The Food Services Sector: Finding good risks shouldn't be left to potluck

By Fritz Yohn

The nation's eating and drinking establishments represent one of the most vibrant and fast-growing segments of the US economy. By 2004, the total number accounts in this sector had pushed appreciably beyond the half-million mark, and were generating a staggering $350 billion in annual revenues.

The very size of the food services sector—with estimated standard lines premium potential of about $6.5 billion—historically has made it an attractive target for commercial lines agents and insurers. Of late, this sector's creation of roughly 4,000 new accounts each year has further bolstered its attractiveness, as carriers struggle to expand premium writings despite softening market conditions.

With about 200,000 accounts each, the "full-service restaurant" and "limited-service restaurant" segments account for 75% of overall food sevices establishments and generate 80% of the sector's revenues. "Other limited service eating places"—including coffee, doughnut and bagel shops; cafeterias, and ice cream shops—account for another 8% of establishments. "Alcoholic drinking places" comprise a bit less than 10% of total sector establishments. "Special food services," the final segment, comprises food service contractors, caterers and mobile food services.

As numerous carriers have demonstrated, size and growth alone do not necessarily guarantee profitable underwriting results in this important market segment. Indeed, the eating and drinking industry's complex makeup, its regional nuances and its changing dynamics, all but demand that carriers carefully evaluate each distinct sub-segment, develop a detailed underwriting appetite and then target only those risks for which they have adequate underwriting expertise and an appropriate rating structure.

While recent growth for the entire food services sector has been strong, its various sub-sectors have demonstrated very disparate growth patterns. This is a key indicator of special issues in underwriting (e.g. changes in loss frequency distribution), as well as in loss control and even premium audit. For example, the "special food services" sub-sector has recorded the strongest of the overall sector's growth, at least in terms of number of accounts. This group's 31,000 accounts grew at a 2.2% annual pace over the 1997-2002 period—almost double the pace at which the economy as a whole added new accounts. (Chart 2)

In contrast, the number of alcoholic beverage drinking places in the US declined at a 1.6% annual rate during the 1997-2002 period. However, while drinking places were one of the few business classes to experience

Chart 1: Composition of the Food Services Sector

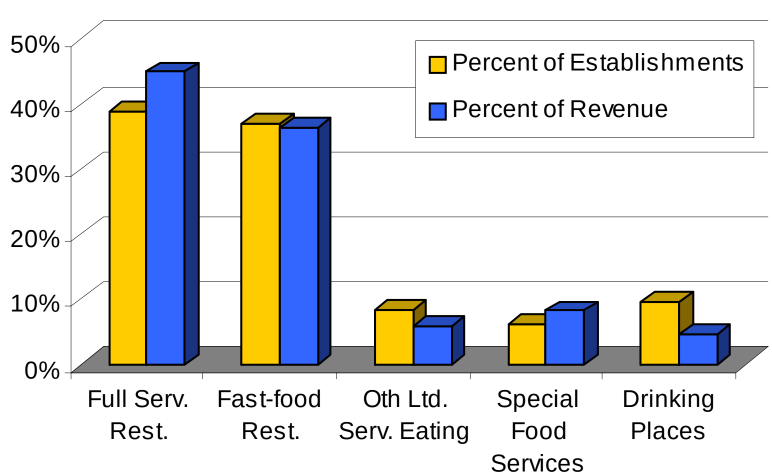


Chart 2: Growth in Eating and Drinking Establishments 1997 - 2002

appreciable, sustained decline in the number of accounts, the revenues generated by these establishments actually rose at a brisk 4.0% annual rate. (This is only a bit slower than revenue growth in the seemingly booming fast food segment.) In fact, growth of revenue generated <u>per drinking place</u> was especially high at 5.6% per year, indicating the importance of both effective account retention and premium audit practices to the successful writing of these alcoholic beverage-related risks.

