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PE & QSR: Ambition on a bun

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Many private equity investors think they can make a fast buck from fast dining, but rolling out a Western-style brand in Asia requires discipline on valuation and competence in execution

Gondola Group was among the last remaining assets in Cinven's fourth fund, and as one LP tells it, exit prospects were uncertain. The portfolio company's primary business was PizzaExpress, which had 437 outlets in the UK and a further 68 internationally as of June 2014. Expansion in China by the brand's Hong Kong-based franchise partner had been measured, with about a dozen restaurants apiece in Hong Kong and the mainland.

Cinven wasn't willing to be so patient. In May 2014, Gondola opened a directly owned outlet in Beijing – as a showcase of what the brand might achieve in China when backed by enough capital and ambition. Two months after that, PizzaExpress was sold to China's Hony Capital for around $1.5 billion. By the start of the following year, Cinven had offloaded the remaining Gondola assets and generated a 2.4x return for its investors. The LP was "pleasantly surprised" by the outcome.

Hony's experience with the restaurant chain hasn't be as fulfilling. Adverse commercial conditions in the UK – still home to 480 of its approximately 620 outlets – has eaten into margins and left PizzaExpress potentially unable to sustain an already highly leveraged capital structure. Hony is considering restructuring options for a GBP1.1 billion ($1.4 billion) debt pile. At the same time, hype about China growth hasn't been matched by execution: there are still only 50 restaurants in the mainland.

Joel Silverstein, president of consultancy East West Hospitality Group, advised a private equity firm that was bidding for PizzaExpress in 2014. His assessment was that it wouldn't be able to open more than 50 new restaurants in China over a five-year period, citing high prices compared to other players in the market and relatively low product acceptance. The client revised downwards both its projections and the enterprise valuation it was willing to pay for the business, and duly lost out to Hony.

"They overpaid because they were too optimistic about China – one Hony executive told me they could open 500 restaurants, which I thought was crazy," says Silverstein. "What none of us saw coming were the problems in the UK, but the way you manage your risk is through the valuation. You put in a buffer in case stuff happens. The problem is there has been too much money chasing restaurant deals in Asia, so investors lost their discipline. Overpayment leads to subpar returns."

Preferred partner?

The attractions of quick-service restaurants (QSR) to private equity are obvious: it is cash generative, conducive to rapid rollouts, and plays into Asia's broad consumption themes. The business model can also be reassuringly predictable. On signing a master franchise agreement with a brand owner, the franchise holder commits to a certain pace of expansion and expenditure and a series of royalty payments based on store numbers and revenue. But the best-laid plans can go awry if projections are too ambitious, execution is flawed, or a brand just doesn't catch on locally.

"It's like building a wall, each brick is a new store. Some stores are more profitable than others, so the bricks aren't all the same size, but you can build relatively quickly. If a brand is recognized, there might be little ramp-up period," says Nick Bloy, a managing partner at Navis Capital Partners, current owner of Dome Coffee in Australia and previous owner of Dunkin' Donuts in Thailand and KFC in Hong Kong. "But you must watch out for fads, where the economics are initially great and then plunge after two years."

There is a long history of investment in Western-style QSR brands in Asia. One of the first came in 1974 when Inter-Asia Venture Management launched McDonald's in Hong Kong. It proved a successful investment, even though the company was forced to leave its first premises when the landlord called a 300% rent hike. AVCJ Research has records of more than 20 current private equity investments in brands ranging from Domino's to Wendy's and in geographies stretching from New Zealand to India.

Results have been mixed, certainly in recent years. Chris Tay, an experienced food and beverage operator in China who now leads consumer-focused LTCV Investments Holdings, questions whether any Western-style restaurant deals in the country pre-2015 have performed well. Investors bought in when valuations were high, and since then labor, real estate, regulation and local competition have become more challenging. Moreover, he has doubts as to whether PE is the best fit for QSR. "It's a longer play, you need someone with deep pockets who can take their time in growing a business," Tay says.

