WOODY'S BURGERS: CUSTOMER SERVICE, PRODUCTIVITY AND WAGES

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ABSTRACT

This case illustrates insights into the potential for providing a "living wage" for workers in a fast food organization. The major thesis of the case is that gains in productivity might offset the higher wage rate so as not to decimate profits. Additionally, the prospect of higher pay in attracting better qualified employees capable of higher output quality combined with productivity gains enhance customer value which can result in increased revenue and decreased costs. While this company is fictitious, the financials closely mirror information about leading fast food restaurants.

WOODY'S STORY

Woody McCarthy started Woody's Burgers 6 years ago in Ashland Springs, a trendy college town in the American South-West. McCarthy had attended the local university but never finished his degree. Instead he dove into his passion of owing a restaurant. He now has three restaurants, similar in size and situated in towns similar to Ashland Springs all within 100 miles of one another. While Woody's Burgers is the restaurant's name, most customers and employees simply call it Woody's.

It made sense to McCarthy to offer burgers made of grass-fed beef, locally sourced when possible, as well as farm-fresh veggies in season. Everything from the burgers to the salad dressing are made in-house. No processed ingredients are used and each burger is hand pressed daily. A 6-ounce burger with the sweet-potato fries is a superb meal. What makes Woody's truly distinctive is the use of wood burning grills. While Woody's is mostly about the burger, their "Fried Cookie", a large cookie studded with chocolate chips that has been deep fried and topped with vanilla ice cream and chocolate syrup and big enough to feed two or three, is a guilty pleasure. The restaurants' ambiance was adapted to the availability of vacant stores in the central business district. The Ashland Springs' location is in a former old-fashioned drug store with many of the drug store artifacts still on the walls and shelves.

While McCarthy replicated In-N-Out's food strategy, his personnel policy, patterned around McDonalds, fell short and McCarthy finally tired of the revolving door turnover of low paid employees. In McCarthy's opinion, worker productivity is about 75% and they only stay with Woody's for about 5 months before leaving.

Most fast food restaurants pay their workers under $8 an hour with Taco Bell coming in dead last at $7.37 an hour, In-N-Out starts their employees at $10.50 an hour. That's the highest of any fast food chain in the country but the higher-than-average pay doesn't stop simply at the young workers manning the cash registers. While the median wage for a manager of a fast food store is $48,000 per year, managers at In-N-Out can eventually work themselves up to $120,000. The company provides vision, medical, and dental benefits to both their full- and part-time workers [5].

Woody's restaurants are uncannily similar to corporate fast food restaurants such as McDonalds. A typical single McDonalds restaurant has the following characteristics: [7].

- Individual restaurants employ approximately 61 people in operations and management positions
- Wages and benefits consume about 31.9 % of McDonalds revenues

- Individual restaurants spend nearly $507,595 on wages (25.1% of each restaurant's revenues)
- An average McDonalds spends nearly $128,325 on manager and support staff salaries
- Employee benefits, about $137,605 per year (which include sick leave, vacations, insurance) take 6.8% of revenues
- Payroll taxes take more than 2.4% of revenues
- The average McDonalds employs more than 3.7 people in career positions

A "typical" single store operating income statement [8] for *Woody's*

		Dollar	Amount	% of	Sales
Net Sales			$ 2,210,500		100.0%
less Cost of Sales					
	Food Costs	627,782		28.4%	
	Paper Costs	83,999		3.8%	
	Crew Payroll	422,026		19.1%	
	Payroll Taxes-Crew	35,167		1.6%	
	Benefits-Crew	121,604	1,290,579	5.5%	58.4%
Gross Margin			919,921		41.6%
Marketing Expenses	Advertising	108,500		4.9%	
	Promotions	14,200		0.6%	
	Outside Services	27,000	149,700	1.2%	6.8%
Operating Expenses	Manager Payroll	100,679		4.6%	
	Payroll Taxes-Manager	8,390		0.4%	
	Benefits-Manager	28,710		1.3%	
	Miscellaneous Operating	96,693		4.3%	
	Rent/Utilities/Insurance	301,501		15.0%	
	Taxes and Licenses	56,589	592,562	1.2%	26.8%
Other Expenses/Income	Depreciation/Amortization	94,500		4.3%	
	Interest Expense	26,850		1.2%	
	Other	5,450	126,800	0.2%	5.7%
Operating Income			$ 50,860		2.3%

Woody's is open 12 hours a day; seven days a week and has 53 members of the operating crew and 4 managers per single store restaurant. The average customer bill is $13.64 and breaks out to 43% for burgers; 18% for fries; 19% for drinks, and 20% for dessert. This is a composite average so each customer might order in different amounts and combinations.

