to gain some indication of the prevailing market price, most purchasing agents were requesting bids from at least three or four processors before placing an order.

Although the quote or list price method of pricing is a reasonably efficient procedure for gathering price information, particularly when relatively few processors need be polled, formula pricing arrangements are preferred by most purchasing agents for a number of reasons. The use of formula pricing facilitates the creation of relatively stable processor relationships. Stable processor relationships are important from a physical distribution standpoint because most foodservice distributors' ordering systems are not particularly well suited to situations that require frequent supplier changes. Such changes are more likely in a situation where list prices or quotes are used than in a situation where the product is formula priced. In the former there are no assurances that the processor supplying product in a given month will do so in future months because there are no assurances that this price quotation will be competitive with those of other processors.

If, however, formula pricing is used to price product, there is a greater likelihood that a particular processor will continue to supply product in future periods, assuming maintenance of quality standards and delivery schedules, because there is no incentive for the foodservice firm to switch to an alternative source of supply.

Another reason why large limited-menu firms prefer formula arrangements is that the formula is usually based on a price reported by either a public or private marketing service that compiles and condenses the data contained in a relatively large number of trades. Thus, unlike a price list or quote which is firm-specific, the prices reported by these services tend to be broader indices of market activity, even though all or even a majority of trades may not be considered. The purchasing agents interviewed preferred broader market indices because they believe them to be more consistent and reliable indicators of prevailing market conditions.¹

A third factor favoring the development of formula arrangements is that they establish constant relationships between the prices of primary raw material inputs and processed products. Once these relationships are established it often becomes easier to forecast finished product prices because the required analysis can be performed on a raw material data series that is more detailed than that of finished products. More accurate forecasts facilitate the budget preparation and planning processes that purchasing agents are primarily responsible for in most limited-menu operations. Thus, from a cost control

¹The purchasing agents interviewed, particularly those of firms using chicken as primary menu items, were generally aware of the controversy surrounding various price reporting services and the representativeness of their reported prices.

standpoint, formula arrangements provide some definite advantages over other pricing methods.

Physical Product Flows

Chicken products used by limited-menu foodservice firms flow through two separate distribution channels. Products purchased in national or regional markets typically flow through the distributor network established by the foodservice firm's purchasing agent, or through the firm's own distribution facilities if it is vertically integrated. In this type of system, the distributor or warehouse manager assumes the responsibility for ordering and inventorying required chicken products from designated processors, establishing processor delivery schedules, and consolidating and coordinating retail level deliveries. Title is taken by the distributor when products are delivered to the distribution facility. When distributor networks are used, title is transferred to the foodservice firm upon delivery by the distributor to the retail units.

In the case where a distributor network is used, the distributor is responsible for making payments to the processor/supplier. Terms normally specify payments to be made within 10 to 14 days from date of delivery. No cash discounts or allowances are applicable. The distributor is reimbursed by the foodservice firm according to the provisions of their contractual agreement, but only after product is delivered to retail units. The timing of distributor payments varies across firms. Some distributors are paid every 15 days for product delivered to retail units during that period; others may only be reimbursed every 30 days.

Unlike the cost of most food and paper items used by limited-menu firms, the cost of chicken products fluctuates in the short run. Prices of shell or pre-cut birds vary from week to week. Since the distributor

takes title to these products and is responsible for processor payments, it is critically important that the distributor know what the appropriate exchange price is during a given period.

The responsibility for keeping distributors informed of weekly chicken prices rests with the purchasing agent. As standard procedure, purchasing agents telephone each foodservice distributor under contract immediately following the establishment of the following week's product cost. Under normal circumstances where formula pricing methods are used, the price is established by late Friday afternoon and applies to all product ordered from the processor from Saturday through the following Friday. Distributors are informed of the price for the following week either late Friday afternoon or early Saturday morning. Follow-up letters confirming the price to distributors are usually mailed either Friday or Saturday.

Vertically integrated firms operate slightly differently. Processors ship product direct to integrated distribution facilities, but send invoices directly to the foodservice firm's purchasing department. There the invoice is reviewed for unit pricing accuracy, and quantities delivered are checked against warehouse receipts to verify their accuracy. Once this internal process is completed, the invoices are forwarded to the accounting department for payment. Payment terms are the same as those required of distributors (i.e., net, 10-14 days). Since there are no vertically integrated limited-menu firms that purchase shell or pre-cut birds, these internal procedures apply only to firms that purchase pattied chicken products.

If product is purchased locally, or the processor operates its own distribution facility for chicken, delivery is usually made by the

processor direct to the retail units. The foodservice distributor is bypassed in this case. Responsibility for inventory control and scheduling of retail deliveries rests with the processor/supplier. Title is transferred when products are delivered to retail units. Product payments are made direct to processor/supplier by the firm's accounting department after delivered quantities have been verified by the purchasing department. Payment is usually made within 10 to 14 days after delivery. No cash discounts or allowances are permitted.

Franchisee Chicken Procurement Procedures

In general, the same limitations imposed by franchisors on the beef procurement activities of their franchisees are applicable in franchisee procurement of chicken products. Franchisors set standards and product specifications for chicken products used by their franchisees. They also approve sources of supply for franchisees to use.¹ If chicken products are available through the franchisor's distributor network, standard franchisor policy is to make available to franchisees the same product prices as those paid by the franchisor. If purchases are made locally by the franchisor, the same rules apply toward franchisees' purchases.

Franchisees may or may not avail themselves of the franchisor procurement program at their own discretion. Undoubtedly some franchisees do participate in these programs, but without a broad survey of individual franchisees' procurement practices it is impossible to know precisely the extent of their participation.

¹See Table 4.1.

Chapter Summary

Despite differences in firm organizational structure, it is apparent that large limited-menu firms share commonalities in the methods used to purchase and distribute beef and chicken items, as well as other food and paper goods to retail units. Fixed price contracts, which serve as master supply agreements, are common between large limited-menu firms and processors of canned and/or frozen food products (except beef and poultry) and paper items. These contracts are often negotiated on a pack or calendar year basis by the foodservice firm's purchasing staff. Since most limited-menu firms are not vertically integrated into the distributor stage, distribution agreements between foodservice firms and foodservice distributors (wholesalers) are common. Most of these agreements specify some type of cost plus pricing arrangement. Distributors are responsible for ordering items against the master supply agreements, inventorying those items, and delivering them to retail units.

Most beef and poultry items used by large limited-menu firms are purchased using some type of formula pricing arrangement. In most cases, the foodservice firm's purchasing agent negotiates a fixed, per unit, processing fee with the beef or poultry fabricator. This fee is then added to a base market price, which is usually taken from either a public or private market quotation, to arrive at an f.o.b. processor facility product cost. Although the time period used to establish the base price differs across both individual firms and specific products, most formula arrangements establish a single price that is applied to all product shipped to a firm or its distributor during some specified future time period (usually 7 days). If a distributor network is used to distribute

beef and/or poultry items, the distributor coordinates delivery schedules with the fabricator/processor and the foodservice firm's retail units.

CHAPTER V

INSTITUTIONAL, ORGANIZATIONAL AND OPERATIONAL FACTORS INFLUENCING VERTICAL COORDINATION PROCESSES

Introduction

Chapter IV examined the functional organization of beef and poultry procurement and distribution activities in the limited-menu foodservice sector. This chapter extends the analysis of procurement activities in this sector by examining various market and non-market factors that influence the beef and poultry procurement strategies employed by large limited-menu firms. Specific institutional mechanisms (e.g., futures markets) are examined for their relevance to limited-menu foodservice operations, as are other risk-reducing or shifting strategies that are potentially available to these firms. Factors influencing the adoption of alternative organizational structures (e.g., vertically integrated operations) are also examined. The latter portion of the chapter examines various firm-level operational procedures with respect to their implications for vertical coordination processes. Specific attention is given to the effects of 1) advertising and promotional practices, 2) menu pricing practices, and 3) formula pricing arrangements employed by limited-menu foodservice firms.

Area of Inquiry: Risk-reducing and/or
Shifting Strategies

Beef Procurement: Buy-ins

In beef procurement, both the fabricator and the foodservice firms typically assume substantial short-run price risks. The formula pricing methods characteristic of most exchange arrangements between these parties do not totally eliminate such risks. Under the typical formula arrangement, processing, storage and distribution costs are negotiated and fixed in the short run. However, these costs are small relative to those of raw material inputs, which may account for 75 to 80 percent of finished product costs. Prices for raw material inputs are usually based on market quotations that can, and often do, fluctuate widely. These fluctuations, especially those in an upward direction, are the source of price risk for both foodservice firms and fabricators.

One risk-reducing strategy that is employed by some limited-menu foodservice firms and/or fabricators is the "buy-in".¹ The "buy-in" is essentially a strategy for hedging against future cash price increases by establishing a current inventory position. This strategy may be used whenever the firms' market analyses indicate that current cash prices are below anticipated future cash prices by an amount greater than the cost of storage and interest payments on quantities purchased currently for future use. Under these market conditions, the purchasing agent indicates to the beef fabricator(s) that a specific quantity of raw material is to be purchased and stored by the fabricator for future use in beef products purchased by the foodservice firm. When

¹Only four of the firms interviewed had used, or contemplated using, this particular procurement strategy.

"buy-ins" are utilized by foodservice firms, the foodservice firm bears the cost of storage and interest payments on inventoried product, but usually does not take title until it receives delivery of fabricated product. The fabricator often acts as a market intermediary for the foodservice firm, making the necessary purchases, arranging for either in-house or public storage of raw material bought for future use, and holding title to the raw material until it is fabricated and shipped to the distributor.

Although "buy-ins" are usually initiated by the purchasing agent, fabricators may also "buy-in" on their own account to protect against expected near term increases in raw material costs. If they do take such action, they bear the cost of storage and interest payments directly. However, they also receive the benefits resulting from forward purchases. The pricing mechanisms used in most exchanges usually do not take into account, either explicitly or implicitly, the prices actually paid for raw material inputs by the fabricator.¹ To the extent that the total cost of forward-purchased raw materials (i.e., raw material costs plus storage and interest payments) is lower than the cost of those materials at the time they would normally have been purchased, the fabricator margin has increased.

The "buy-in", whether initiated by the foodservice firm or the fabricator, is a short-term strategy to hedge against increases in raw material costs. Most forward purchases cover only 30 to 60 days' supply of product. Due to the storage requirement, this strategy is limited to those firms using frozen product in their operations. Fresh

¹The procurement arrangements reportedly used by McDonald's are an exception.

product cannot be stored for a sufficient length of time to make the "buy-in" an effective procurement strategy. The strategy can be used, however, in either purchases of domestic or imported boneless beef.

From the foodservice firm's standpoint, the actual decision to "buy-in" is usually made on an ad hoc basis. The limited-menu firms interviewed did not have specific standard operating procedures to follow in guiding "buy-in" decisions. But they did use standard procedures for monitoring beef market activities that eventually lead to such decisions. The purchasing agent, or in some cases market research personnel, usually monitors seasonal price movements, cattle on feed, futures prices and other market indices to gain insights into current and expected future cash price levels.¹ Federal government research reports, as well as those offered by private consulting firms, are often used as inputs in this process. Particular attention is usually given to factors influencing supply, demand and price levels 30 to 90 days in the future, although factors affecting longer term market conditions are also monitored. More attention is given to the near term market situation because of the immediate impact of higher raw material costs on food budgets and margins. In some cases, the effect of increasing raw material costs may necessitate budget revisions and increases in menu prices. In other cases, the firm may opt to "buy-in" and maintain their budget position and menu prices.

Poultry Procurement: Buy-ins

"Buy-in" strategies similar to those used by limited-menu firms that purchase large quantities of beef cannot be readily utilized by

¹Firms using imported frozen boneless beef also monitor market conditions in potential exporting countries.

firms purchasing broilers. Firms purchasing broilers buy fresh product exclusively. Fresh product cannot be stored for a sufficient length of time to make "buy-ins" a viable procurement strategy.

