

Delivery

the Disruptor

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DELIVERY THE DISRUPTOR

Delivery has become recognised as the number one disruptor of the restaurant industry. This worldwide phenomenon is already worth well over £100 billion in sales to the consumer and is expanding rapidly.

My experience of talking with operators and investors around the world and analysing restaurant delivery on three continents, leads me to the conclusion that the same issues are playing out everywhere. Not only that, but the issues are morphing at speed.

The purpose of this white paper is to provide the context for these changes as a contribution to a wider debate about restaurant delivery. I pay particular attention to the UK because it is one of the top 3 restaurant delivery markets (the other two are the USA and China) and spend per head is higher than in any other large market.

I am not suggesting that the issues raised in this white paper are the entirety of the discussion about the future of delivery. But they are some of the most important.

And the key question that faces delivery companies and investors both in the UK and across the world is: where is the market going?

Whilst I can point to the general direction of travel, I can also foresee a time when there is a complex mega market for food delivery to consumers wherever they are – at home, at work, at leisure – one that blurs the lines and stretches from delivering groceries, all the way through to meals cooked to order.

I welcome your comments, questions and feedback.

WHO MAKES THE £?

Delivery is a catch-22 for restaurant operators. If they don't do delivery, they risk losing business and when they do it, the costs are so significant, that whilst turnover might be high, they lose out on profit margin. Added to which is the threat of reputational damage because the restaurant doesn't know who the customer is, let alone have any opportunity to engage. Plus, there is no control over the condition of the dish that's 'served' to the customer, by the deliverer, a third party. How do you grow and protect the reputation of your brand, when you have no control over these key touchpoints?

Like all business ecosystems, food delivery contains elements that are less profitable than others. Given that it's often impossible to calculate the profitability of

the individual elements, simply put operators' cost per unit of delivery is less than the financial benefit of doing it. And crucially, the most unprofitable element is delivering over the last mile; its cost versus the potential return is often so high it makes the whole model unprofitable.

On the other hand, there are elements which are profitable, such as the commission for capturing the order in an online marketplace. Consequently, everyone within the delivery ecosystem is fighting for the most profitable elements, whilst attempting to offload the unprofitable, namely the last mile delivery, to someone else. How this tension plays out in the longer term will determine whether and how restaurant delivery will evolve.

DELIVERY TERMINOLOGY

AGGREGATOR – a digital marketplace/platform that captures customer orders and passes them to the restaurant

Examples: Just Eat, Takeaway.com, DoorDash

AGGREGATOR DELIVERER – a digital marketplace/platform that captures customer orders, passes them to the restaurant and delivers the order over the last mile

Examples: UberEats, Postmates, Deliveroo

Note: some companies are both Aggregator and Aggregator Deliverer but one of these activities usually predominates

LAST MILE DELIVERY – picks up the order from the restaurant and delivers it to the customer

Examples: Stuart

ON DEMAND DELIVERY – an Aggregator or Aggregator Deliverer that services more than one “vertical” (market sector)

Examples: Glovo (based in Spain), Quicup (in the UAE, & formerly in the UK)

TRADITIONAL PIZZA (AND OTHER OFFERS) – a branded restaurant that captures orders via its own website or app, prepares the order and delivers it

Examples: Domino's, Pizza Hut, Papa John's

TRADITIONAL INDEPENDENT – An operator that does not use an Aggregator or Aggregator Deliverer but captures orders on its own (e.g. via its own website, telephone, walk-in custom)

DARK KITCHENS – this is a term with many synonyms and meanings

For the purpose of this white paper they refer to food preparation kitchens that have no front-of-house offer

They may be referred to under many names including ghost, shadow, virtual, delivery kitchens... and new names are being constantly developed

Dark kitchens operate from designated sites and there are usually several dark kitchens on a single site



The Aggregators win... for now

The most profitable parts of the supply chain are those with the lowest running costs – and these profitable parts are populated by Aggregators, also known as marketplace or discovery apps, such as Takeaway.com, that don't do delivery over the last mile.

This model is pretty close to the "ideal" tech model; revenue flows into the business without overly large operating costs. Because this model is based on enabling the consumer to choose from a selection of restaurants via a smartphone (or desktop) it requires ongoing investment in software, maintaining the right number and range of restaurants on the platform to meet consumer demand, and above all, investing heavily in marketing to the consumer. Cost of sales on the other hand are

low and once the running costs have been covered, additional revenue flows straight to the bottom line. Companies that follow this model are able to increase their market coverage profitably, and the best have done so while minimising, or killing, the competition by acquisition or by making life sufficiently unprofitable for them to continue. One way to do this is by competing with heavily discounted commission rates (for a period). The prime example of a success is the emergence of Just Eat as the undisputed market-leading Aggregator in the UK, having seen-off Takeaway.com in its UK home market, and having acquired competitors (notably HungryHouse) and Aggregators working in adjacent markets, such as City Pantry and Urbanite in the corporate B2B lunchtime market.