Restaurant Brands International (RBI), owner of Burger King, Tim Hortons and Popeyes, would likely disagree with this assessment. The company, in which 3G Capital is the majority shareholder, currently works with private equity firms as master franchise partners in China, Taiwan, Japan, Korea, India, Indonesia, and New Zealand. Over the past seven years, the number of Burger King restaurants in the region has risen from 1,000 to around 3,000.

In several cases, PE firms replaced corporates as master franchisors with a brief to reinvigorate unloved, undermanaged and often undercapitalized businesses. For example, when VIG Partners bought Burger King Korea from Doosan Group in 2012, it was a non-core subsidiary that required an entirely new senior management team. Nexus Point Capital was awarded the Taiwan franchise two years ago after RBI took it back from the corporate incumbent. The notion of private equity as a focused partner with limited delivery timeframe is compelling, but RBI claims to be agnostic as to the source of capital.

"The key to success is having the right partners and we work with corporates, family offices and private equity all over the world. Every market is nuanced," says Sami Siddiqui, president for Asia Pacific at RBI. "We didn't enter China in 2012 [when RBI teamed up with Tab Food Investments, its master franchisor for Turkey, and Cartesian Capital Group], we entered well before that. But it took time to find the right partner and structure the right agreement."

In and out

RBI was a relatively early adopter of master franchise agreements whereby individual partners receive exclusive development rights for entire markets in Asia. Under the traditional US model, franchisees operate single outlets or limited regional territories, perhaps making as much money from sale and leaseback of the land on which a store stands as from the store itself.

While there is some sub-franchising in Asia, notably in more mature markets such as Australia and Japan, most international brands prefer to deal with a single owner-operator. That group may have the right to sub-franchise if certain performance targets are met. In China, the initial problem was a lack of potential franchise partners. Then it became finding partners that could be trusted. Franchisors have asked franchisees to put money in escrow accounts or buy goods and services instead of paying a percentage of revenue due to concerns about accounting accuracy, industry sources say.

KFC and McDonald's entered China as owner-operators of their own stores and it is only relatively recently that they switched to master franchises. Yum Brands spun out its China entity into a separate listed entity in 2016, with backing from Primavera Capital Group and Alibaba Group's Ant Financial. A year later, McDonald's followed suit, carving out its mainland China operation and selling an 80% stake to CITIC Capital, CITIC Group, and The Carlyle Group.

Indeed, the McDonald's transaction was in part driven by the company's hit-and-miss experiences with franchising. In 2012, a US-inspired dual model was adopted, comprising small-scale franchises for existing stores at local level and provincial level development agreements with minimum store opening requirements. Five years on, about 600-700 of the 2,500 stores in mainland China were franchised out and the provincial businesses were underperforming.

Recognizing the approach wasn't working but still keen to increase the franchise percentage globally from 83% to 95%, McDonald's looked for a master franchise partner, ideally a corporate that would stick around for the long term and leverage relationships with government and property developers. CITIC Group was drafted in by the financial sponsors to add strategic heft.

D.J. Luo, a managing director at CITIC Capital, suggests the franchisees struggled because they were not sufficiently financially committed, young and inexperienced, or unwilling to devote the time required to make it work. "From day one, the consensus view was that we would grow the business by ourselves instead of granting more franchises," he says. "We will stick to our commitment to open more directly owned stores and pursue aggressive expansion."

McDonald's was also motivated to sell by the long road to recovery following a food safety scandal in 2013 and the fact that it didn't enjoy a market-leading position in China. This is blamed to varying degrees on the absence of a medium-term development plan and a failure to localize the product offering. There were more than 5,000 KFC outlets nationwide when the McDonald's deal was announced. Even if the PE buyers achieve their goal of 2,200 new store openings by 2022, McDonald's will likely still trail KFC by a sizeable margin.

For all but a handful of brands, of which McDonald's China is one, this competitive dynamic could be a turnoff for private equity. It is generally agreed that frontrunners enjoy inherent advantages, such as access to the best locations and public recognition, which make them difficult to reel in. There must be a compelling reason – such a strong brand – to back lower-tier player.