Although these firms cannot use "buy-ins" to hedge against expected increases in cash broiler prices 30 to 60 days in the future, they can make some modest adjustments in their weekly purchase patterns to reduce the impact of week to week increases in product costs. Some firms, for example, opt to place a larger than normal order for product toward the end of the buying week if they believe that the following week's price will be higher than that of the current week. In most cases, such orders would be placed on either Thursday or Friday and delivery taken within a day or two. Conversely, if the following week's price is expected to be lower than the current week's, they may delay purchases until Saturday that might otherwise be made on Friday to take advantage of the lower price.

Preliminary market price reports issued by various price reporting services are a valuable aid to foodservice firms contemplating their end-of-the-week purchasing options. Many reporting services report mid-week (Wednesday) preliminary figures on trades that have taken place between Monday and Wednesday. These reports are barometers of market conditions and are often reasonable estimates of the prices that can be expected at the close of trading on Friday afternoon. Purchasing and market research personnel use these estimates in conjunction with their own assessment of market conditions in reaching decisions on end-of-week purchases. If a distributor network is used to deliver broilers to retail units, the purchasing agent typically contacts foodservice distributors and instructs them to order specific additional quantities

of product, or alternatively suggests that they reduce their order quantities, as conditions demand.

Although firms can adjust their purchasing patterns to take advantage of differences in week to week product costs, they are able to do so only on a limited basis. Distributors normally purchase broilers on a more or less continuous basis throughout the week. Increasing or decreasing order quantities at the end of the week usually only affects product costs a day or two into the following week. While such strategies may lower the average cost of product throughout a week, and indeed that is their intended purpose, the coverage effects of these strategies are not as great as in the case of frozen boneless beef "buy-ins". Still they offer an opportunity for foodservice firms to shift some price risk.

During the time interviews were conducted, firms purchasing both fresh and frozen pattied chicken products were not using "buy-in" strategies of any type for these products. These products are relatively recent additions to the firms' menus, however, and most firms were still developing supply sources and familiarizing themselves with market conditions, various market reports and the like. Thus, most firms were not in a position to make intelligent "buy-in" decisions on these products. This was particularly true of firms that had not previously used chicken in their foodservice operations. In addition, most firms were purchasing these products based on processor price lists or quotes. The price was usually established on the first working day of the month and remained fixed throughout the month. With prices fixed up to a month in advance of purchases, the pressure to time weekly purchases in such a way as to reduce average product cost is reduced. Firms would

still like to take advantage of any monthly price differences in these products, but can do so only if they develop adequate market analyses.¹ The lack of reported market prices for pattied product is an impediment to the development of the requisite market analyses.

Uses of Futures Markets in Beef Procurement Strategies

Although a large majority of purchasing agents interviewed stated that they had at one time or another researched the feasibility of using futures markets to hedge beef purchases, only a very few firms are actively hedging at the present time.² The consensus of opinion regarding the use of futures markets is that the contracts currently available do not provide an effective risk management tool for limited-menu food-service firms. This view was shared by purchasing personnel of nearly all firms in the sample and thus, the position is independent of firm organizational structure differences. Given the current beef futures contract offerings, it is highly unlikely that most limited-menu firms will be heavily involved in beef futures trading for hedging purposes in the foreseeable future.

A number of factors militate against the use of futures by limited-menu firms. Perhaps the most significant factor is that the beef inputs used by these firms cannot be hedged directly. There are no futures contracts for domestically-produced boneless beef, which is the primary beef input used by many limited-menu firms. In order to take a position

¹All purchasing agents with firms that had recently introduced chicken patties as menu items indicated that they had assigned a high priority to expanding and deepening their individual knowledge of chicken marketing.

²Seventy-five percent of the firms interviewed that use beef in their operations indicated that they had considered the use of beef futures.

in the futures market, firms purchasing domestically-produced beef must cross hedge in live, fed cattle futures.¹ Most firms are reluctant to use cross hedges because of a high perceived risk factor associated with these transactions. A number of purchasing agents interviewed pointed to the recent multi-million dollar loss Burger King experienced with its hedging strategies as an example of the risk inherent in futures trading by limited-menu firms.

Firms utilizing imported lean frozen boneless beef do have an opportunity to hedge that product directly. The New York Mercantile Exchange offers a 30,000 pound futures contract for imported boneless beef. The volume traded and liquidity of this contract is low, however. In 1978, the open interest on these contracts, a measure of market liquidity, averaged only 274 contracts per month over the calendar year. The low trading volume of this contract substantially reduces its value as a hedging medium. Prospective hedgers are vulnerable in low liquidity, thin markets because they often cannot lift hedges and close out their position without adversely affecting the futures price itself. In low traded contracts, both hedgers and speculators alike may also experience difficulty in clearing their market position. The low level of trading often makes it more difficult to match buyers and sellers at particular points in time. These disadvantages are not limited to foodservice firms alone, but are the primary reasons why firms using imported beef in their foodservice operations do not hedge.

Despite the reservations most firms hold with respect to futures trading for hedging purposes, there are a few firms that do cross hedge

¹An example of how cross hedging can be used by foodservice firms can be found in Miller, S., 1980.

at least some of their beef purchases. These firms do so, however, only under some very specific market conditions. Under normal circumstances, the only beef products actually owned by large limited-menu firms are those products that are held at the retail level.¹ Thus, in general, at any given point in time the foodservice firm's inventory position is small relative to its total product usage. Store level inventories also turn over rapidly, at least once or perhaps twice per week. Together, these factors preclude firms from taking "short" hedging positions.

A "short" position (i.e., selling future contracts) under the conditions described is essentially a speculative action. With virtually no beef inventories actually owned by the foodservice firm, a "short" position, which is taken for hedging purposes to protect against losses that might be incurred on inventory held by the firm, is basically a gamble that the futures price will fall and the contract can be bought back at a profit. The purchasing personnel interviewed, including the few actively cross hedging, saw such speculative activities as extremely high risk endeavors and steadfastly avoided them. This position was consistent across all firms in the sample, including the few that operated their own beef processing facilities. Some firms have even gone so far as to develop written policies that specify that "short" positions are never to be taken under any circumstances.

The limited cross hedging activity that does take place is confined to "buy" or "long" hedges. Firms need not own inventory to take "long" hedging positions. Long positions are usually only taken under certain,

¹The exceptions are the few firms that are vertically integrated into beef processing activities and those that operate their own distribution facilities and distribute beef through them.

specific market conditions. The few firms that hedge do so only when their market analyses indicate that cash prices are expected to rise significantly in the near term.¹ Buying futures under this situation is a method to hedge against short-run cash price increases. Since beef items will be purchased in subsequent time periods, the long position is a hedging, rather than speculative, action.

Firms do not concern themselves with futures trading if their market analysis of future cash prices indicates that these prices can be expected to remain stable or decline in the near term. If prices are expected to remain stable, the firm faces only minimal risk of rising cash prices for beef items that might temporarily squeeze profit margins. Hedges are not needed to reduce this risk. In the case where cash prices are expected to decline in the near term, a firm would forego the temporary benefit resulting from lower cash prices it pays on future beef purchases if it took a long position. The effect of taking a long position when cash prices are expected to decline would lock in the present cash price in most circumstances. The firm would not realize the lower future cash price because the difference between the current and future cash price would be offset by an opposite movement in the difference between the current futures price and the futures price effective at the time the contract was closed out. Thus, long positions are not generally taken by foodservice firms when future cash prices are expected to decline.

A few diversified beef fabricators do offer hedging programs to

¹Firms were especially reluctant to reveal the exact set of market conditions that trigger beef hedging activities. They were also reluctant to indicate the number of contracts they held.

their foodservice customers. Unlike most limited-menu firms, these fabricators purchase a broad array of beef products, since they often supply many different types of foodservice operations. The diversity in their beef procurement activities allows these fabricators to hedge their purchases more effectively than can foodservice firms which use more specialized beef inputs. Since most fabricators supplying large limited-menu firms tend to be specialized fabricators, these hedging programs are primarily available to foodservice firms with more diversified menus. Some smaller regional limited-menu operations use diversified beef fabricators and may use their hedging programs, but only under the conditions described earlier. In general, hedging activities performed by specialized fabricators are confined to their operations alone and are not made available to their customers.

Use of Futures Markets in Chicken Procurement Strategies

Unlike the case in beef procurement, limited-menu firms specializing in chicken items do use futures markets. However, these firms find themselves in a somewhat different position than large users of beef in that they purchase the same product that is traded on futures markets. Thus, the firms need not cross hedge if they wish to hedge product. This is a definite advantage, and one that is not overlooked by the foodservice firm. Unfortunately, however, there are other limitations that constrain the usefulness of broiler futures as a risk transference medium, and, apparently due to these limitations, the use of futures has declined by these firms over time.

Perhaps the most significant factor limiting the use of broiler futures is the market thinness of the contracts offered. Between 1976 and 1980, the yearly number of iced broiler contracts traded declined

from 117,641 to 49,316. During that 5 year period an average of 68,011 were traded annually, compared to an annual average of 242,956 contracts during the 1973-75 period.¹ With fewer trades being made in recent periods, broiler futures have experienced liquidity problems similar to, although not as great as, those in imported lean beef futures. As noted earlier, highly liquid markets are required if futures markets are to provide a measure of risk protection and efficiency. At the present time, broiler futures do not always afford that protection to potential hedgers.

Despite the problems with broiler futures, foodservice firms continue to hedge their broiler purchases when conditions permit. Generally, due to the fact that these firms, like many firms purchasing beef, do not hold large inventories for any length of time, they tend to confine their use of futures to long positions. Short positions are not usually taken because of their speculative nature, and the aversion most firms seem to hold toward speculative activities of this type.

The firms that do use futures vary their contract holdings depending on market conditions. When the probability of higher future cash prices is high, firms will generally hedge a larger proportion of their future purchases than in a case where the probability of such increases is not as great. Thus, during periods of excess supply, firms tend to be less heavily involved in futures trading than during periods of relative shortage.²

¹Commodity Year Book, 1977 and 1980.

²As in the case with firms hedging beef, firms that hedge chicken were reluctant to reveal the specific rules employed that govern the amount of contracts traded and the timing of trades.

Cross hedging of major feed inputs is relatively common by foodservice firms purchasing broilers. Feed costs have averaged about 72 or 73 percent of cash broiler prices in recent years.¹ By hedging these inputs the foodservice firms can obtain some measure of risk protection against broiler price movements, but not to the degree afforded by a direct hedge. Firms were reluctant to discuss their cross hedging activities in detail. However, in general, it would seem that during periods where higher cash input prices are expected in the near term, futures purchases would be a more likely occurrence. If this is indeed the case, then cross hedging activities would follow a similar pattern as direct hedging would if it were possible.

Futures hedging of chicken used in pattied chicken product is not possible without cross hedging into either broiler or feed input futures. At the time personal interviews were conducted, pattied product was not in wide use and hedging was not an important activity. Since that time the use of pattied product has expanded; however, it is unlikely that this product is currently being hedged, particularly by firms operating in the hamburger segment of the industry. As noted earlier, these firms are reluctant to use futures markets because of a high perceived risk factor associated with cross hedging of beef items. The same conditions prevail in the hedging of chicken patty products.

Vertical Integration: Beef Operations

Most large limited-menu foodservice firms are not vertically integrated into distribution activities. Even fewer firms are vertically integrated into beef processing activities, and those that are perform

¹Commodity Year Book, 1978, p. 82.

only fabricating functions; they do not slaughter.¹ Both franchise and non-franchise systems exhibit similar structural patterns in this regard. The personal interview process revealed a number of reasons detailing why most firms have chosen not to integrate into beef processing activities more heavily, and also the reasons underlying some firms' decisions to vertically integrate into beef fabrication operations. Some of these reasons are related to the purchasing procedures currently employed by foodservice firms; others are related to various environmental uncertainties that the firms face and must contend with.

The non-integrated firm's viewpoint is perhaps best characterized by the following purchasing agent response,

"Why on earth would we (the foodservice firm) ever want to be involved in beef processing activities? We already enjoy most of the benefits, without incurring any asset liabilities. Besides we would be subject to the same price fluctuations we experience currently. We wouldn't spread our price risks. We would also have to contend with our franchisees and that is always a potential problem."