Future growth is challenging

The sticking point for Aggregators and the challenge for the delivery ecosystem, is that there is a limit to the number of restaurants that are prepared, and able, to do their own delivery. Consequently, the limits to growth are broadly fixed, meaning that discovery-only platforms face a limit to their finite market. This is already happening to Just Eat in the UK and GrubHub in the USA.

Takeaway.com hasn't yet had to face the same challenge as its core operating areas, the Netherlands and Germany for example, are in geographic locations populated by large numbers of restaurants still prepared to do their own delivery.

Can the cycle be broken?

But for Aggregators like these to grow, they will need to influence, or incentivise a cadre of new operators to do their own last-mile delivery, or grow the overall market (a very expensive activity). Or, they will need to get restaurants on board by expanding existing operating models to include last mile delivery. These actions are expensive and much less profitable than the core Aggregator operating model, meaning that profit opportunities are limited.

A profitable delivery model

Despite the challenges involved in the delivery ecosystem, some operators have shown that it is possible to execute a profitable model. One example, if not the only one, is Domino's which has fully integrated discovery, production and last mile delivery. For the outsider at least, it's not possible to identify the profit or loss of each of the individual elements but the whole, leavened with a large dose of successful franchising, delivers a business model that is profitable.

Is this fully integrated model the goal for the Aggregator Deliverer? Up until now, delivery models haven't included the physical production of the food; it has been outsourced to a restaurant. Consequently, there is a battle between the Aggregator and the restaurant over the profits from "food production". The Aggregator Deliverer has a large interest in grabbing much more of this profit, because it is seen to offset the losses from last mile delivery.

We are now starting to see the leading players in the market 'play out' this formula.

So, how are they doing it?

The formula for profitable success in restaurant delivery

$$\text{High profits from discovery} - \text{Losses from last mile delivery} + \text{Profits from the kitchen} = \text{OVERALL PROFITABILITY}$$



Consolidating discovery – with high fixed costs and moderate running costs, the discovery element of the delivery journey benefits hugely from scale. The result is a battle for market share, not confined to a city or country, but on a global scale.

Outsourcing last mile delivery

– third parties, like Stuart, Glovo and Quicup, are specialists in their field and therefore inherently more efficient than an Aggregator Deliverer.

Last-mile specialists usually make their economics work by offering their services to a number of “verticals”. Most focus on the food vertical from restaurants (but also retailers); other verticals include medicines (delivered to residential addresses as well as to pharmacies), clothes and office supplies. Having multiple verticals on their platform, means that last mile specialists have a flow of

business throughout the day that maximises demand for riders' time. This allows the company to offer relatively attractive financial conditions to their riders; and, in turn, allows the deliverer to ensure more reliable rider availability, and more reliable delivery times, to platform partners (such as restaurants) and customers.

Operating kitchens – gaining profits from operating kitchens is being achieved through dark kitchens. In concept this is easy to understand; remove the front-of-house offer from a restaurant, move it to a location with low running costs, and concentrate offers and delivery in a single place for enhanced profitability. As a result, dark kitchens are getting a lot of interest from investors. (See page 11 for more on dark kitchens).

SUSTAINABILITY

Delivery, a huge disruptor, is coming into contact with sustainability, which perhaps is the biggest disruptor of all. But the nature of this contact and what it will mean in the future is not yet clear.

Currently, there is some discussion about the waste involved in the packaging that makes delivery work in practice. There are plastic bowls, lids, cutlery and straws; and there are cardboard containers that are coated with plastic, or contaminated with food, and therefore in effect, not recyclable.

This waste is one cross against the sustainability credentials of restaurant delivery.

But there may be ticks as well. The cost to the environment of a rider pedalling over the last mile is, surely, enough to more than offset the environmental cost of driving a car (or maybe even more than one) to a restaurant? The case is not yet made, let alone proven, for this effect but just also consider the dishes that deliver well – sushi, poke, pizza (none of them are meat based) – and compare them with steaks and burgers that do not deliver so well.

All in all, delivery just like all other activities will increasingly have to prove its sustainability credentials. If it can come out on the positive side, its future will be brighter.

WHO OWNS THE CUSTOMER?