"To do QSR right, you need a strong brand. You might be paying up to 5% of your top line to the franchisor, so you better make sure the brand is worth what you are paying for," says K.C. Kung, founder of Nexus Point. "The margins in QSR aren't great, usually below 20%. Suppose your margins are 15% but you need to pay a 5% royalty, your margins drop to 10%, and that's one-third gone. Whether it's the brand itself or the value the franchisor brings you through, for example, bulk purchase discounts or marketing know-how, you need to make up that 5%."

Brands apart

Brand strength is often synonymous with ability to scale, but some investors have built successful second-tier businesses through differentiation. Earlier this year, Proventeus Capital exited the Philippines franchise of Kenny Rogers Roasters with a more than 5x return, having increased the store count from 35 to 90. This is a fraction of McDonald's or Jollibee – which do follow small-scale franchising models in the country – but Proventeus delivered revenue growth by focusing on a market niche.

"Whenever you have a dominant local brand you should avoid that segment. Taking it on is expensive and it's a 10-year game. Few funds have that level of patience," says Lew Oon Yew, the firm's managing partner. "One of the things that attracted us to Kenny Rogers was its positioning in the healthy segment, offering roast rather than fried chicken as well as salads. It had better food, better ambiance and a higher price point than the big brands, and it had been there for 15 years, so the business was proven."

The Longreach Group took a similar approach to Wendy's Japan, despite the US burger brand's previous failures in the country. Instead of just taking the master franchise, the private equity firm engineered a merger with First Kitchen, a Suntory Holdings subsidiary with 136 existing locations. This effectively saved it the trouble of building out a physical footprint and a workforce in a market known for expensive real estate and labor shortages.

So far, 48 of those locations have been converted to the Wendy's First Kitchen model, which combines the Wendy's burger menu with First Kitchen's offering of pasta, salads and desserts. The aim is to create a diversified menu and an upmarket service that appeals to a broader demographic, thereby avoiding head-to-head battle with McDonald's and Mos Burger, which have 2,900 and 1,300 outlets, respectively.

Wendy's is said to have been flexible as to what it would allow in Japan – bubble tea is one of the more popular menu innovations – and this willingness to compromise can make or break a local business. Master franchise agreements typically hold the franchisor to minimum requirements in terms of network expansion, marketing spend, equipment usage, and service standards. Brand owners also sign off on any marketing campaigns and menu changes to ensure they are consistent with their principles.

According to investors with exposure to the QSR space, marketing is rarely a stumbling block, but adherence to kitchen best practices and product standardization is scrutinized. Several Asia-based PE executives have undergone training with RBI and worked shifts at Burger King in Singapore, so they fully understand the process and culture. Guidance from brand owners is valued because they are equipped with in-house resources and have seen what has and hasn't worked across multiple markets, yet tensions can emerge if the permitted degree of localization is less than the franchisor would like. Food is an obvious sticking point.

"It's not just a case of ensuring it is consistent with what Burger King stands for but who the suppliers are and meeting quality assurance standards," says RBI's Siddiqui. "We try to have a close relationship with management at the ground level. We have global specifications for flagship products like the Whopper, but in India for example, the crispy veg patty is unique to that market. Our product innovation team worked with the culinary team at the franchisee and the suppliers to come up with something."

A new or modified recipe typically undergoes extensive tests and then trialed in a handful of restaurants before getting the green light to launch. Sometimes successful concepts are given an even wider audience. During VIG's ownership of Burger King Korea – it exited to Affinity Equity Partners in 2016 – the four-cheese Whopper was developed and subsequently rolled out in several other markets.

This attention to detail on menu is not limited to RBI. McDonald's engaged in lengthy discussions with the private equity owners of its China franchise as to whether muffins should be the sole breakfast staple. The global brand had previously shut down a move to sell congee. The franchisor argued that for breakfast to grow as a platform in China, McDonald's must adapt to local tastes.

"We worked closely with McDonald's global, researched it properly, and together came to the conclusion that congee was indeed the right product," says Luo of CITIC Capital. "You need the right infrastructure to do that. We worked with third-party aggregators like Meituan-Dianping and Ele.me, collected data points, and identified key SKUs [stock keeping units] for development. Now congee has become a key driver for our breakfast business."