Woody's Wage Distribution [8]	$7.25-$8.50	$8.50-$9.50	$9.50-$10.50	$10.50-$12.00	$12.00 +
Percent of workers	45.6%	36.8%	7.0%	3.5%	7.0%

Number of workers	26	21	4	2	4
Average wage	$7.65	$8.74	$9.82	$10.95	$13.62
Hours per week	24	26	28	35	44
Weeks per year	34	38	42	42	42

WOODY MCCARTHY'S EDUCATION CONTINUES

One of McCarthy's steadiest customers is Professor Allard Thompson, a retired professor and now Woody's mentor. Thompson stops by at least twice a week and after dinner converses with McCarthy about challenges his business faces. The last time Thompson stopped by, the two had a long discussion about the "$15 per hour wage" movement.

McCarthy's position could be summarized as: *In examining my operating income statement, it is clear that each percentage point increase in* payroll *expenses would have an enormous impact on overall profitability. For instance, an increase of just one percentage point of payroll as a percentage of sales would cause my bottom line to shrink by 43%, from 2.3% of sales to 1.3%. I can't see the advantages in paying my employees a higher wage and still be able to stay in business.*

Professor Thompson approached Woody's skepticism indirectly by talking about the value of customer service. He would get to the point of Woody's cynicism later. Thompson stressed that outstanding customer service is necessary to build strong bonds with customers. Traditionally, marketing emphasized techniques for attracting new customers, but with mature markets and heightened competition, the focus of marketing has expanded to include customer retention. A key to building strong relationships with customers is to provide remarkable customer service during the service encounter. From a long-term perspective, customer service can reduce costs since many experts speculate that it costs five times more to acquire a new customer than to generate repeat business from present customers [3] [4] [6].

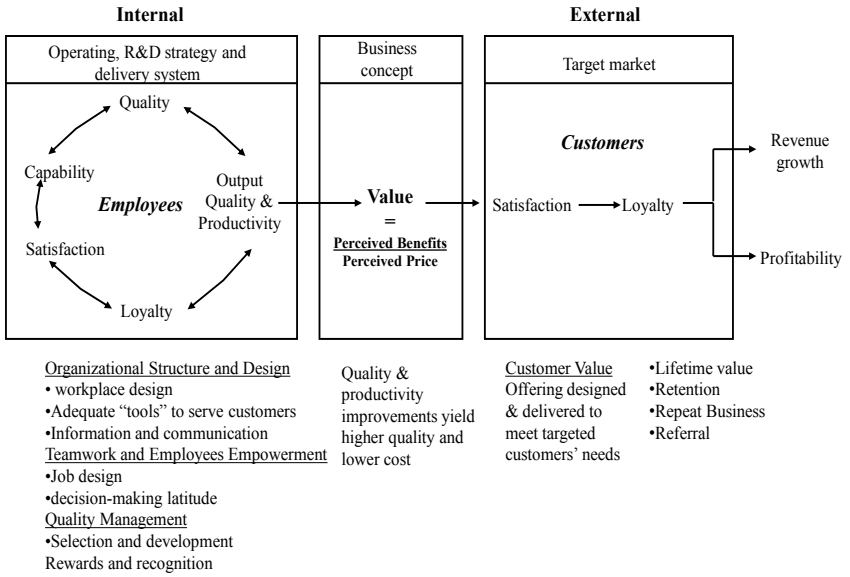
As Thompson walked toward the restaurant's front door, he turned and looked Woody in the eye and said. *"I think the root of your problems lies with the high turnover of employees which add hidden costs to your business and drives customers away due to poor service. Hiring employees at a better wage is an opportunity to stabilize your work force so when properly trained you can deliver the customer service that is consistent with the quality fast food sold and the great ambiance provided."* With that said, Thompson slipped out the door.
Professor Thompson decided he needed to guide Woody towards the enlightenment he so desperately needed. A couple of days later, he sent a note to Woody.