The above paraphrased quotation effectively summarizes the position held by most limited-menu firms toward vertically integrated beef operations. The consensus of opinion within this market segment is that vertical integration into processing activities in general, and beef processing in particular, is not desirable for a number of sound economic reasons.

First, and foremost, most firms do not see any economic advantage in vertical integration. They believe that their current operating and procurement procedures are sufficient to guarantee that they can secure adequate quantities of beef products at "competitive" prices without

¹See Chapter III for details, especially pages 64-67.

undertaking the functional responsibilities of a fabricator. The formula pricing methods employed by most firms are viewed as checks on fabricator profitability. Firms that have negotiated access to their fabricators' accounting documents are in a very strong position to extract the knowledge and technical expertise of the fabricator without incurring the risks associated with asset ownership.

Second, vertical integration does nothing to stabilize the price of raw materials used in the fabrication process. Those prices fluctuate with broader supply and demand forces that are beyond the direct control of either the foodservice firm or the fabricator. Thus, backward vertical integration into the fabrication stage by limited-menu foodservice firms does not afford the firm any additional risk protection against increasing or widely fluctuating beef prices. In fact, it may increase the firm's risk exposure to price decreases if the firm has to increase its beef inventory holding as a result of the vertical integration. By vertically integrating, the firm also accepts the risks associated with fabricating product that does not meet minimum specification standards. If the product is far out of specification it may have to be sold at a substantial loss, if it can be sold at all.

A third factor influencing a firm's decision to vertically integrate is the expected reaction of its franchisees. Franchisors, as a group, are very sensitive about franchisee relations. A decision to vertically integrate can present problems that franchisors would like to avoid. One potential problem is the degree of franchisee participation in purchases from the integrated facility. On the one hand, if the franchisor's integration venture was successful in terms of lowering average prices for beef items used in the system, then in all likelihood some

franchisees would want to participate in the venture. Problems could arise over the level of exchange prices and the sharing of profits from this activity. On the other hand, an inefficiently-operated fabrication facility might tempt the franchisor into trying to promote greater franchisee participation in the operation. This too could present problems for the franchisor.¹ Largely to avoid problems similar to those described above, most franchisors have not vertically integrated into beef fabrication operations.

Approximately one-half of the limited-menu firms in the sample that used beef acknowledged that they had considered the option of purchasing feeder cattle and having them custom fed and slaughtered for use in their foodservice operations. A major supplier of McDonald's, Keystone Foods Corp., was reported to be pursuing just such a strategy in 1978.² This is apparently an isolated case, however, since no firms in the sample were involved, or even seriously considering such action at the time interviews were conducted. Firms reported that when they considered this option they viewed it primarily from a quality control and supply assurance standpoint, rather than as a method to spread price risks. Most firms experienced some difficulty in securing adequate beef supplies during 1973, and during the next two or three years were exploring options to avoid similar problems in the future. Purchasing feeder cattle and contracting for custom feeding was one of the options considered. Eventually most firms concluded that such activities created

¹Running afoul of specific antitrust provisions and the decisions in case law that pertain to franchisor-franchisee relationships is of primary concern here.

²"Beefing up herds to protect meat supplies," Nation's Restaurant News, December 18, 1978, p. 62.

more problems than they solved. A major problem in this regard is the fact that limited-menu firms are unable to utilize a wide range of beef cuts. Thus, had they decided to become involved in feeder cattle programs, they would also have had to establish auxiliary market linkages to dispose of those beef cuts which they could not use themselves. In most cases, the value of these cuts exceeds the value of the cuts used by limited-menu firms. The firms concluded that under these conditions the establishment of feeder cattle programs increased, rather than decreased, the firms' risk exposure. Apparently the expected costs associated with this activity exceeded its benefits at the relevant discount rate because most firms have elected not to enter into these programs.

When asked whether a return to the tight supply situation of 1973 would influence their view of these feeder operations, most purchasing agents responded that their first and foremost concern was to maintain adequate supplies of beef for their retail operations. They also suggested that programs like contracting their own feeder cattle to custom feeders would need to be re-evaluated in light of prevailing market conditions. One might conclude from this that the prospects for feeding programs operated by limited-menu firms will likely increase under prolonged, tight supply conditions, but are unlikely to develop without considerable exogenous pressures.

Despite the general misgivings about beef fabrication operations that are held by most foodservice firms, a few limited-menu firms are vertically integrated into beef fabrication operations. A major factor influencing their decisions to undertake beef processing activities was the added control over product quality that these operations afforded. The prospect of lower raw material costs was also cited as a

factor.¹ Vertically integrated firms often use both domestic and imported beef in their operations. The opportunity to balance procurement between domestic and imported beef sources, and thus take advantage of the different seasonal marketing patterns for culled dairy animals in the Northern and Southern Hemispheres, was a major factor influencing the integration decision for these firms.

Vertical Integration: Chicken

As noted earlier in Chapter IV, the structural organization of the broiler subsector is characterized by vertically integrated broiler processors. An estimated 97 percent of all broilers produced in the U.S. are produced within these integrated firms. Approximately 90 percent of domestically-produced broilers are produced under some type of production contract, and an additional 7 percent are produced directly by integrated processors.² In addition, most processors also control, either via ownership or through contractual relations, hatchery supply flock and hatching operations. The high capital and operations barriers posed by these integrated systems are substantial, and are reasons why limited-menu firms specializing in chicken items are not currently integrated into processing activities, even though a few are large enough on an annual product volume basis to justify such a move.

Another factor influencing vertical integration by these firms is the relative instability in the year to year profitability of broiler

¹ Another reason cited was lower labor costs in processing facilities, which were reportedly realized through the use of semi-skilled labor, rather than skilled butchers. One interviewee suggested that the wage differential amounted to nearly \$2 per hour. It was not possible to document this assertion.

² Reimund, et al., 1981, p. 3.

processing operations. Reportedly, this is the primary reason why Heublein, Inc. disposed of the integrated broiler processing operation (Spring Valley) that was owned by Kentucky Fried Chicken at the time Heublein acquired that firm. Apparently the experience of Heublein and KFC, which was one of adverse profit swings in both processing and foodservice operations during the same periods,¹ has not been lost on other limited-menu firms.

In addition to the above factors, firms vertically integrating into broiler processing operations could be expected to encounter problems with "out-of-spec" product and franchisee difficulties similar to those described earlier. While such problems, in and of themselves, might not preclude firms from operating vertically integrated processing facilities, they nonetheless are factors to be considered before making final decisions.

At the present time there are no major limited-menu firms vertically integrated into broiler processing activities, nor were there any firms seriously contemplating such action at the time interviews were conducted. High capital barriers and unstable returns were viewed as the primary deterrents to entry by most purchasing agents. Given these barriers it is highly unlikely that any large limited-menu firms will be involved in broiler processing activities in the near future.²

¹ See statement by R. L. Duffy in Pricing Problems in the Food Industry, 1978.

² The reference here is to backward integration by foodservice firms. As noted earlier, both Perdue and Holly Farms have integrated forward into foodservice operations. Acquisitions of foodservice firms by companies with broiler processing activities are also a distinct possibility given the recent merger history of foodservice firms and food and tobacco processors.

Advertising and Promotion: Market Coordination
Mechanisms?

All large limited-menu firms engage in advertising and promotion activities. For many firms these activities are substantial.¹ Franchisors and their franchisees often form national and regional cooperatives expressly for the purpose of organizing and coordinating their activities in these areas, and to avail themselves of the economies that large advertisers enjoy vis-a-vis smaller ones.² Firms may use advertising and promotions for a variety of purposes. For example, they may be used as a response to the activities of market rivals. In this case, the programs could be viewed as forms of non-price competition. The various sweepstakes and "buy a soft drink and get a free glass" promotions, which seem to have increased in frequency in recent years, are examples of non-price centered promotional strategies that are popular with limited-menu firms.

Advertising and promotions are also used to introduce new menu items, to special selected menu items, and to promote the foodservice operation in general. To the extent that the advertising and promotional activities engaged in by limited-menu foodservice firms are effective instruments to stabilize and/or expand foodservice sales, these activities affect vertical coordination processes because they influence the demand for food and other items used by the firm. A relevant question in this regard is, "Are advertising and promotion programs coordinated internally with purchasing programs?" If they are, then these programs may assist in the clearing of market surpluses or minimize the impact

¹See Chapter III, especially footnote #2 on page 69, for details.

²See Chapter III, especially pages 69-71, for details.

of market shortfalls for beef and/or poultry products.

While it is not possible to evaluate the impact of these programs in a quantitative way within the research framework, it is possible to make a qualitative assessment of their effect. In general, the responses of purchasing agents indicated that there is only minimal interaction between purchasing and marketing departments concerning the planning and implementation of advertising and promotional programs. This response was consistent across all firms in the sample. Purchasing personnel do not communicate general market and price conditions in input markets to marketing personnel under normal circumstances.

There are a number of reasons for this lack of interaction. One of the primary reasons why procurement and marketing policies, particularly advertising and promotion, are not more closely coordinated within the firm is the relatively long lead time required to develop and implement these programs. This is particularly true of national and large regional advertising and promotion programs. Firms simply cannot respond quickly enough with these programs to take advantage of temporary market surpluses in beef and/or poultry inputs, which could lower the effective cost of promotional programs. Conversely, once programs are planned adverse conditions in input markets cannot be easily avoided.

Another factor reducing the importance of inter-departmental interactions is that national and regional promotion programs are generally timed for specific periods during the year. Many firms establish standard policies in this regard. Promotional programs are often targeted toward specific holidays such as Memorial Day, the Fourth of July and Labor Day. Promotions take place during these periods regardless

of conditions in primary input markets. Marketing personnel do sometimes use the budget projections prepared by purchasing in estimating the expected costs of these promotions. But, in general, these budget projections have little or no impact on promotional decisions or the timing of the promotions.

Foodservice distributors and processors supplying limited-menu firms have virtually no incentive to undertake any promotional activities that might directly affect consumer demand for their products used by foodservice firms. Unlike products marketed through retail grocery operations, most food products supplied to foodservice operations undergo a physical transformation at the foodservice retail level. Due to this transformation, the identity of the product with its processor/fabricator is obscured. This is particularly true in the case of beef and poultry items, but it is also true of most other food items used by foodservice firms. In this sense, distributors and processors, even national brand processors, are more like producer-goods suppliers in their relations with foodservice firms. With no effective means to influence foodservice-related consumer demand for their products, these processors are forced to rely upon their promotional activities in other sectors (e.g., grocery retailing), or the promotions undertaken by the foodservice firms themselves, to move surplus inventories. National brand processors may possess the former option, as may a few poultry processors that market branded product through retail grocery channels, but, in general, the specialized beef fabricators that supply limited-menu firms do not have this option.

The conclusion that one reaches in regard to advertising and promotional activities undertaken by limited-menu firms is that these

activities do not necessarily improve vertical coordination processes. In fact, under some circumstances, these promotional activities may adversely affect the degree of coordination. Such would be the case if the demand for an input (e.g., beef) were to increase as a result of promotional activities at a time when supplies were relatively short. Conversely, given the intra-organizational linkages between purchasing and marketing personnel in most firms, promotions that correspond with conditions of excess supply in input markets are coincidental, rather than planned. Thus, while advertising and promotion programs may temporarily improve foodservice sales, which is their principal purpose, they do not necessarily create positive externalities with respect to the balancing of supply with demand. Hence, a possible salutary effect of these activities is not realized.

Menu Pricing Policies: Market Coordination Mechanisms?

Limited-menu foodservice firms, as a group, are very reluctant to adopt pricing strategies that require frequent changes in their menu prices. Decisions regarding menu pricing are usually made by top level management using the annual and quarterly food budgets prepared by purchasing personnel and growth projections made by the marketing department.¹ Over 90 percent of the firms interviewed evaluated their menu pricing at least once every quarter. Many firms review pricing decisions more frequently than once each quarter, particularly in those instances where budget projections appear inconsistent with actual food costs. Since most firms enter into fixed price contracts with food and

¹In franchise systems, franchisees retain autonomy with respect to their own menu pricing.

paper processors, and also either contract for distribution services with foodservice distributors or operate their own distribution facilities, the budget estimates for most food and paper goods are very close to actual costs. This is not the case, however, with beef and/or poultry products. As noted in Chapter IV, the cost of these items typically fluctuates from week to week. Consequently, changes in the costs of these items which exceed budget projections are a major factor affecting menu re-price decisions.