Seeking a balance

The trick of localization is offering enough familiarity to entice consumers without undermining the brand integrity of the franchise or eroding the efficiencies achieved through standardization. Tay of LTCV suggests that a Western QSR chain must include a Chinese element in at least 15% of menu items to get people through the door. But it must first arouse curiosity to make them cross the street and that often means emphasizing Western heritage, for example through celebrity endorsements.

There are some concepts that simply don't sell. CVC Capital Partners failed with KFC in Korea because it was unable to carve out a niche in a market overflowing with local fried chicken establishments. RRJ Capital and Jollibee raised eyebrows in 2014 when they took over the Dunkin' Donuts franchise for China given scant evidence of any meaningful local demand for the pastries. "Krispy Kreme failed. Mister Donut failed. Donut King failed. Dunkin' Donuts failed twice. How much more pain and suffering do you want?" asks Silverstein of East West Hospitality Group.

Others just don't sell as much as expected, usually because investors overstate the expansion opportunity or underestimate the competitive threats in their target market. Strong management is essential to QSR rollouts, which is why PE firms recruit leaders from a seemingly bottomless pool of former Yum Brands and McDonald's executives. They tend to be the first ones to get fired when things don't go according to plan, says Tay. Struggling franchises backed by an impatient GP have been known to go through a string of CEOs before handing power to the CFO as a last resort.

"That's usually a disaster," Tay explains. "The CFO is incredibly conservative, and he only listens to the private equity guys on the board. The fund life is running out, so they tell him there's no more money to spend, nothing for marketing, and any growth must be organic. The CFO is simply there to cut costs, make the numbers look good, and sell the company. But decision making based purely on financials often doesn't cut it in F&B."

Once a restaurant brand gets caught in a downward spiral it is very difficult to recover, as evidenced by a general reluctance to take on turnarounds. Picking the right concept at the right time – and paying a sensible valuation for it based on a sustainable business model – is therefore incredibly important. If these conditions cannot be met, the smart money walks away.

"After we sold Burger King Korea, so many people came to us with dining franchises. We turned them all down because we couldn't find anything with scarcity value," says Jason Shin, a managing partner at VIG. "It is hard to find a recognizable brand or concept in a space that isn't so crowded, but where you know there is consumer growth."

SIDEBAR: Franchisor vs franchisee

When Allegro Funds acquired Pizza Hut Australia in 2016, the delivery chain was badly in need of restructuring and rejuvenation. The private equity firm had faith in the product – it performed well in blind tastings – but the technology offering was outdated and the franchisee network inefficient, with 220 partners for just 270 stores. These franchisees were also in open revolt.

One of the reasons Yum Brands sold the business was a breakdown in relations over a A$4.95 ($3.40) pizza. In launching this special offer against their will, the franchisees claimed that Yum had no interest in their profitability and therefore had a conflict of interest. They took the company to court but lost. The appeal, also unsuccessful, was heard after Allegro took over. One of its first tasks was rebuilding bridges.

"We listened to them and almost everything they raised was valid. Mostly, they just wanted to be listened to, and to see us acting on their recommendations," says Chester Moynihan, a managing partner at Allegro. "You must have a healthy franchise network with a profitable economic unit. If you don't, existing franchisees will become disengaged and potential new franchisees won't invest."

The brand owner-franchisor and franchisor-franchisee relationships are intended to deliver an alignment of interests, but sometimes tensions flare-up. The former's main income stream from the latter is a royalty based on revenue, not profitability. While they want those streams to be consistent and long duration – so there is reason to help the franchisee build a sustainable business – it isn't unknown for them to push for an ambitious growth plan or an aggressive price-led promotion.

"The franchisor model is a bit more predictable in projecting growth. If there is a lot of franchising, they get a percentage of revenue and it's predictable because stores generally don't halve their previous revenue. The fixed cost base is lower as well because they aren't paying for rent and labor," says David Gross-Loh, a managing director at Bain Capital, which has served as a brand owner and a franchisor. "Such businesses are a lot more profitable, they are high margin, and they trade for very high multiples."