Professor Thompson's Note to McCarthy
Woody,
What you will find with this note is a consulting project I did about 8 years ago. Later, I used this example (name modified) in class, a class that you did not seem to take very seriously. With your business on the line, now is the time to implement. From what we have talked about over time, I believe that you have a pretty good handle on the "numbers" but you may need to dig deeper into your analysis.

People with an ability to provide excellent customer services are few and far between. But the difference they make for the success of a business is immense. Excellence in customer service is one of the ways in which a firm can set apart their offering so that it can make the offering more valuable, and result in customer loyalty. It would be natural to assume that providing a good level of quality at a fair price would entice customers to come back. It is probably more important that the customer is "touched' by the personal nature of the encounter necessary to complete the transaction. It's about creating positive experiences for customers from the word "go" through an endless string of needs understood and promises kept. Good customer service can translate into doing business with larger volume, higher prices and lower costs and therefore higher profits for your restaurant and greater satisfaction for your customers.

About twenty years ago, I had the opportunity to meet with Herb Kelleher, then the CEO and President of Southwest Airlines. If you know anything about Kelleher, you know he was always focused on his employees. About the same time, a book by a group of Harvard Business School professors was published, the book The Value Profit Chain: Treat Employees Like Customers and Customers Like Employees [2] *Kelleher talked at length about how this model fit the Southwest Airlines philosophy. Take a long look at the left hand side of the model and consider what you might do to get this model to work for you.*

Value Profit Chain Model



Organizational structure, teamwork and employee empowerment as well as quality management are the structural elements that leading value oriented firms pay attention to in the operation of their business. This structure fosters capable, satisfied employees who are loyal and quality conscious in carrying out

their work. These are critical elements to the creation of customer value. On the right side of the figure is the end result of value creation where customer satisfaction is derived from the offering designed and delivered to meet their needs. Customer satisfaction leads to loyalty behaviors such as retention, repeat business and referral of others. All of this leads to increased revenue and profitability for the firm.

I have used this model extensively in my teaching as well as consulting opportunities. I think this model fits your situation. It is not surprising that people want to work in a company that has a reputation for providing high levels of customer service. When customers are treated well, there is a spillover effect that enhances morale in the workforce. The result is that fewer people are needed to produce more. Service providers can hire fewer people, produce more and earn more with lower labor costs.
A number of years later I was reminded of Kelleher's philosophy in an article where he emphasized five points for success. It was sweet and to the point. What does this mean for your restaurant?

- *Keep costs down*
- *Focus on customers*
- *Keep employees happy*
- *Keep it simple*
- *Screw conventional wisdom – You might wonder about this but just Google "Kelleher and screw conventional wisdom" and you will be enlightened.*

Could you articulate a strategy based on this to put your employees first and leverage this commitment to increased productivity as well as attaining higher levels of service quality? Can you pay your employees an average wage of $15 and still increase your profit? Maybe not, but what about $13? I suggest that you build a model based on what you know and reasonable assumptions that you need to make to see if this possible. Dr. T

Bill Dodds 9/1/2014 7:48 PM
Comment [1]:

Consulting Brief: Developing Financial Incentives for Providing Excellent Customer Service [1]

Bank, Rupp & Baroque, a typical mediocre financial firm specializing in the credit card business has 100 employees, each earning about $30,000 each. The business is described as mediocre because the average productivity of the workers is about 65%.

Increased Productivity: It is not surprising that people want to work in a company that has a reputation for providing high levels of customer service. When customers are treated well, there is a spillover influence that enhances morale in the workforce. The result is that fewer people are needed to produce more.

Bank, Rupp & Baroque is paying $3,000,000 in wages to their employees which are equivalent to paying 65 employees who work at a 100% productivity level (100 x 65% = 65 x 100%). It might be unreasonable to expect employees to work at 100% but 95% could be reasonable under better conditions. If *Bank, Rupp & Baroque* could attain 95% then they would need to employ 68.4 (let's say 68) employees (100 x 65% = 68.4 x 95%). Total wages would be $2,040,000 which is a savings of $960,000. This represents a potential "bonus" of $14,118 per employee.

Lower Costs: Employees in a high quality service environment enjoy the high morale, good pay, and family surroundings. Lower turnover translates into lower recruitment costs, lower training costs, and more people with the requisite skills and experience to maintain and enhance the service commitment.