Within the food services industry, the sources of an individual establish-ment's revenues are an important factor in its loss exposures and insurance coverage needs. Among full-service restaurants, for example, alcoholic beverages account for 17% of revenue on average and are served by fully 66% of these establishments. (Chart 3)

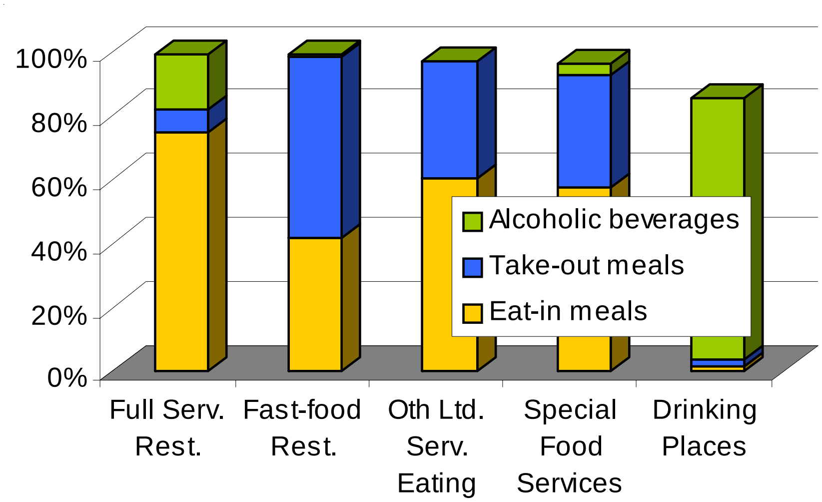
In contrast, alcohol is a minimal component of total revenue among limited-service restaurants and other limited service eating places (snack shops, etc.). That being said, however, among the 9.5% of limited-service restaurants that report serving alcohol, about 8% of revenues came from this source.

With respect to alcohol-related exposures, caution is called for in two segments. The first such segment is special food services. Here almost 10.5% of establishments report serving alcohol. While this is a relatively limited share of total accounts, the exposure in these accounts is roughly as sizable as that in full-service restaurants— about 15.4% of their revenues are derived from alcoholic beverage sales. Smaller still in number are alcohol-serving food service contractors, yet these firms reported generating almost 25% of their revenues from alcoholic beverages.

The other segment with an unexpected alcohol-related exposure? Well, it's full-service restaurants again. This time, however, it's the firms selling packaged alcoholic beverages for off-premises consumption. Nationally only 2.6% of restaurants reported selling packaged alcoholic beverages, but those that did realized almost 10% of their revenues from this source.

Alcohol exposures aren't the only issue in successful underwriting in the rapidly changing food services industry. As in so many sectors of the US economy, food service firms have been under enormous pressure to increase productivity. Indeed, most anyone who's had the opportunity to watch a burger assembly line in operation for a few minutes can appreciate the potential impact on loss frequency each time productivity increases another notch. A workers compensation claim arising from deep fat frying gone amok, or a slip and fall claim caused by a stray french fry, are just two of the readily apparent elements of loss potential that can be exacerbated by an accelerating pace of food service. (Chart 4)

Chart 3: Composition of Food Services Segment Revenues

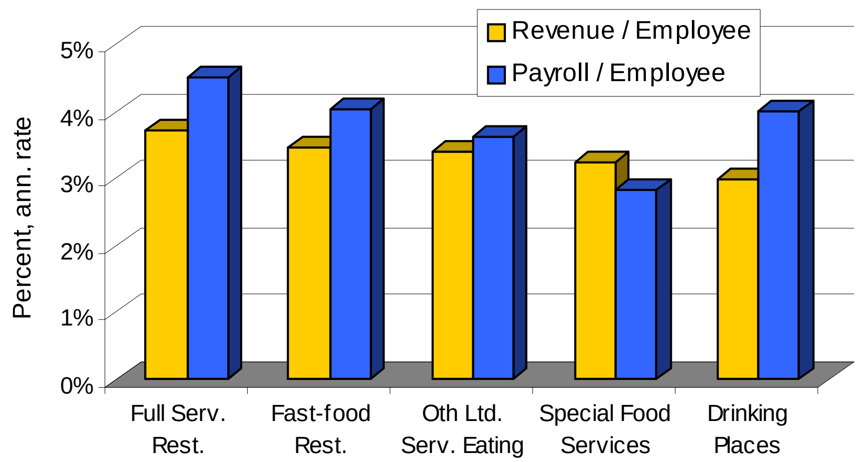


Surprisingly, revenue growth per employee has been fairly uniform across the various food services segments. Such growth was a bit stronger in the full-service segment (rising at a 3.7% average pace), nevertheless, revenue per employee in both fast-food restaurants and other limited service eating places (snack food shops) were not far behind – with each recording 3%-plus gains in this measure of productivity.

In contrast, payroll per employee, a measure of growth in the rating basis for workers compensation, rose significantly faster in the full-service segment than it did in special food services. As a result of the sizable rise in premiums that resulted, it's quite likely that workers comp loss experience improved significantly among full-service restaurant workers. In the special food services segment, however, the more sluggish pace of payroll growth means that rising loss costs will likely outpace the premiums collected.