A significant issue for the restaurant operator that uses Aggregator Deliverers is the loss of connection with the customer because the Aggregator Deliverer captures the order and delivers the final meal. Consequently, the restaurant has no idea who the customer is, or indeed has no idea about the customer's needs and perceptions (and therefore loses any understanding about the customer). The Aggregator Deliverer, on the other hand is in a position of strength knowing all about the customer – and how each customer shops at other online restaurant offers.

Clearly, the Aggregator Deliverer owns the customer (the situation is different when an Aggregator is involved since, by doing no delivery, details of the customer must be passed on to the restaurant). Consequently, the Aggregator Deliverer is in a very strong position to influence how the customer shops between different online restaurants.

The challenge for Aggregator Deliverers is to get customers to use their app or website rather than a competitor's. Evidence points to the stages that the customer goes through in order to place an online order. And this evidence suggests that customers tend not to select a restaurant and then find an app or website that will lead them to the restaurant. While this might be the case for some strong, well known brands – McDonald's is an example and Domino's with their own website, another – for most brands, the customer goes to the app or website of their choice and finds the restaurant that provides the food offer they are looking for, or where the search algorithm points them. So, becoming the app or website of choice is one place where marketing budgets are spent by Aggregator Deliverers.

DARK KITCHENS

The key issue for a dark kitchen is that it is a restaurant without a physical presence. For some operator brands this is not a major drawback because they already have a highly visible presence—again, McDonald's is the prime example, but there are many more, such as Wagamama in the UK, or Starbucks (in China especially, where the coffee chain's online delivery is a strong feature of the market). The customer knows the brand and will reasonably expect the food to be prepared in a restaurant.

For lesser known brands, with smaller coverage, the vast majority of the brand experience is on the discovery platform. And, in the extreme case of a dark kitchen brand, there is no customer-facing bricks and mortar presence on the street at all, just the opportunity to find it in on the discovery app. This 'virtual' brand model is becoming increasingly popular, so

the question to consider is how to build and maintain a brand under such conditions? Without the "real-life" experience, does this new type of brand merely become a menu on a website. How do you create a viable and long term branded presence via a discovery app? It's certainly food for thought.

Aggregators are armed with data

Aggregator Deliverers argue that they are fully aware of what customers want from the millions of orders that they generate daily. And this knowledge puts them in a very strong position to recommend to operators what to offer on the app. And, I would underline that the knowledge that Aggregator Deliverers accumulate enhances their market value (especially if they are not making a profit, which is the case for most of them).

Right now, we are seeing traditional restaurant operators developing multiple online brands. The Restaurant Group in the UK has Jumping Pans, Pyjama Hotel, Stacks, Birdstar, Cornstar Tacos, Kick Ass Burrito, Daily Naan, K Bird, Chicken Cartel, Baragara, while Mitchells & Butlers, the UK pub operator, has Veg Heads, Ruby Jeans, Marvellous Pub Grub Co and Chicken Society. Interestingly, Chicken Society is a former bricks and mortar brand that has become solely a “virtual brand”. The question here is what is the longevity of these brands and how can they be sustained?

The dark kitchen model

There are many different types of dark kitchen. It’s a complete ecosystem in its own right. Yet, its existence and growth has only been made possible by the growing demand for delivery. Without a front-of-house presence there is no way to bring the food to the customer without delivery over the last mile.

Over the past eighteen months I have identified many different models of dark kitchens with new variants emerging continually. Here’s six examples of different types:

1

This type of kitchen is owned by an Aggregator Deliverer but is run by another party. This may be a recognised brand with a high street presence, an experienced operator with an online presence, or an entrepreneur without any bricks and mortar presence. The Aggregator Deliverer influences the range and pricing, and maybe even the brand name that appears on the app. Championed by Deliveroo, this is a low capital intensive model for operators and is attractive to companies with a rate of high cash burn in other parts of its activities.

2

Another approach is for the owner of the dark kitchen to do the cooking and the delivery. Examples are Rebel Kitchen in India, and look-a-likes such as Keatz in Germany and Taster in the UK. From the operator’s perspective, this model requires lots of capital but gives control throughout to the owner of the ecosystem.

3

Other players have identified opportunities in the delivery kitchen ecosystem, usually arranged around real estate. For example, Reef Technology, the California-based start-up, provides access to over 4,500 garage and parking lots in North America and more in the UK and Spain, and offers to put up kitchens (often housed in containers) on suitable sites. This is a pure real estate play which has the possibility of lowering costs and providing flexibility for dark kitchen operators.

4

Yet another model is the one espoused by companies like Eathos in India. It provides funding for acquiring suitable property and kitchen infrastructure, such as marketing advice, and as such, acts like an incubator.