Although personnel interviewed were reluctant to intimately discuss their menu pricing strategies, it is clear that budget projections, as well as the firm's product/service mix, play a significant role in these decisions. It is also clear that modest fluctuations in beef and/or poultry prices are accommodated by some foodservice firms through their budget and menu pricing practices. If these fluctuations were not absorbed, there would be evidence of more frequent bi-directional menu price changes at the retail level that reflected movement in wholesale prices.

There are a number of reasons why limited-menu firms are reluctant to make frequent minor price changes. One reason is that input price changes are often relatively small. The expected impact of these changes on retail demand is also small and may not even offset the intra-organizational costs associated with changing menu prices at the retail level. A second reason is that constantly changing menu prices are viewed by management as a destabilizing force on retail sales. Management recognizes that consumers tend to be frustrated as well as confused by constantly changing prices. Limited-menu firms are sensitive to this fact and are willing to absorb some changes in input costs to avoid this potential problem. A third reason is that a firm's menu

pricing strategy is an important element in both the firm's planning and marketing activities. A change in menu prices could affect either or both of these activities. While firms would be expected to systematically evaluate their strategies in these areas, they would also be expected to do so on a much less frequent basis than changing input prices might otherwise dictate. Thus, for reasons primarily related to organizational certainty, and in order to facilitate the development and implementation of plans, there is a general bias toward pricing stability.

Managements' capacity to absorb upward input price movements is at least partially a function of their budget processes. In order to accommodate modest input price fluctuations without unduly pressuring short-term earnings, there is a tendency to introduce an upward bias into food cost estimates. Although this bias may be a small percentage of total food costs, perhaps on the order of one or two percent, it results in a cost cushion that can be utilized to cover unanticipated increases in food costs. Since food and distribution costs are fixed in the short-term through supplier and distributor agreements, the cost cushion is available to defray price increases in food items not covered by fixed price contracts. As noted earlier, beef and poultry items are the principal food items not covered by these contracts. Given an estimate that these items represent an average of 50 to 60 percent of total food costs, a bias of one or two percent of total food costs would accommodate perhaps as much as a four percent increase in the cost of these items before total food expenditures would exceed budget projections.

The menu pricing and budget control processes employed by limited-men foodservice firms influence vertical coordination processes in a

number of different ways. For example, firms that systematically absorb modest fluctuations in the cost of beef and/or poultry items create an institutional barrier that moderates the role of prices as resource allocation media. Distortions related to the timeliness with which changing input prices are conveyed throughout a given market channel are one direct result of these actions; increased price volatility may be another.

Depending on the magnitude of input price movements and the amount of slack in budgets, firms may experience extended periods of time where no menu pricing adjustments need occur, even though input prices are changing on a daily or weekly basis. Such periods may have either detrimental or salutary effects on a market system depending on the prevailing supply and demand conditions. During periods of temporary excess supply in input markets, firms employing rigid menu pricing strategies are not significant participants in market clearing activities beyond those associated with their normal business activity. This is especially the case when the price changes resulting from oversupply are modest. Under such conditions, budget projections and related accounting control rules are not violated, and no remedial management action with respect to pricing is triggered. With no downward adjustment in retail menu prices, there is no demand-pull effect that would tend to reduce excess supplies in input markets.

When there are only modest movements in input prices, and no significant excess supply or demand conditions, a rigid menu pricing format may actually improve market coordination. The budget processes used by many limited-menu firms tends to average out modest price fluctuations over time. As a result there is a relative stabilization between input and retail prices. By eliminating some of the variability

in these prices, there is an opportunity to plan and coordinate procurement activity at a level beyond that attainable under less controlled situations. The degree to which vertical coordination is improved in such cases is uncertain, although it is generally acknowledged that a reduction in price variability is a desirable outcome from a market performance standpoint.

It is reasonably clear that the menu pricing/re-pricing policies used by limited-menu foodservice firms are designed to stabilize retail demand for their output. It is also clear that budgetary processes are designed to complement these policies. To the extent that these policies are effective, it raises the question of how the market systems for beef and poultry products adjust to changing supply and demand conditions. These adjustments, at least in the short-run, are not readily accommodated by the standard operating procedures employed by limited-menu firms.

Formula Pricing: Market
Coordination Mechanism?

As noted in Chapter IV, there are sound economic and organizational rationales for the use of formula pricing arrangements in fabricator/foodservice firm transactions involving beef and/or poultry products.¹ Stability in fabricator/foodservice firm relationships, certainty with respect to the cost of fabrication if not the level of raw product prices, and reduced personnel requirements in purchasing departments were cited among the important factors contributing to the use of

¹The relevant sections of Chapter IV are pages 167-78 and 186-95.

formula pricing arrangements. Each has the potential to reduce the real costs incurred by firms in executing market transactions, especially transactions that are highly repetitive in nature. Indeed, the most often cited advantages attributed to formula pricing arrangements are those associated with transactional efficiencies, and more specifically lower search and exchange costs. Although from a transactions standpoint formula pricing arrangements are efficient, one must also consider the impact of these arrangements on the broader marketing system before reaching any conclusion about their overall effects. Among those factors that deserve attention are 1) the stability effects of these arrangements on the broader market system, and 2) the resulting distributional effects on market participants. Although the methodology employed in this research does not accommodate a quantitative analysis of either the stability or distributional effects of formula pricing agreements, it is possible to make a limited qualitative assessment on these counts.

Formula pricing arrangements for beef and poultry products are common both in the limited-menu segment of the foodservice sector and in the retail grocery sector. In fact, the use of such arrangements is the rule rather than the exception for many large firms.¹ However, there may be important differences in their effects on market stability, depending upon the relative responsiveness of each sector's firms to changes in wholesale prices.

As noted earlier, the budget process tends to create a small cost cushion that can be utilized to absorb unanticipated increases in the

¹See contributions by R. Duffy and L. Haverkamp in Pricing Problems in the Food Industry, 1979.

cost of food items. This cost buffer has the effect of reducing the firm's sensitivity to modest input price changes, especially those that occur in the short run, and thereby allows the firm to pursue a more stable menu pricing strategy. This same buffer, however, also has the effect of reducing a firm's sensitivity to the market conditions that gave rise to the price change. The result is that an important market signal, which would normally be expected to trigger an adjustment in the level of beef or poultry purchases by the firm, is dampered, and minor purchase adjustments are not even considered by the firm, much less implemented.

The concern in this regard is not with the budget process itself or with the use of formula pricing arrangements by individual firms, but rather with their joint, aggregate effect on market systems. From a performance standpoint, the emphasis is macro, rather than micro in scope. It centers on the relationship between a set of outcomes or adjustments that occur within a market system and the firm level decisions that precede and give rise to these outcomes.

In the beef and poultry procurement activities of large limited-menu foodservice firms, there is a general tendency toward pricing stability at the retail level that is accommodated by the firms' procurement and budgetary processes. Planning with respect to marketing activities tends to take place within the closed environment of the firm and is largely independent of conditions in input markets, particularly in the short run. Formula pricing arrangements complement these activities by significantly reducing the burden of purchasing personnel with respect to the monitoring of input costs and by stabilizing supplier relationships. From a firm level or micro standpoint, the internal procurement system is rational and

transactionally efficient.

Although these procurement systems are efficient systems for individual firms, their aggregate effect may be to destabilize prices in input markets. In general, these firms do not possess the marketing flexibility of grocery retailers, who can utilize variable margin pricing across a broader range of products. Instead, limited-menu firms are constrained by their product service mix to a fairly narrow range of output. The narrowness of this range increases the firm's dependence on primary inputs such as beef or poultry and creates an operating environment where the acquisition of adequate supplies to meet anticipated demand becomes an overriding concern. The result is a condition where, at least in the short run, limited-menu firms are relatively insensitive to price/quantity relationships in major input markets.

Given the firm-level incentives that exist for limited-menu firms in procurement relations, a relevant question is, "what are the likely consequences of such actions on price stability in relevant markets?" If one hypothesizes that during any given time period, aggregate beef and poultry quantities purchased by limited-menu firms are constant, which is a reasonable assumption given procurement SOPs, then their actions would tend to result in increased price instability. This result follows from the fact that limited-menu firms do not adjust purchases in the face of changing supply conditions. Adjustments that are required to clear input markets are shifted to other market participants, particularly the retail grocery sector.

A logical argument can be made that, due to the nature of limited-menu procurement SOPs, the adjustments required to clear markets are

larger than if both sectors adjusted purchasing patterns in a timely fashion. The larger quantity adjustments, in either direction, that are required by the relatively more price-sensitive retail grocery sector result in relatively wider price movements to clear markets, even though formula pricing is used extensively in both sectors.¹ Since limited-menu firms' purchases are relatively constant, prices in input markets must fall relatively further to accommodate conditions of excess supply or rise relatively high during periods of excess demand. Thus, price variability is probably increased even though supply conditions may be relatively stable.

The distributional impact of increased price instability is difficult to evaluate for it depends crucially on the magnitude, frequency and direction of price movements. As a general proposition, however, those market participants most adversely affected by greater instability are those participants that lack the ability to pass through costs associated with adverse price movements. In general, both foodservice operators and retail grocery firms, because of their proximity to final consumer demand and their consumer franchises, possess some capacity to manage or flow-thru these costs. Therefore, it is reasonable to conclude that the burden associated with greater price instability falls disproportionately on those market participants occupying less advantageous market positions.

Beef and poultry fabricators would normally be included in this group. However, their procurement relationships, and in particular

¹This is not to say that grocery retailers respond perfectly to changing conditions in input markets, but rather, that they do respond in a more timely fashion than do limited-menu firms.

their formula pricing arrangements with foodservice firms, reduce their vulnerability to price instability. Livestock and poultry producers are not parties to these arrangements and, given the vertical linkages between other market system participants, are those most likely to incur a greater than proportionate share of the costs associated with instability. Moreover, they are the market participants most distant from final demand and, therefore, are often viewed as residual claimants lacking power in the marketplace. This combination of factors makes them more, rather than less, likely to be burdened with these costs.

Although a final determination as to the distributive consequences of greater price instability must be left open, for it is ultimately an empirical question, it seems likely that livestock and poultry producers are among those most disadvantaged. Formula pricing arrangements alone do not necessarily result in this situation. However, the use of formula arrangements along with the generalized budgetary systems and procurement SOPs adopted by limited-menu firms tend to create an environment where increased instability is a likely outcome. To the extent such conditions exist, they result in less preferred outcomes and adversely affect vertical coordination processes.

Chapter Summary

This chapter has focused upon institutional, organizational and operational factors influencing vertical coordination processes between limited-menu firms and their beef and/or poultry suppliers. Specific risk-reducing and/or shifting strategies available to these firms were examined for their relevance in these relationships. Among the conclusions reached were that (1) futures markets do not

generally provide limited-menu firms the opportunity to effectively reduce price risks associated with beef and/or poultry procurement; and (2) vertical integration into either fabricator-level operations or into cattle feeding activities are not viable options for most limited-menu firms.

Various operational factors were also considered with respect to their vertical coordination consequences. Included among these factors were (1) the nature and timing of advertising and promotional activities undertaken by limited-menu firms, (2) the general menu-pricing policies of these firms, and (3) the likely effects of formula pricing arrangements and budgetary processes on general price stability in input markets. Advertising and promotional activities, while possessing the potential capacity to positively influence the coordination process, were found to lack necessary intra-firm linkages that would enable firms to more closely coordinate their activities in these areas with conditions in input markets. The menu-pricing strategies employed by limited-menu firms and their general procurement and budgetary SOPs tend to introduce price instability in input markets. The incidence and magnitude of the costs associated with this instability are not clear; however, producers of beef and poultry are likely to be among those participants most adversely affected.