Navis Capital Partners has also fulfilled both functions, previously as a master franchise holder for Dunkin' Donuts in Thailand and KFC in Hong Kong, and currently as the owner of Australia-based coffee chain Dome. Nick Bloy, a managing partner with the firm, has no desire to become a franchisee again, citing the unpleasant experience of being squeezed by an aggressive franchisor at one end and a rent-hungry landlord at the other.

"The returns are not as good from franchisee businesses. It is much better to be a brand owner, even if you are not franchising to other people but rolling out your own brand," he says. "You don't have to pay an upfront franchise fee, a fee for every store you open, a cut of revenue, and make contributions to a central marketing fund."

PE & QSR: Going greenfield in India

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Localization was the key for Everstone Group when rolling out Burger King in an India market that is both price-sensitive and not known for its appreciation of beef

Most private equity investors blanche at the prospect of a greenfield quick service restaurant (QSR) rollout in Asia. Restaurant chain expansions are based not only on general projections of market growth, but on insights into when and where stores should be opened and how menu items should be selected and priced. It is far easier to get comfortable when there are already restaurants on the ground and data on the spreadsheets.

When Everstone Group agreed to launch Burger King in India seven years ago, it was taking a step into the unknown – and in a country where beef eaters are in the minority. There are currently 224 stores and Everstone claims average revenue per outlet is almost on a par with competition, compared to an index of 50-60% in the US. Burger King, which is contracted to reach at least 700 stores by 2025, filed for a domestic IPO this week.

“There are several greenfield challenges,” observes says Sami Siddiqui, president for Asia Pacific at Restaurant Brands International (RBI), Burger King’s parent company. “One, you have to spend a lot of time understanding the consumer and tailoring your menu to local preferences. Two, you need to set up supply chains that are formidable and meet the same quality standards as other places in the world. Three, you are building the team from scratch, not just the management but everyone down to the restaurant level.”

Everstone embarked on the project with its eyes open. The private equity firm decided on a buy-and-build strategy after finding that all existing desirable QSR brands in India were trading at 25-30x EBITDA and therefore out of reach. The team spent 18 months mapping out the US market and identifying brands that were scalable, had international franchise partners but were not yet in India, and had a cuisine and format that were suited to the country. Burger King was at the top of a 25-name shortlist.

There followed extensive commercial due diligence and negotiations with RBI. “We invest for five years, maybe eight for a platform deal, but with a greenfield rollout you spend first three to four years building and then scaling up. The question was how could we build a scaled business and make it a profitable investment” says Amit Manocha, a managing director at Everstone. “It was important they were comfortable with us making all the decisions on marketing, menus, supply chains and pricing.”

Once the joint venture structure was in place – a model seldom used by RBI whereby it takes a stake in the franchisor entity – Everstone put together a management team. Rajeev Varman, an Indian-born executive who had spent the previous 13 years with Burger King in different markets, was recruited as CEO. They also built a cold chain system, persuading a smaller local operator to invest in capacity by pledging volume based on the projected store rollout, and devised menus.

Fries are probably the only item familiar to US diners. Half the burgers are vegetarian, and India is the only market globally able to tamper with the Whopper; it is served with a chicken, lamb or vegetarian patty. Pricing strategy was equally important. Burger King meals are cheaper in India than the US due to value-focused market and currency – a combo meal costs under \$2.50 versus \$6.99 in US – but the menu price range is laddered across steps, from as low as \$0.40 to \$2.00. This has helped support a higher average per capita spend than the competition, Manocha says.

A similar approach was taken to marketing, which initially was primarily through digital channels. "We started by announcing the brand and focusing on the flagship product, which is the Whopper. As the brand awareness started increasing and we had presence with scale in multiple cities, marketing messages switched from premium product to value offering to get more people in the door, have them experience the product and climb the ladder."