Nationally, full-service restaurants account for a sizable 45% of all eating places. However, the composition of the sector varies appreciably state-by-state. As shown in the accompnaying map, full-service restaurants comprise the largest share of all eating places in the Northwest, and in many of the Mountain and Northern Plains states. Many of the Central Atlantic and Midwest states, in comparison, tend to have fairly low percentages of full-service restaurants, and by implication, larger proportions of fast-food and snack food shops.

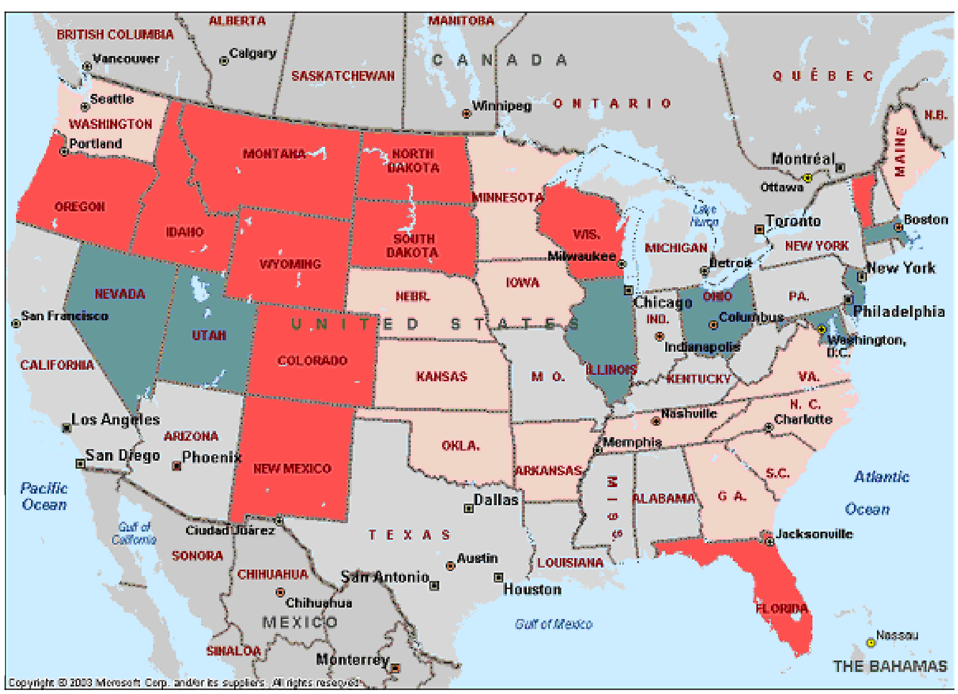
Chart 4: Growth in Revenue and payroll per Employee

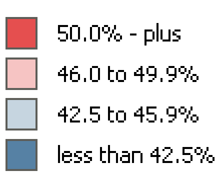


Indeed the highest share of fast food and snack food shops relative to total eating establishments exists in Maryland, which at a full 51%, narrowly edged out New Jersey and the District of Columbia for this distinction. Other states with especially high concentrations of fast food risks include the quick growth markets of Nevada and Utah. In contrast, Florida – another rapid growth state – has a relatively low concentration of fast food establishments in its quite large food services sector.

Fast-food versus sit-down restaurants, alcoholic beverages versus dry establishments, fast growth versus modest growth locales—the number of potential combinations of characteristics within the food

Full Service Restaurants as Share of All Eating Places





services sector may seem as overwhelming as the ingredients typical of potluck gelatin concoctions. However, the recipe for success in this sector relies simply on sticking to the basics.

Identify a segment, or set of segments, with homogeneous risks that match your underwriting expertise. Make sure that an adequate number of prospective accounts exist for those segments. Then be certain that they have positive growth prospects. Finally, select the target group of states in which this combination of characteristics is most consistent. Following such time tested techniques and ingredients will assure that your offering will produce a crowd-pleasing performance.

Frederick Yohn, PhD, is the developer of the MarketStance market analysis tool for the U.S. commercial property-casualty industry. MarketStance is a registered trademark of IntelliStance, LLC., in Middletown, Connecticut. www.marketstance.com. 888-777-2587.

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213 Court Street, 6th Floor
Middletown, CT 06457
888-777-2587
www.marketstance.com