CHAPTER VI

SUMMARY, CONCLUSIONS AND RECOMMENDATIONS FOR FUTURE RESEARCH

Summary

This research effort has focused primarily upon delineating the changing structure of the limited-menu foodservice sector and examining the beef and poultry procurement procedures employed by large limited-menu foodservice firms. Emphasis was given to identifying specific standard operating procedures and practices used by these firms to acquire beef and poultry products for their foodservice operations and to assess the vertical coordination effects of these procedures. Since there are substantial differences in the structural organization of limited-menu firms, structural factors were controlled for in the research process. Where appropriate, comparisons and contrasts were drawn between the procurement and input pricing arrangements employed by structurally different types of firms. In many instances, the procurement procedures used for a specific input were found to be largely independent of structural conditions.

The research identified a number of different procurement relationships that are involved in the distribution of food and paper products to limited-menu retail operations. In large limited-menu foodservice

firms, there is a functional division of responsibility. The food-service firm's purchasing department controls the procurement process through a system of contracts and distribution agreements with both food processor/suppliers and foodservice distributors. Fixed price contracts with processors and pre-negotiated distributor margins are used to control the cost of many food and paper items delivered to retail units.

Unlike most food and paper items, fixed price contracts are not common in the procurement of beef and/or poultry items used by limited-menu firms. Frequent price changes in these items make such contracts difficult to negotiate. Most beef items are priced using some form of formula pricing arrangement. In these arrangements, processing costs, shrink allowances, and storage and delivery costs are negotiated between transaction participants on a systematic basis. The price of raw material inputs used in the fabrication process is usually tied to a base market price quotation that is agreed upon by both parties. The Yellow Sheet is commonly used to establish these costs for beef items. The USDA 9-city price, the Georgia Primary and the Los Angeles market price are often used to establish base prices for broilers.

The normal pricing cycle for both fabricated hamburger product and broilers is seven days in duration. Prices are established in advance of purchase and remain fixed throughout the length of the pricing cycle. Various methods are used to determine the base market price. In some cases, a weighted average price for a specific previous period (e.g., the closing market quote for the preceding five days) is used. In other cases, the closing quote at a specific market on a

specific day establishes the base market price for the next seven day period.

Distributors perform most of the physical activities and related record-keeping duties required to distribute products to retail outlets. Distributors order and inventory items from designated processors and assemble and coordinate retail store deliveries. Although they are responsible for physical distribution activities, distributors serving large limited-menu accounts are not usually involved in processor price negotiations for these firms. The only exception is where the foodservice firm has elected to use distributor label products in their operations. In this case, the foodservice firm negotiates directly with the distributor over the price of these items, and the distributor, in turn, negotiates with the distributor-label processor.

Processor deliveries to foodservice accounts may be either direct to retail unit or channeled through foodservice distributors. Firms using fresh beef in their retail operations more frequently are supplied directly by local beef fabricators. Frozen beef products are more frequently delivered to designated foodservice distributors who subsequently deliver them to retail units with other food and/or paper items. In some instances, broilers are delivered direct to retail units by processor-owned wholesale distributors. In other cases, processors may deliver to foodservice distributor facilities for reshipment to retail operations. When beef or poultry products are delivered by foodservice distributors, the distributors take title to the products upon receipt. Title is transferred to the foodservice firm upon delivery to retail units.

Detailed product specifications and in-house quality assurance

personnel are often used by foodservice firms to maintain quality standards for fabricated beef and poultry products. Franchise firms employ these procedures as well as a system of approved suppliers and/or distributors to maintain the quality of products used by their franchisees. As standard practice, franchisors offer their franchisees the same prices for food and paper items they negotiate with processors and/or distributors.

Franchisor/franchisee procurement arrangements are typically voluntary relationships. The prevailing case law, as it applies to purchase relations and product or equipment tie-ins between franchisor and franchisee, clearly establishes the right of franchisees to purchase products independently of any franchisor sponsored procurement system. In certain instances, for example, where a trade secret would be jeopardized by the absence of such an agreement, a franchisor may tie its franchisees to a specific third-party supplier.

The incidences of such restrictions are infrequent, however, and when occurring are limited primarily to products such as sauces or special seasonings. Efforts by franchisors to require their franchisees to purchase items such as chicken, beef, bakery products and paper articles through tie-in arrangements have been prohibited through various court rulings. As a general rule, if it is possible to establish product standards without revealing a trade secret, then the product or item cannot be tied. Voluntary procurement arrangements between participants in a franchise system are not prohibited, and many such arrangements exist in the foodservice sector.

The system of procurement SOPs used by limited-menu firms was found to be internally consistent, as well as both physically and transactionally efficient from the firms' standpoint. Procurement relations between beef and poultry fabricators and large limited-menu foodservice firms are relatively stable by design. The formula pricing arrangements prevalent between these parties contribute significantly to the stability of inter-stage relationships by reducing the incentives for either party to seek alternative exchange arrangements. By reducing these incentives, both parties to the exchange are afforded the opportunity to plan and coordinate their individual procurement and distribution activities more closely. Physical and transactional efficiencies between these parties in the exchanges are a result. Important efficiencies realized at the firm level are lower personnel costs and reduced search costs. These savings result from the fact that fewer internal resources are required to manage a formula-based pricing arrangement than one that requires a more or less continuous monitoring of the terms of trade offered by potential exchange partners.

Despite the transactional simplicity and efficiency of the procurement SOPs used by many limited-menu firms, their aggregate effect on the performance of input markets may be adverse. The general budgetary systems used by limited-menu firms, coupled with their extensive use of formula pricing and relative insensitivity to changing supply conditions, especially in the short run, appear to create an environment where price instability may actually be increased in input markets. To the extent that the aggregate effect of these factors results in additional price instability, it seems

likely that producer groups are among those market participants most affected.

Changing Structural Environment

The commercial segment of the foodservice industry, of which limited-menu foodservice operations are a part, has undergone significant changes during the past 25 years. The fast food segment of the industry has expanded rapidly and accounted for an estimated 35.1 percent of all eating place sales in 1977. Just 10 years earlier their share was about 18 percent of these sales. Multi-unit operations' share of eating place sales increased from 23.7 percent to nearly 41 percent over the same ten year span. Most of this growth was due to the expansion of multi-unit fast food operations.

Franchising has become an increasingly important activity within the commercial sector of the industry, particularly for fast food and other limited-menu firms. The share of restaurant sales accounted for by franchise systems increased over 70 percent between 1972 and the end of the decade. Franchise systems with at least 500 establishments recorded about 70 percent of all franchise restaurant sales in 1979, even though they represented less than 6 percent of all franchise restaurant systems. Franchisor-owned establishments accounted for nearly one-third of franchise sales in 1979.

Seller concentration levels are relatively moderate in most segments of the industry, especially when compared to those that exist in some food manufacturing industries. However, concentration estimates reported by census do not account for either the local market nature of the industry's activity or the possible effects of franchising activity. Thus, census estimates of market concentration understate

both buyer and seller concentration levels, albeit by an unknown degree.

In terms of changing ownership patterns, the industry has undergone a significant transformation since 1965. Mergers have played an important role in this transformation, and large food processors have been particularly aggressive in acquiring foodservice firms. Between 1965 and 1980, thirty-eight of the 200 largest food processors initiated a total of 70 separate mergers with foodservice firms. Slightly over \$3 billion in sales and nearly 9,900 foodservice establishments were acquired in these mergers. Seventeen of the very largest food processors -- those included among the largest 50 processors in 1975 -- were responsible for exactly one-half of these mergers. Foodservice acquisitions by food processors spanned the full range of market segments within the foodservice industry; however, limited-menu firms were the most frequent acquisition targets. Approximately one-third of acquired foodservice sales and about 45 percent of the acquired establishments were in this segment.

The expanded relationship between foodservice firms and large food processors resulted in 46 of the 200 largest processors of 1975 operating a total of over 14,700 establishments with aggregate sales of nearly \$6.4 billion in 1979. Franchised restaurant systems were an important component within this relationship; an estimated 34 percent of all franchise foodservice sales in 1979 were accounted for by food processor-owned systems. Ten of the 25 largest franchise systems were owned or controlled by food processors, including six of the 10 largest systems. Mergers were directly responsible for all 23 food processor/franchise system ownership linkages that were operative in 1979. Overall, mergers and acquisitions were directly traceable to the foodservice

holdings of 36 of the 46 food processors active in the foodservice industry in 1979.

Although all the ramifications of the expanded ownership linkages between foodservice firms and large food processor are not clear, it is likely that these relationships will continue to be forged through mergers and acquisitions. Such mergers, at some point, increase the potential for vertical market foreclosure and, hence, merit closer scrutiny for possible antitrust violations. Given the observed propensity for food processors to acquire franchise operations, particular attention should be given to those mergers where there is an obvious potential for the development of restrictive covenants, of either a voluntary or involuntary nature, between franchisor and franchisee with respect to procurement activity.

Conclusions

The results of this research can be effectively summarized by considering the relationship between procurement SOPs used by limited-menu firms and other structural or institutional factors that have relevance from a market performance standpoint. The following section presents a discussion of these relationships. It concludes with a brief discussion of the appropriateness of the research methodology employed in the study.

Power Relationships

Limited-menu firms, due to their proximity to final demand and relatively strong consumer identification with their operations, hold substantial power relative to distributors and processors that supply them. Unlike the situation in the grocery retailing industry,

foodservice-oriented processors and distributors have no effective way to influence foodservice-related consumer demand because their products are not identifiable by consumers. The physical transformation process that occurs in foodservice operations obscures this linkage. Thus, advertising and promotional activities, such as those used by processors supplying products to the retail grocery industry, are not effective in processor/foodservice interactions.

Although foodservice firms hold power relative to their beef and/or poultry suppliers, they also apparently recognize their interdependencies with these suppliers. Foodservice firm/supplier relationships tend to be very stable. This is particularly true in the case of beef and poultry processor relationships. The stability of these relationships suggests a mutual recognition of interdependence between these exchange parties.

Formula pricing arrangements are a major stabilizing factor in these relationships. These pricing arrangements significantly alter the incentive structure of transaction participants by reducing the expected gain associated with additional search activity. Stronger, more stable relationships result, planning is enhanced, and internal resources are conserved.

The stabilizing effect of these standard pricing arrangements may also have the salutary effect of limiting the monopsonistic power of large buyers. Strict adherence to formula pricing arrangements would seem to suggest that the monopsonistic tendencies of large buyers would be at least partially curbed. If this is indeed the case, then standard procurement procedures play an important role in balancing market outcomes between parties with substantially different market power.

Vertical Integration

It is unlikely that there will be any significant movement by limited-menu firms to vertically integrate, via asset ownership, either into the foodservice distributor level or into beef and/or poultry processing activities. The procurement SOPs used are viewed by management as effective means to secure products at acceptable prices. In addition, nearly all large limited-menu firms already assume some of the price risks associated with fluctuating wholesale prices of beef and poultry items through their arrangements with fabricators, and manage them within their budgetary process. Vertical integration into processing activities would not effectively mitigate those risks already assumed, and, in fact, would undoubtedly increase them. Given these relationships, and considering the specialized products used by most limited-menu firms, significant expansion of a vertical nature is doubtful.

Although vertical integration via asset ownership is unlikely, it is possible that more procurement arrangements of the general type reportedly used by McDonald's may be adopted by other firms. Based on reports in the trade press, it appears that this type of relationship is largely indistinguishable from what might normally be considered vertical integration. Only asset ownership is missing; all other elements of control are present. In those cases where all or a large proportion of a fabricator's output is supplied to a single foodservice firm, the prospects for a gradual evolution toward a McDonald's-type procurement system would appear to be relatively strong.

Forward integration by a few poultry processors into foodservice

operations has been accomplished on a limited scale. There may be additional, although limited, activity of this nature by other large processors in the future. It is unlikely, however, that any significant backward integration by foodservice firms into poultry processing activity will occur. The poultry industry is highly integrated between the processing stage and the production level, and capital barriers are high. This set of factors presents a formidable barrier to vertical integration by limited-menu or other foodservice firms.

General Vertical Coordination Effects

It appears that the menu-pricing practices, budget processes, and input pricing arrangements used by large, limited-menu firms jointly function as a buffer against fluctuating near-term wholesale prices for beef and poultry products. Marginal wholesale price changes in either direction do not appear to be reflected at the retail level, especially in the short term. This buffering of wholesale prices has implications for vertical coordination processes and market performance. An important implication of this behavior is that large limited-menu foodservice firms do not necessarily participate effectively in market clearing activities beyond the level dictated by their internal planning system and their historic product usage pattern. This suggests that the grocery retailing industry -- the other major market channel for beef and poultry products -- is the sector primarily responsible for market clearing adjustments.