PE & QSR: Selling pizza in Japan

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From delightfully indulgent pizza toppings to delivery world records, Domino's Japan has added a splash of color to the food and beverage space. It also served up robust private equity returns

With the opening of its 600th store in June, Domino's Japan supplanted Four Seeds-owned Pizza-La as the local market leader. Five months, later the company gained global bragging rights as the Yotsuya store in Tokyo achieved an average safe delivery time – i.e. no speed limits were exceeded in breaking this record – for a freshly made pizza of two minutes 38 seconds over the course of one week.

The 34-year journey of Domino's Japan from pizza pioneer to third-place laggard and back to the summit is among the more rousing in Asia's quick-service restaurant industry, featuring a cross-cultural entrepreneur, caviar toppings, and TV ads about opening outlets on the moon. Bain Capital arrived in 2010, convinced it could help the 175-store chain realize its potential.

"It's tough being the number three player. You wind up not getting the best real estate locations, you wind up at a scale disadvantage, and sometimes it's hard to attract the best people," says David Gross-Loh, a managing director with the private equity firm. "While it was not the market leader at the time we invested, Domino's Japan was the best box economic model, and its profitability and delivery approach were best in class. We felt if we could take it nationally, we could bring the company to its rightful leadership position."

Impact on arrival

Domino's made its Japan debut in 1985 courtesy of Ernest Higa. It was he who convinced founder Tom Monaghan to break with the tradition of only handing out franchises to those who had worked their way up through the organization and were imbued with its culture. "I told him I could learn Domino's Pizza quicker than he could learn Japan," Higa told AVCJ earlier this year.

It was thought that Shakey's Pizza and Pizza Hut had struggled in Japan because local people didn't like natural cheese. Higa put it down to a failure to localize – and duly turned the traditional Domino's model on its head. Diners were confronted with a plethora of pizza topping and beverage options, and there was an emphasis on quality over supersizing orders. Toppings were either deliberately colorful or delightfully indulgent, while cheese and dough recipes were tweaked to suit local tastes.

The price points were high – top-end pizzas cost as much as JPY5,000 ($46) in the late 2000s – by necessity. "In the US, Domino's is low-cost fast food for college kids," Higa explains. "In Japan, the mass market is a bowl of noodles. I knew if I positioned pizza as fast food, we wouldn't make money. We needed a higher average check because we wouldn't get the same frequency of orders as the

US.”

Success was almost immediate. The average monthly take for a McDonald’s store in 1985 was JPY5-6 million; the first Domino’s outlet generated JPY30 million. Margins were boosted by the focus on delivery, which meant outlets could be small and located away from expensive, high traffic areas. However, growth slowed in the 1990s and then retrenched, reflecting a general stagnation in Japan’s restaurant industry. By the time Higa sold to Bain, Domino’s was still Tokyo-centric and hadn’t opened a new store in years.

The new owner responded with a push into franchising, inviting managers of existing stores to open new ones under an “employee-to-own” program. A franchisee financing initiative helped them buy equipment, while equipment standardization reduced the capital required to launch an outlet by half. By January 2017, there were 472 outlets, one-third of them franchised.

Under a new management team headed by Scott Oelkers, who previously ran Domino’s in Taiwan, the company moved away from the premium-only model. Elaborate toppings were joined by more basic offerings – as well as special offers such as two pizzas for JPY1,400 – to widen appeal. Steps were also taken to improve store-level efficiency. Rather than incentivize managers purely based on revenue, a new set of metrics including labor and food costs was introduced.

“Once the stores became more profitable, it was easier to justify the capital expenditure to open new stores, which made franchising more attractive,” says Gross-Loh. Before the end of 2013, Domino’s Japan had reclaimed second place in the market, by store numbers, from Pizza Hut.

Selling a narrative

These efforts were supported by a creative approach to marketing. In addition to having Oelkers – dressed in a full astronaut suit – announce in a TV ad that Domino’s Japan’s expansion plans were, literally, out of this world, the company launched a competition based on delivering a pizza the farthest distance ever. “There was a lot of buzz, but it was around things new things we were doing – carry out, buy one get one free, thin crust pizza, entering Nagoya,” Gross-Loh adds. “By the end, we had enough stores to justify national TV advertising.”