5

Another approach is a “virtual” food court. The dark kitchen, which will likely house half a dozen units anyway, houses carefully selected brands to maximise customer choice. This leads to multiple meal options being prepared under one roof and is ideally suited to orders from groups of consumers. For example, a group is watching a film on Netflix; one wants a burger, one wants pizza, another wants sushi and all want ice cream. This disparate order can be readily satisfied by a dark kitchen site acting as a virtual food court.

6

And a variation on this model, adopted by kitchen operators like Karma Kitchens in London, is to provide the ability for one operator to use space for only part of the day while another operator uses it for other dayparts. This provides flexibility, focuses food offers by time of day and provides the opportunity for small scale operators and start-ups to become a delivery kitchen operator at lowest cost.

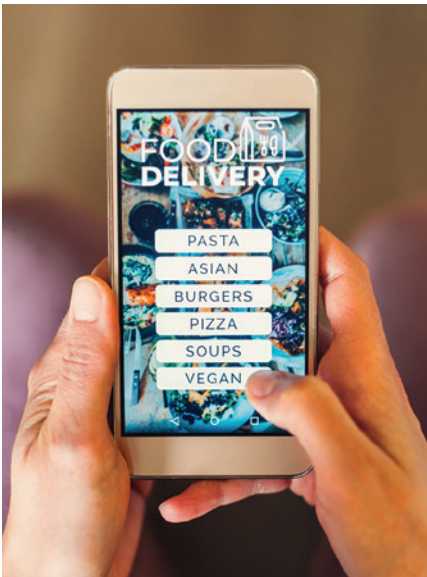
WHAT WILL HAPPEN NEXT?

We are seeing many battles being played out amongst many players in the restaurant delivery ecosystem. The big question is where is all of this going?

One direction, for the reasons I have already outlined, is consolidation. We are seeing this in the case of Takeaway.com and Just Eat; and another example is the departure of UberEats from the Indian delivery market (where its operations have been acquired by Zomato), and the investment by Naspers (via its Prosus investment vehicle) in delivery companies as widespread as Mail.Ru (in Russia), Delivery Hero (in Germany) and iFood (in several South American countries). DoorDash and UberEats were reportedly in merger discussions in mid-2019. And currently, the UK's CMA is questioning whether the Amazon investment in Deliveroo is the first step in a takeover.

Another development surrounds attempts to increase prices on the basis that raised prices and static costs leads to profits. So far, the consumer has been relaxed about paying for the costs of delivery whether in the UK, or Brazil or India. The question is: how high can these prices be raised? The Aggregator Deliverers are finding out. Deliveroo, for example has started to make a delivery charge on all its orders even those from subscribers to its Deliveroo Plus subscription service which promised, when it started up in late 2017, to provide "Free delivery all day, every day". There is clearly a limit to how much consumers will pay. The question, though, is it enough to provide the necessary profits? Or will demand start to fall away?

Deliveroo is also instituting surge pricing in selected areas to drive up prices when demand is high. But there are downsides to this, especially when consumers come to believe what appear to be random price changes are an attempt to charge unfairly; then they will surely react against such companies.



THE BIG QUESTION

But it seems to me that the core question is whether restaurant delivery is the 'whole' market it appears to be? Or is it part of a much larger ecosystem?

Consider this: it is possible to get food by going to a shop. It is possible to have groceries delivered within twenty four hours to your home. It is possible to receive so-called "ultra-fast" delivery of groceries (that is, on the same day) from the Co-op (Deliveroo will do the delivery). It is possible to get freshly prepared sushi delivered from a local supermarket as if it was from a sushi restaurant.

What all of this tells us is that there is a grocery food ecosystem which aligns with the restaurant delivery ecosystem.

Are they about to merge? Are the big players in each of the different food delivery options (from grocers to full service restaurants) about to encroach on each other's spaces in this ecosystem? Or are new players about to emerge? Who will win?

About Peter Backman



Peter is an expert and commentator on the structure and dynamics of the foodservice sector and its supply chain, in the UK and internationally. Over the last four years, he has made a speciality of analysing the restaurant delivery market. He enlightens senior executives and other people who make significant decisions in the foodservice sector including investors, operators and suppliers to the sector. His forthright and challenging views are based on data-driven insights – as a former scientist his view is “if you can’t measure it, it doesn’t exist”.

He has been involved, as a researcher and consultant within the sector, for over 30 years blending his knowledge with a deep understanding of the trends, key players and challenges of organisations with an interest in foodservice. He regularly speaks at conferences worldwide and his views are sought by television, radio, and the national and trade press. Peter has many innovations to his credit having been the first person to define the structure of the eating out market in the terms which are now widely used by the industry, as well as building the most extensive database model of the foodservice sector. Peter is the author of “Restaurants also sell food” – published in London, Toronto and Chicago.

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Published Spring 2020

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