The relative insensitivity of limited-menu firms to supply conditions in input markets also suggests that relative price movements required to clear markets during times of either excess demand or supply are larger than if the sector was more responsive. To the extent

greater price instability results from this behavior, market performance suffers, as do some market participants.

From an organizational planning standpoint, the procurement procedures used by large limited-menu firms are a stabilizing force in their relationship with their suppliers. Foodservice firm/processor relationships tend to be stable, facilitating raw product procurement by processors. Processors supplying products to large limited-menu foodservice firms know that these firms are going to be "in the market" each and every week, and that given seasonal market patterns, they have to purchase product to meet retail demand. This consistency in procurement patterns helps promote stability between exchange participants. The advantages accruing as a result of these relationships are likely to be at least partially offset, however, by the higher levels of price instability, and associated costs, that other market participants must bear.

The potential of advertising and promotional activity as a coordinating mechanism is largely untapped by limited-menu firms. Although some of these firms are very large advertisers, their activity in this area is usually uncoordinated with supply conditions in input markets. The result is that these activities do not systematically assist in the clearing of excess supplies, or dampen the effect of excess demand, in input markets. The major impediment to better coordinated programs appears to be the lack of internal communication linkages between marketing and purchasing personnel.

The futures market, a major risk-reducing institution in many agricultural marketing activities, is not an effective risk management medium for most limited-menu firms utilizing beef. The major problem

in its use is that the product used by these firms cannot be hedged directly, and the alternative -- cross-hedging -- is viewed by industry participants as highly risky. The result is that few firms are using the market to manage risk.

Firms utilizing broilers have the capacity to directly hedge that product. However, rather serious liquidity problems have reduced the effectiveness of broiler contracts as hedging media. The relatively recent introduction of a broiler contract on the Chicago Merchantile Exchange offers some hope of improved liquidity, but acceptance by traders remains to be established.

Methodological Considerations

A major objective of this research effort was to test the appropriateness of the research methodology in examining vertical coordination processes. An explicit assumption was that vertical coordination processes, and the resulting market performance, were systematically related to the behavior of market participants. Standard operating procedures, to the extent that they are manifestations of control and response elements within a firm, were seen as both major structural and behavioral components of the firm. They are structural components in the sense that they are well-defined, systematic rules; they are behavioral components in the sense that they guide, shape and reinforce behavioral patterns and responses. A major premise of the study was that specific, detailed knowledge of SOPs, and the more widely used standard industry practices, would reveal special insights into vertical coordination processes when they could be isolated and identified.

Although it is difficult to establish unequivocally the appropriateness of this research methodology, the general research approach

did produce an enhanced understanding of the procurement orientation of large limited-menu firms. In the process, it clearly established the linkage between the incentive structure operative at firm-level decision points and specific procurement SOPs. Clear relationships were also established between specific sets of SOPs and various aspects of vertical coordination processes and market performance. To the extent that such relationships expand our knowledge of food system operation and performance, the methodology used is validated.

Recommendations for Future Research

During the course of the research, a number of additional areas where further research would be beneficial were discovered. From a market performance standpoint, probably the most important of these areas is the nature of price adjustments required as a result of the procurement SOPs utilized by limited-menu firms. The results of this study suggest that procurement SOPs probably contribute to greater price instability in beef and poultry input markets. This relationship was not tested directly, however. A research effort directed toward evaluating price movements could clarify the nature of these interactions. The scope of any research undertaken in this area should include an evaluation of the distributional impacts associated with any changes in the level of price stability in input markets.

The procurement SOPs used by many limited-menu firms include formula pricing arrangements with beef and/or poultry fabricators. Invariably such arrangements establish the value of raw product inputs to the fabrication process by using a price quotation from a market reporting service (e.g., Yellow Sheet). In many instances, these

quotations are established on a very small percentage of both total trades and volume traded, and, therefore, may not be necessarily representative of underlying supply and demand conditions. Given the importance of these quotations, not only to limited-menu firms, but also to the retail grocery industry, research directed toward establishing reliable price reporting media is of considerable value.

A forward deliverable contract market (FDCM), a market for contracts structured similarly to futures markets but established with the intent of traders actually exchanging possession of the commodity, is one reporting medium that deserves consideration. Such a system could not only increase the number of trades, which would increase the reliability of prices, but also could provide additional market stability with respect to supply and demand conditions by affording better planning opportunities to market participants. The potential stabilizing characteristics of a FDCM system are certainly not incompatible with the procurement orientation of most limited-menu firms.

This research effort has focused on delineating the beef and poultry procurement procedures used by large limited-menu foodservice firms. Research which examines these procurement procedures in either other segments of the foodservice sector or in other commodity areas would add significantly to our knowledge of the industry and its aggregate influence within the food marketing system. No recent studies of this type were encountered in the review of literature. A logical component of a research project examining procurement relationships between foodservice firms and major food processors would include an evaluation of the contractual arrangement between these parties.

A limitation of this study is that it was confined to a relatively

small number of firms. Although many of these firms were franchisors, relatively few interviews were conducted with franchisees, and no systematic effort was made to survey their purchasing policies because it was viewed as beyond the scope of the study and incompatible with the research methodology employed. A survey of franchisees could provide important information regarding the impacts on franchisees of franchisor approval and/or purchasing programs. Nearly all franchisors use such programs. The results of such a study would provide more accurate information pertaining to the degree of buyer concentration within the foodservice sector.

A section of Chapter III was devoted to describing the effects of mergers and acquisitions on the structure of the commercial foodservice sector. A number of conglomerate mergers between foodservice firms and large food and tobacco processors took place during the 1970s. The effects of these mergers on the procurement activities of the acquired foodservice firms are not entirely clear. A limited number of case studies which focused on the organizational, operational and financial impact of these mergers on the acquired firm, that firm's franchisees, if appropriate, and foodservice competitors, would be valuable, particularly in light of the trend in foodservice acquisitions by food processors.

APPENDICES

APPENDIX A
FOUR-DIGIT SIC CODES
(FOOD AND TOBACCO PROCESSING)

The following is a description of the 4-digit industries that are defined within the Census classifications SIC 20 (Food and Kindred Products) and SIC 21 (Tobacco Products).

<u>SIC Code</u>	<u>Description</u>
201	Meat Products
2011	Meat Packing Plants
2013	Sausages and Other Prepared Meats
2016	Poultry Dressing Plants
2017	Poultry and Egg Processing
202	Dairy Products
2021	Creamery Butter
2022	Cheese, Natural and Processed
2023	Condensed and Evaporated Milk
2024	Ice Cream and Frozen Desserts
2026	Fluid Milk
203	Preserved Fruits & Vegetables
2032	Canned Specialties
2033	Canned Fruits & Vegetables
2034	Dehydrated Fruits, Vegetables and Soups
2035	Pickles, Spices and Salad Dressings
2037	Frozen Fruits & Vegetables
2038	Frozen Specialties
204	Grain Mill Products
2041	Flour and Other Grain Mill Products
2043	Cereal Breakfast Foods
2044	Rice Milling
2045	Blended & Prepared Flour
2046	Wet Corn Milling
2047	Dog, Cat and Other Pet Food
2048	Prepared Feeds, N.E.C.
205	Bakery Products
2051	Bread, Cake and Related Products
2052	Cookies and Crackers
206	Sugar Products
2061	Raw Cane Sugar
2062	Cane Sugar Refining
2063	Beet Sugar
2065	Confectionery Products
2066	Chocolate and Cocoa Products
2067	Chewing Gum

207	Fats and Oils
2074	Cottonseed Oil Mills
2075	Soybean Oil Mills
2076	Vegetable Oil Mills, N.E.C.
2077	Animal & Marine Fats and Oils
2079	Shortening and Cooking Oils
208	Beverages
2082	Malt Beverages
2083	Malt
2084	Wines, Brandy and Brandy Spirits
2085	Distilled Liquor, Except Brandy
2086	Bottled and Canned Soft Drinks
2087	Flavoring Extracts and Syrups, N.E.C.
209	Miscellaneous Food and Kindred Products
2091	Canned and Cured Seafoods
2092	Fresh or Frozen Packaged Fish
2095	Roasted Coffee
2097	Manufactured Ice
2098	Macaroni and Spaghetti
2099	Food Preparations, N.E.C.
2111	Cigarettes
2121	Cigars
2131	Chewing and Smoking Tobacco
2141	Tobacco Stemming and Drying

APPENDIX B
FRANCHISOR APPROVED SUPPLIER
CLAUSES

NOW, THEREFORE, in consideration of the premises and the mutual covenants, conditions and agreements hereinafter set forth,
 _____ and the Owner hereby agree as follows:

1. As the total fee for the franchise and license granted hereunder, Owner agrees to pay to _____ the sum of _____ as follows:

(Contract Particulars)

2. Subject to the terms and conditions of this Agreement, _____ does hereby grant unto the Owner a _____ franchise and license for a term of fifteen (15) years, with a five-year option on terms to be arrived at by mutual agreement between _____ and the Owner, commencing with the "completion date" of the construction of the building and improvements on the premises leased to Owner by _____ Development Company by a Lease Agreement dated as of the _____ day of _____, 19____ (the premises covered by such Agreement being hereinafter sometimes referred to as the "leased premises").

3. For so long as this Agreement and above referred to Lease Agreement remain in full force and effect, the Owner shall have the right and the duty to operate a low-cost _____ restaurant under the name of _____ in, on and from the leased premises.

4. The Owner agrees to establish and conduct his restaurant business operations in, on and from the leased premises strictly in accordance with the uniform standards prescribed from time to time by _____, and specifically, Owner agrees as follows:

(a) Owner agrees to serve or sell in, on or from the leased premises only such food and other items (whether or not such items are food-related) as have been made, stored and/or prepared in accordance with _____ specifications for securing uniformity in quantity, quality and appearance in the products served or sold in or from a _____. The Owner further agrees that all food and beverages and other consumable products and/or all of the ingredients thereof will be purchased by the Owner only from among those suppliers who shall have been approved by _____ as of the time of such purchase(s). If the Owner desires to purchase any such products or ingredients from a supplier who has not been previously approved, the Owner shall make request to _____ for approval of such supplier on forms from time to time prescribed by _____ and _____ shall proceed with diligence to . . .

10. RESTAURANT CONSTRUCTION. Licensor shall provide Licensee with site plan, standard plans and specifications for the type of restaurant building recommended by Licensor for use by Licensee. The building to be constructed by Licensee for operations under this agreement shall conform to the recommended plans and specifications furnished by Licensor, with only such modifications as Licensor may approve in writing. All costs of construction, licenses, permits and other costs relating to construction shall be paid by Licensee including the cost of any modification of the plans or specifications requested by Licensee. In the event a modular building is recommended by Licensor, the building constructed by Licensee for operations under this agreement shall be of modular construction in conformity with the plans and specifications recommended and furnished by Licensor.

11. EQUIPMENT. Licensee agrees to purchase or lease equipment, signs and fixtures in accordance with the standard equipment specifications and layout of Licensor, which fixtures, signs and equipment Licensee agrees to cause to be installed on the premises, all at Licensee's expense. Equipment meeting such specifications may be purchased or leased by Licensee from any available source. Any such equipment manufactured under patents or patent applications owned by Licensor may be purchased from Licensor at Licensor's list prices in effect from time to time or may be leased from Licensor upon the terms of Licensor's current equipment lease form, or may be purchased or leased from a supplier licensed by Licensor to manufacture the equipment under commercial contract. Any such equipment leases or sign leases will require security deposits equal to the amount of the last three month's rentals.

12. SUPPLIES. Licensor shall furnish to Licensee, as needed, the special seasoning and flavoring blend mixtures used for preparing, the processing and batter mix in accordance with Licensor's secret formulas, at Licensor's list prices in effect from time to time. All other supplies used in Licensee's restaurant may be purchased from any supplier whose products have been determined by Licensor to conform to Licensor's specifications and quality standards as in effect from time to time.