Having acquired Domino’s Japan for a reported JPY6 billion, Bain sold a 75% stake to Domino’s Pizza Enterprises (DPE) – the master franchisor for Australia, New Zealand, and parts of Europe – for JPY12 billion in 2013. The deal included JPY9 billion of new debt funding, implying an enterprise value of JPY25 billion. The GP also secured a put option for its remaining 25% stake and this was exercised in mid-2017.

When DPE acquired the business, it wanted to reach 850 stores by 2022. The long-term target has since been pushed out to 1,000. The barbell menu strategy continues – prices range from JPY799 for basic pizza to JPY3,800 for toppings such as wagyu beef – while delivery and technology are prioritized as highly as in DPE’s other markets. The average delivery time for non-franchised stores is 19.2 minutes and by next year 40% of orders will be made by e-bike.

In 1985, part of Higa’s pitch to Monaghan was that Japan was so different from other markets – and his local expertise therefore so valuable – that he “wasn’t about to start as a driver” in the hope of one day being awarded a franchise. It is perhaps a mark of the business’ maturity that the wheel has turned full circle. A recent winner of the Domino’s Japan franchise owner of the year award started out as an hourly wage driver in 2005 and now owns five stores.

PE & QSR: Dining disrupted

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With ubiquitous delivery services, ordering apps that learn user preferences, and intelligent inventory management, technology is changing China's restaurant industry. Operators are in a race to stay relevant

Luckin Coffee is on course to become China's largest coffee shop chain. Founded in early 2018, the company had 2,963 outlets as of June, most of them small-scale premises designed for collection of orders made via app. The goal is to reach 4,500 by the end of the year, supplanting Starbucks as number one by number of cups sold and number of stores.

Rapid expansion comes at significant cost. Revenue came to RMB909.1 million ($132 million) in the second quarter, up from RMB551.8 million for the previous three months; operating expenses rose from RMB1 billion to RMB1.6 billion. However, costs at a percentage of revenue dropped, the continuation of a trend the company attributes to increased economies of scale and technology-driven operations.

Technology drives the Luckin business model in several respects. First, the company's mobile app covers the entire purchase process, creating a cashier-less environment. Second, the app enables continuous customer engagement. Luckin tracks who they are, what they buy and where they come from, and can turn this knowledge into targeted marketing efforts that reduce customer acquisition costs. Third, technology delivers backend efficiencies through better inventory and staff management.

To some, Luckin represents a transformative force in new retail and a case study in how food and beverage operators can leverage data analytics and artificial intelligence (AI) to boost their bottom line. To others, technology simply adds gloss to an unsustainable narrative.

"Luckin's technology story? I buy one-quarter of that," says Chris Tay, an experienced food and beverage operator in China who now leads consumer-focused LTCV Investments Holdings. "AI is still a story in F&B. You can use technology to deliver more targeted marketing, but this isn't new. KFC and McDonald's can do the same thing. Where is the proprietary technology? Everyone uses the Amazon story to justify their business model and explain why they aren't profit-making."

Age of aggregators

However, technology is, without doubt, transforming fast dining. No operator of scale can exist without an app, a digital marketing strategy, and some kind of order-tracking system – the question is how do they interact with the plethora of third-party logistics providers that have democratized the industry, making it as easy for small-scale players to reach consumers as it is for international brands.

Martin Mok, a partner at EQT, identifies digitization as one of the most important considerations for master franchisors, alongside the arrangement with the brand owner, recruiting a team that can execute a store rollout, and achieving consistency on food quality. EQT owns China F&B Group, holder of the franchise rights to Dairy Queen and Papa John's Pizza in eastern, central and southern China.

"We used to have our own call center and distribution teams, but now we rely on external aggregator platforms. You must be able to leverage those channels, while streamlining your in-house resources," Mok explains. "You need digital DNA in the management team, so they know how to cooperate and promote on aggregator platforms, whether that's buying rankings, location-based preferences, or limited time offers. Advertising on these platforms doesn't always recoup the investment cost, so you must be selective, knowing the demand elasticity curve in each location."