At this point we can now describe two firms, the "old" *Bank, Rupp & Baroque*, a poor service provider with 100 employees and the "new" *Bank, Rupp & Baroque*, a good service provider with 68 employees. If the cost of finding, hiring and training new employees is $10,000 per employee then let's examine the impact on our two firms in terms of turnover.

"Old" Bank, Rupp & Baroque		"New" Bank, Rupp & Baroque
20% per year	Turnover	5% per year
20 (100*20%)	New employees	3.4 (68*5%)
$200,000	Annual New Employee cost	$34,000

This is an additional $166,000 in annual savings due to decreased turnover. This represents a potential "bonus" of $2,441 per employee.

Share of Wallet and Customer Retention: Two issues are in play here, retention of existing customers and the amount of new business versus what continuing customers give. Service providers with a great level of customer service tend to gather a large percentage of what is referred to as "share of wallet" from customers. It is much more expensive to sell to a new customer then it is to sell to an existing customer. Customer retention is a direct link to lowering costs in a competitive marketplace. Satisfied customers stay with a seller that tends to their needs and they buy more. More and more buyers are trying to reduce their time debt by relying on a single source.

Let's assume that the overall customer base for both firms is 100,000 and the average expenditure per customer is $200. If the "old" *Bank, Rupp & Baroque* retains only 20% of their customer base and gets 55% of existing customer expenditures and 25% of new customers expenditures:

"Old" Bank, Rupp & Baroque

New customer's expenditure	(80%*100,000*25%*$200)	=	$4,000,000
Existing Customer's expenditure	(20%*100,000*55%*$200)	=	$2,200,000
Total expenditure			$6,200,000

The "new" Bank, Rupp & Baroque retains 80% of their customer base and gets 60% of existing customer expenditures and 30% of new customers:

"New" Bank, Rupp & Baroque

New customer's expenditure	(20%*100,000*30%*$200)	=	$1,200,000
Existing Customer's expenditure	(80%*100,000*60%*$200)	=	$9,600,000
Total expenditure			$10,800,000

Total expenditure by the customers should be recognized as revenue for the firm. In this case, given the retention and share of wallet issues, "new" *Bank, Rupp & Baroque* makes $4,600,000 more in revenue, or $67,647 per employee.

Word of Mouth: Word of mouth advertising from solicited customers reduces the cost of attracting new customers. In essence, customers are working for the provider and the only "cost" is delighting current customers. Customers tell other people about their "delight" with the high-end service provider. There are many people who are prepared to pay a premium for a product when there is a high service commitment wrapped around it.

There are two implications here. Expenditures for advertising and promotions are a necessary expense for attracting and retaining customers but in this case, it is logical to assume that the "new" *Bank, Rupp & Baroque* will not need to make as large of an expenditure as the "old" *Bank, Rupp & Baroque.* Secondly, customers might be willing to pay a bit more for their burgers when there is a higher service commitment.

I want to reinforce what we have been talking about. Escalating the level of customer service provides strategic competitive advantage options for competing on higher quality and prices or good quality at a lower price. Value is created by satisfied, loyal and productive employees. This value to customers accrues direct from the high output quality of employees and their enhanced productivity to build a strong relationship with customers while freeing up money to find and retain good employees through better pay, benefits, and working conditions. Whether one is working for the "new" Bank, Rupp & Baroque or In-N-Out, the benefits of providing quality customer service along with a quality product or service can lead to a rewarding career.

I hope this helps you in applying these concepts to your restaurant. I would be hard pressed to find a better burger if you failed!
Dr. T

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[5] Paulas ,Rick Why does In-N-Out Pay So Well? *http://www.kcet.org/living/food/food-rant/why-does-in-n-out-pay-so-well.html*.

[6] Szabo, Joan "Service = Survival," *Nation's Business*, March 1989, 16.

[7] We are... Michigan Jobs *http://www.mcmichigan.com/2661/30770/default-page/*.

[8] Wicks-Lim,Jeannnette and Pollin , Robert The Costs to Fast-Food Restaurants of a Minimum Wage Increase to $10.50 per Hour http://www.peri.umass.edu/fileadmin/pdf/research_brief/PERI_fast_food_wages.pdf, , September 2013.

A teaching note and a spreadsheet file is available from the author at dodds_b@fortlewis.edu. This note contains three critical notes from Professor Thompson to assist students in developing a workable solution while the spreadsheet tracks the analysis necessary for a workable solution.