13. COVENANTS OF LICENSEE. The undertakings of Licensor hereunder and the grant by Licensor to Licensee of the license hereunder are upon and subject to the following express terms and conditions set forth in this paragraph 13.

- (A) The fast food restaurant to be constructed hereunder shall be, and shall remain, constructed and equipped in accordance with the building blueprints and the equipment layout plan as are standard in the System and as may be directed from time to time by Licensor. The building shall be surrounded by a parking lot paved with asphalt or other hard surface material, which shall be maintained by Licensee at all times as a parking area for the exclusive use of Licensee and the customers of Licensee in the conduct of the enterprise herein contemplated and only for the use . . .

FRANCHISEE shall have the right to purchase directly from any approved source the equipment, paper goods and other products required by FRANCHISOR to be utilized in the establishment or operation of FRANCHISEE'S outlet. FRANCHISOR shall promptly (and in any event within 30 days) furnish to FRANCHISEE at his request the then current standards and specifications applicable to any equipment, supplies, trademarked paper goods or other products required by FRANCHISOR to be utilized in the establishment or operation of an outlet, provided that FRANCHISOR shall not be obligated to disclose any of its trade secrets. In addition, FRANCHISOR shall promptly (and in any event within 30 days) furnish to FRANCHISEE at his request the names and addresses of all manufacturers and suppliers currently approved by FRANCHISOR from whom such equipment, supplies, trademarked paper goods or other products which do not meet FRANCHISOR'S standards and specifications or which constitute or embody seasoning or other trade secrets of FRANCHISOR. FRANCHISOR shall not be arbitrary or capricious in establishing applicable standards and specifications. If FRANCHISEE desires to purchase the required products from a manufacturer or supplier not then approved by FRANCHISOR, FRANCHISEE shall provide FRANCHISOR with all information regarding such manufacturer or supplier reasonably requested by FRANCHISOR and, where appropriate, the manufacturer or supplier may be required to provide FRANCHISOR with samples of the products that FRANCHISEE desires to purchase. Any tests reasonably required by FRANCHISOR to determine whether the products meet current standards and specifications shall be performed by or under the direction or supervision of FRANCHISOR but at the cost of the manufacturer or supplier. On the completion of any tests and any other procedures reasonably required by FRANCHISOR, and on completion of FRANCHISOR'S determination as to whether the manufacturer or supplier possesses adequate capacity and facilities to supply the FRANCHISEE'S needs in the quantities, at the times and with the reliability requisite to an efficient operation, FRANCHISOR shall promptly notify FRANCHISEE and the manufacturer or supplier whether FRANCHISOR approves the manufacturer or suppliers as a source of supply of the product involved to FRANCHISEE; and, if not, FRANCHISOR shall advise FRANCHISEE and the manufacturer or supplier of the basis for its decision. FRANCHISOR may from time to time review the quality of such equipment, supplies, paper goods and other products produced or supplied by approved manufacturers and suppliers and their capacity and facilities, and shall have the right to monitor the production, use and ultimate disposition of items bearing FRANCHISOR'S trademarks. On the basis of such review and monitoring, FRANCHISOR may remove such manufacturers or suppliers from the list of approved sources. In such event, FRANCHISOR shall promptly advise FRANCHISEE of such action.

APPENDIX C
HAMBURGER PROCESSING
AND HANDLING SPECIFICATIONS

PRODUCT SPECIFICATIONS

PRODUCT: All-Beef Hamburger - portions per pound;
15 portions to layer; 20 layers per case.

1. GENERAL REQUIREMENTS:

- A. All deliveries shall conform to requirements of the Federal Food, Drug and Cosmetic Act, State and Municipal Regulations, and any Amendments thereto, and must be delivered to destination warehouse at zero degrees F. or lower and in keeping with bacteriological and fat levels as specified under Standard Section. Truck operators will be expected to take temperatures at stop points and Area destination and maintain temperature records for inspection at delivery point.
- B. All products shall come only from sources that are using an extruding horn which has been supplied by the general office in , and the products therefrom are exclusive property of U. S. Patent No.
- C. Any purveyor who supplies 100% beef portions will welcome inspection of any and all of its operations (production, storage, raw material source and distribution) by authorized personnel during business hours.

2. RAW MATERIAL STANDARDS:

- A. hamburger portions shall be prepared only in plants operating under the Meat Inspection Division of the U. S. Department of Agriculture and shall be inspected, passed and marked in accordance with regulations governing the meat inspection of the U.S.D.A. All purveyors who supply raw material to the processors of ham-burger patties must be under U.S.D.A. inspection and offer or allow inspection by authorized personnel.
- B. Frozen beef raw material is not to be held longer than 60 days in freezer storage, from date of packing unless approved by a duly authorized representative of Executive Offices in Raw material is to be in good, fresh condition and to be trimmed properly prior to packing and freezing, it must be held in storage at zero degrees or lower

and transported and arrive at processor's plant at a maximum zero degrees F. No fresh or thawed raw material is to be utilized.

- C. When raw material is received at production point, it is to be inspected by authorized quality control personnel for general quality, condition and conformance to purchase specifications and samples are to be taken for microbiological analysis. All raw material, regardless of source, must be thoroughly inspected for wholesomeness at the unloading dock or other plant locations, utilizing procedures that will eliminate the use of off-flavored meat, etc., in product. Nonacceptable raw material is to be rejected for White Castle production.
- D. Fat meat (50% chemical) is to be plates, navels or trimmed steer flank from prime, choice or good cattle. Lean meat (85% or 90% chemical) is to be of good manufacturing quality, chuck preferred, and both lean and fat meat must be free of blood clots, bone or cartilage and be free of all foreign material. Only domestic meat shall be used in hamburger portions. Lean meat (percent lean), i.e., 85% or 90%, must be approved by _____ No imported beef is to be used in producing _____ hamburger patties unless prior written approval has been given by a duly authorized representative of _____ Executive Offices in _____

3. MEAT PATTY STANDARDS:

A. Product Color:

Bright red upon defrosting or during cooking stage. Product should carry well distributed white fat particles with no evidence of chunks or heavy accumulation of fat. Yellow fat particles are not desirable and must be held to a very low minimum or eliminated entirely.

B. Fat Content:

minimum - maximum fat by chemical analysis. A sufficient number of fat analysis will be made by the supervisor or manager of the patty supplier's quality control department of raw material and finished product. Batching of fat and lean raw material is to be of sufficient quantities to assure equal distribution of fat before the log extrusion process. All purveyors must accept the responsibility to keep fat levels well under the 30% maximum standards as established by Federal, State and Municipal regulations, and strictly in keeping with _____ standard. Processors' fat analysis procedures should be conducted under the plant's quality control

department using a modified Babcock Method, or preferably the ether extract method as recommended by the Association of Official Analytical Chemists (A.O.A.C.) or any other method which is suitable from an accurate and consistent standpoint.

C. Sanitation:

Processing equipment in the plant should be monitored weekly, or more frequently if necessary, for microbiological sanitation in addition to daily visual inspections. In this connection, swab tests of an 8" square sample should be held to 300 or less, standard plate count, 100 on yeast and 30 on mold. Samples should be taken daily at time of packaging for bacteriological analysis. In the event of any nonconformance, the product should be retained and not packed for

D. Inspections:

Daily inspections shall be made for product appearance and packaging and samples taken for cooking and evaluated for flavor, texture, etc. Weight checks are to be made for correct marked weight and piece count. Care should be taken to assure uniform thickness of patties (see Section 4, Paragraph E). Spot checks should be made at time of loading for:

1. Condition of boxes -- tight sealing -- cleanliness, etc.
2. Proper loading practices. If boxes are palletized, proper care must be applied to prevent load shifting enroute. Also, adequate insulation must be used in separating sections on stop trucks.
3. Age of product -- to guarantee proper rotation of product.

Also, the vehicles should be inspected for cleanliness, etc. If product is palletized, no more than one processing date should be on a pallet (if at all possible).

E. Size:

Portions to be sliced from sections or logs of meat as extruded from the _____, approximately 2-5/8" x 2-5/8" in cross section and of correct density to maintain the weight of _____ per pound. Meat portions will be manufactured in a manner to provide for an after cooking size of 2-5/8" x 2-5/8" or slightly larger.

F. Additives:

None. all-beef portions must be 100% beef,
nothing added.

G. Cooking:

Flavor and aroma to be typical of cooked fresh beef.

H. Bacteriological Guidelines:

Total Plate Count per gram:

Below 500,000

Total Coliform per gram:

Not to exceed 200

E. Coli per gram:

Below 100

Fecal Strep per gram:

Not to exceed 200

Staph/Coag. Pos. per gram:

Not to exceed 100

Cereal/Soya:

None

Negative for rodent hair, insect parts, insect eggs, larva or any other foreign matter.

I. Final Grind:

Raw material, prior to extruding step, must be ground through 1/8" plate. Grinding plates must be cleaned as necessary to prevent heavy accumulation of bone chips, etc., which could be forced through final grind plate into product. Also, prebreaking of raw material should be done in a manner as to assure proper distribution of fat and lean and to prevent noticeable spots of fat.

4. PACKING AND MARKING:

- A. Curled, broken or cracked patties are not to be packed. Patties should have flat surface,
- B. 15 all-beef portions per layer on polyethylene, wax or suitable separators to prevent sticking.
- C. 20 layers to case.
- D. 300 portions to case.
- E. Net weight to be between 16 lbs. 6 oz. minimum and 16 lbs. 12 oz. maximum.
- F. Inner box liner to be polyethylene bag, or overwrap sheet large enough to provide the same protection as a bag. This material should provide for a tight adherence to product to prevent "frost burn" pockets.
- G. Carton to be design and approved. Cartons can be press seal type (self-adhesive), taped (clear) or glued; however, if glued, care must be taken to prevent overuse of glue with resultant poor appearance of carton.

- H. Markings on all-beef hamburger cartons to be U.S.D.A. inspection marked and carry insignia (rhomboid) with /R/ for registered trademark, and Patent Number. Also, the carton must contain the company's name that processed the beef. Legend to prescribe: "Keep frozen at zero degrees F. or lower". Legible and understandable date of process on every carton (month, day and year, and packer's number).
- I. Storage and shipping should be handled in a manner to insure proper rotation of stock on a "first in, first out" basis. Product, from manufacturing date to customer must not exceed 12 days unless special permission is granted by a duly authorized representative of Executive Offices in Product is to be stored and transported at zero degrees F. or lower. Product is to be stored with spacers between cartons, or cartons offset in such a manner to provide proper circulation of air at zero degrees F. or below temperatures. Cartons should be removed from sharp or blast freezers, if used, immediately after reaching zero degrees F., inner product temperature, to prevent dehydration of product and frost accumulation.

5. QUALITY CONTROL:

- A. suppliers of meat portions are to maintain an adequate quality control staff to make corrections when production and distribution functions are not being followed in keeping with specifications or acceptable quality control practice. Quality control should be authorized to stop production, if necessary, until corrections have been made.
- B. A quality control laboratory should be maintained in the plant to properly follow fat analysis and bacteriological procedures, etc., and proper records will be made available for inspection by
- C. In addition to certain points previously covered, quality control should be involved in:
1. Spot analysis at all production, freezing and loading levels, on raw materials and finished product to assure strict adherence to specifications.
 2. Samples of product to be collected and analyzed for fat content before extruding.
 3. Fat analysis on finished product to be conducted on a programmed basis throughout the day.

4. Assuring that each product log and finished portion must clear through operating metal detectors prior to sealing of cartons to detect metal particles.
5. Assuring special care on raw material or formed logs held over the weekend to prevent improper temperatures and poor appearance of sliced product.
6. Tempering of raw material or logs to assure proper handling and in a manner to assure correct temperature for slicing and proper product appearance.
7. Assuring cartons which are palletized at the end of the packing line must be put in the freezer within 30 minutes, or preferably less time, to prevent thawing and frost formation.
8. Assuring when fresh carcass beef is boned and frozen at the processor's plant for production, a careful physical inspection will be made of the carcass. In keeping with Section 2, Paragraph B, outside suppliers of raw material should maintain similar quality control procedures. product must not contain fresh or unfrozen lean or fat meat.
9. Assuring sanitizing pans, containing Roccal or something equally effective, are used at each wash stand and production people on lines are regularly instructed in their use. After returning from washrooms or other sections of the plant, hands will be washed and sanitized.
10. Assuring plant employees on lines will wear proper head coverings at all times. Also, all operators touching meat must wear suitable hand coverings, which should be changed when necessary.
- D. In general-- the quality control staff will spend a sufficient amount of time on in-process as well as inspections of raw material and finished product to produce acceptable product in keeping with established specifications.