Online-to-offline services platform Meituan-Dianping and Alibaba Group-owned Ele.me between them control more than 90% of China's online food delivery market. Both are plugged into wider ecosystems, with Meituan the partner of choice for Tencent Holdings and its social networking, payments and mini-app behemoth WeChat, while Ele.me sits under an umbrella local services entity alongside Koubei, making deliveries for multiple consumer-facing Alibaba Group entities as well as for third parties that use Alipay.

Meituan completed 2.1 billion food delivery orders during the three months ended June, generating RMB12.8 billion in revenue. Across all segments, the platform boasts 422 million transacting users and 5.9 million merchants. Alibaba's local services business boasts 245 million users and revenue for the second quarter was RMB6.8 billion. Both companies continue to subsidize drivers and diners as they battle for market share, but they are an integral part of the new normal for restaurant operators.

Meituan and Ele.me do not share individual user data with customers; rather, they provide aggregated numbers to facilitate targeted advertising on their platforms. Restaurant operators take orders, collect user data, and run loyalty programs through their own apps, offering customer insights on the front-end even if they rely on Meituan and Ele.me to handle deliveries. When CITIC Capital, CITIC Group and The Carlyle Group became the master franchisor for McDonald's in China and Hong Kong in 2017, the business was trailing on both fronts.

"Before we came in, they had started working with Meituan and Ele.me and we helped to bring in a WeChat mini-app," says D.J. Luo, a managing director at CITIC Capital. "We encouraged McDonald's to work closely with Tencent, which is a shareholder in CITIC Capital, and it took no more than three months to launch the app. We now have more than 100 million users, and it's a channel we control."

Playing catchup

McDonald's was playing catchup with Yum Brands – owner of KFC and Pizza Hut – which had spun out its China business into a separate listed entity 12 months earlier. As of September, the KFC and Pizza Hut loyalty programs had 200 million and 65 million members, respectively. The McDonald's membership is nearly 100 million.

The scale of Yum's loyalty program is the result of an aggressive pursuit of digital and delivery strategies. Nearly half of all orders were placed via app in 2018 – a super app that covers everything from pre-ordering to e-gifting – 86% were settled through digital payment, and program members were responsible for 47% of overall sales. Delivery accounts for 20% of sales, although the volume of delivery sales has grown 3x in the last four years.

Following the arrival of the new owners, the McDonald's delivery figure has risen from sub-10% to over 20%. Almost all the delivery volume is handled by the aggregators, but the company is wary of becoming overdependent on one platform. "In the US, it's just Uber Eats. In China, you need to work with multiple platforms," Luo says. "If you rely on one and they raise prices, you have little bargaining power. We work with Meituan and Ele.me, and we also endeavored to develop self-owned ordering channels. We brought in one of our portfolio companies, SF Express, as well. Having several strategic partners is key to delivering sustainable margins."

There is still a huge amount of white space to be tapped. McDonald's processes 1.3 billion transactions a year and knows very little about most of those customers, who are predominantly walk-ins. Most industry participants agree that the depth of data on individual customers is thin.

Even if Luckin has yet to fully realize the technology-enabled model that it champions, AI appears to be the future through personalized menus and special offers, intelligent sales forecasting and store management, and dynamic delivery routing. What remains to be seen is to what extent brand equity is driven by technology – helping operators provide a higher level of service – or disrupted by it.

Mobile ordering and delivery have led to an increase in dining options as restaurant chains with few consumer-facing storefronts, or perhaps none whatsoever, can build a broader customer base. While delivery is becoming more prevalent, it still makes up a relatively small percentage of the overall quick-service restaurant (QSR) industry. On top of that, concerns over food safety in China push consumers towards recognized brands. But independent dark kitchens are gaining traction – and in some cases VC backing – across the region.

"Ubiquitous home delivery of any kind of food you want, made in dark kitchens located anywhere, perhaps to the same quality standards and delivered faster than you can deliver it, that's a real game-changer for the industry," says Nick Bloy, a managing partner at Navis Capital Partners, which has past and existing exposure to QSR chains. "We haven't seen the full impact of home delivery on QSR and casual dining. The economics of yesterday do not predict the economics of tomorrow."