6. SHIPPING:

- A. Before product is loaded into the carriers' equipment, the vehicle refrigeration system must be checked to see that it is in proper working order.

- B. On trucks making more than one delivery, the product for each stop must be adequately protected from fluctuating temperatures during each unloading.
- C. Bills of lading and waybills must bear the following notation: "Frozen foods - to be maintained and transported at a temperature no higher than zero degrees F.".

7. REPORTS:

- A. The suppliers of all-beef hamburgers will send a monthly report (or more frequently if requested) to _____ Inc., _____, covering the following subjects:
 - 1. Bacteriological - indicating the high, low and average of tests and number conducted.
 - 2. Fat Analysis - the high, low and average results and number of tests on raw material and finished product.
 - 3. Approved Listing of Purveyors - supplying raw material for production and details on findings, changes, etc.

FROZEN FOOD RECEIVING, DELIVERING AND STORING SPECIFICATIONS

AREA WAREHOUSE

A. GENERAL SECTION:

Frozen meat patties and other frozen foods shall be held at an air temperature of zero degrees F. or lower. The temperature of the product in the center of the carton shall be maintained at zero degrees F. or lower. When the product is subjected to unusual conditions during loading or unloading, then the product temperature in the center of the carton shall not exceed 12 degrees F. to be acceptable, and such product shall be returned to zero degrees F. as soon as possible.

B. WHEN THE SUPPLIERS TRUCK HAS ARRIVED AT THE WAREHOUSE:

Cases selected from an incoming load for temperature readings should either remain in the load stack of the vehicle, or moved into a cold storage area for temperature measurement. Product temperatures should be recorded on each lot of frozen products received. Pallets should carry only one processing date (if at all possible). In measuring the temperature of the product in the center of a carton;

1. Insert probe of thermometer in several areas of the package with the sensing element in firm contact with the product.
2. Record the temperature when the needle gives a steady reading.
3. Sufficient measurements should be made at the front, middle and back of the load to be sure of proper temperatures.
4. This could amount to 12 or 15 determinations if temperatures have been recorded over 12 degrees F. If this should occur, four corner cartons from the front, middle and back stack within the load should be checked with the option of testing the center case from each of the three stacks.
5. Once the temperature has been recorded, move the product as fast as possible into zero degrees F. storage.

If products are received in the frozen food thaw range of 15 to 32 degrees or above, the following steps should be taken immediately:

1. The product should be placed in zero degrees F. storage and preferably lower.
2. The supplier notified of the situation without delay.
3. Notify Marketing Research Department in
4. A follow-up report should be sent to the Marketing Research Department using Food Protection Program, Quality Control Form 170.

If the Area is requested to use the product by the shipper, and product appearance is satisfactory, a sufficient number of samples shall be taken to an outside laboratory for analysis to be assured of wholesomeness before using. A copy of the laboratory report should be sent to the Marketing Research Department in

Frozen products should be moved or handled at the Area warehouse level in a manner to minimize exposure to elevated levels of temperature, rainfall or other weather conditions. As an example: Fluctuating temperatures can cause discoloration of meat, patties sticking to dividers and other problems associated with "up and down" temperatures.

All temperature measuring equipment should be checked for accuracy on a routine basis.

C. FAT ANALYSIS PROCEDURE ON MEAT:

In addition to temperature checks on all frozen products, a fat analysis must be taken on our meat patties.

Our fat specification to meat suppliers are to (Federal regulations state ground meat to be called hamburger must not be over 30% fat.) It is impossible to keep the fat content in every portion exactly to specifications, because we blend lean meat and fat meat, and they frequently vary from one mixing to another, although this situation should be adjusted by the meat supplier to the specified range of to

Therefore, the following steps should be followed in conducting a fat analysis:

1. Take three (3) patties each (from different layers) out of four (4) different boxes.
2. If more than one processing date is received in a shipment, keep the twelve (12) patties from each processing date separated.

3. Let patties thaw on aluminum foil or china plate (do not use paper plate).
4. Make one (1) ball out of the twelve (12) patties (one ball of 12 patties for each processing date).
5. Take a 2 oz. sample from the ball to be used in the tester.
6. The test or tests, depending on the number of processing dates received, should be fairly close to our fat specification of _____ to _____ (giving consideration to the Univex tolerance of 2% to 3%).
7. If there is a considerable difference, run a second test, using another 2 oz. portion from the processing date where the difference occurred.
8. List the results on your Form 170 meat report.
9. Random samples should be selected and cooked to evaluate for flavor (taste) and aroma (odor).

SPECIAL NOTE: At least once a month, a twelve (12) patty sample of one processing date should be taken to an outside laboratory for a fat analysis by the ether solvency method. Recommended by AOAC (Association of Official Agricultural Chemists).

D. TRANSPORTATION BY AREA WAREHOUSE ON FROZEN FOOD TRUCKS

Transportation vehicles should be maintained to transport frozen products at a consistent temperature of zero degrees F. or lower throughout the load. The thermostat on the vehicles' refrigeration unit should be set at zero degrees or lower, and be equipped with an appropriate temperature measuring device, located properly, to indicate accurate air temperature inside the vehicle. The interior of the vehicle should be constructed to provide clearance for proper air circulation around the load. The vehicle must be free from any dirt, debris or offensive odors. In addition, a freezer by-pass curtain and/or strips should be on all doors of the freezer truck to prevent loss of temperature during loading and unloading.

E. RECOMMENDED PRACTICES FOR THE HANDLING OF FROZEN _____ PRODUCTS AT AREA WAREHOUSE AND _____

1. Each Area warehouse freezer should be equipped to maintain an air temperature of zero degrees F. or lower and be equipped with an accurate temperature measuring device. Temperatures should be recorded daily and filed for future reference. In addition, a freezer by-pass curtain and/or strips should be on all doors of the freezer to prevent loss of temperature during loading and unloading.

2. The "first-in", "first-out" (FIFO) method of inventory control is of prime importance at the warehouse level.
3. Frozen products should be moved or handled at the Area warehouse level in a manner to minimize exposure to elevated levels of temperature, rainfall or other weather conditions. As an example: Fluctuating temperatures can cause discoloration of meat, patties sticking to dividers and other problems associated with "up and down" temperatures.
4. To prevent sharp temperature fluctuation in the warehouse storage area, the sensing element of temperature measuring devices should be located not more than six feet or less than five feet from the floor, and not in a direct blast of refrigerated air, or near entrance doors.
5. Frozen products in storage shall be stacked to permit free circulation of air around all sides.

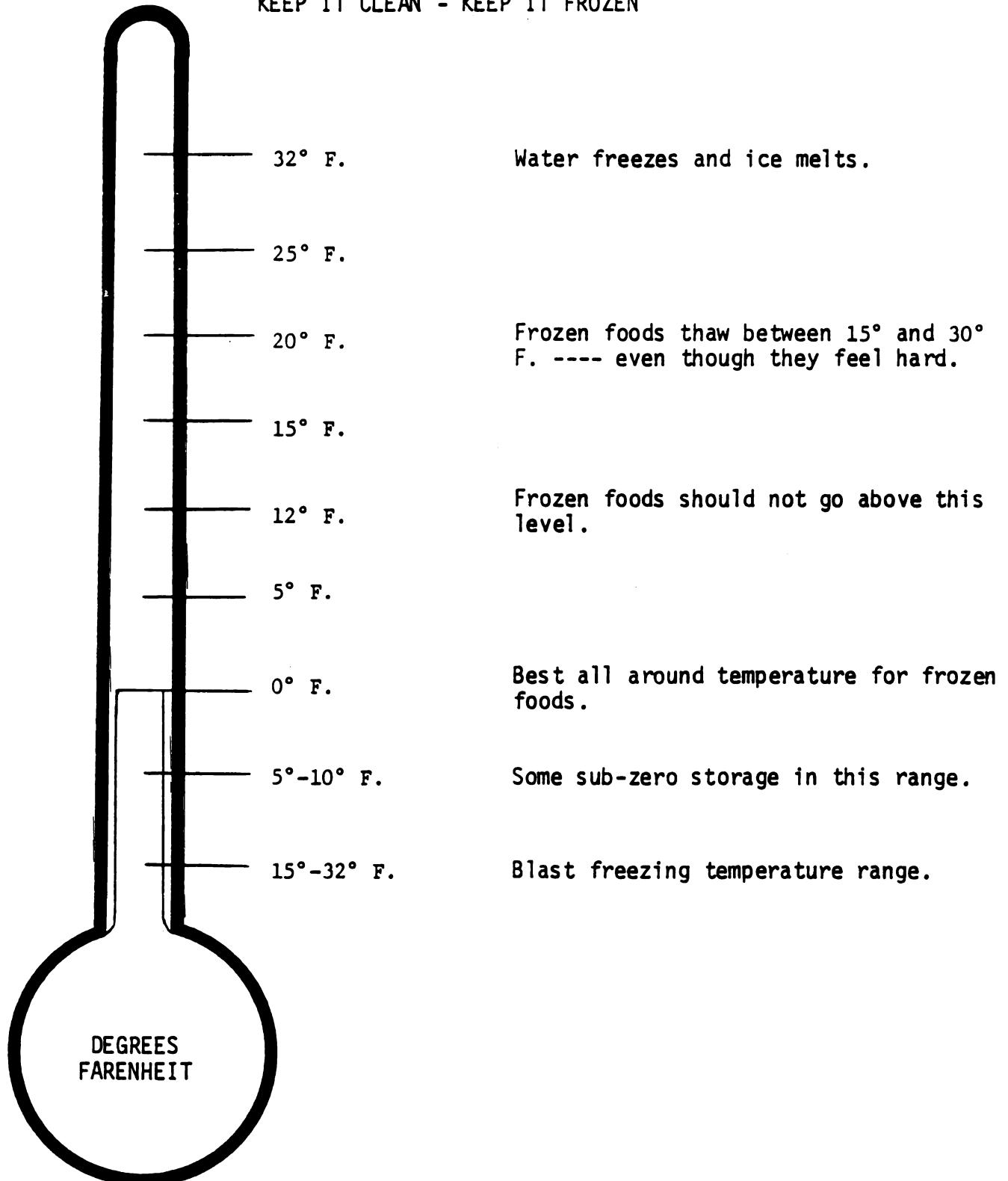
F. SPECIFICATION SECTION:

1. DO NOT allow boxes of meat patties, or any other frozen food, to remain outside of your storage freezer. Product unloaded from warehouse delivery truck should be moved promptly by roller conveyor, or other suitable means, directly into the freezer storage. frozen food storage facilities should be maintained at an air temperature of zero degrees or lower.
2. Freezer storage facilities should be equipped with an accurate thermometer, the sensing element of which should be located in the upper third of the distance between the floor and ceiling and away from any entrance door or direct air blast from cooling unit or evaporator coil.
3. In addition, a freezer by-pass curtain and/or strips should be on all doors of the freezer to prevent loss of temperature during handling or product in and out of freezer.
4. Frozen product should be stored to provide proper circulation of refrigerated air around all sides, top and bottom. Also, stored in a manner to prevent bulging or distortion of packages or boxes.
5. Frozen foods should be stored under established sanitary policy. If frozen foods are received with an internal product temperature exceeding 12 degrees F., the condition should be reported to the Area office immediately.
6. should rotate frozen product inventories on a "first-in", "first-out" (FIFO) basis.
7. All product should be removed from storage in quantities only sufficient for immediate use.

The following illustration indicates what happens to frozen products at various temperature ranges.

Please do your part in following the preceding Area Warehouse and Specifications to assure a top quality product.

KEEP IT CLEAN - KEEP IT FROZEN



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