The Four Horsemen of the Restaurant Apocalypse?

How lessons from the travel industry's response to online travel agencies may enable restaurants to survive (and hopefully thrive) in a delivery-heavy future.

by Zach Goldstein, CEO and Founder, Thanx

The Original Mel's diner is a Northern California legend. Now at 22 locations, the classic drive-up service is long-gone, just one of many necessary adaptations for a restaurant that celebrated its 70-year anniversary two years ago. The latest evolution may be most challenging yet.

"In our first two years on the delivery platforms, revenue went up 20% year-over-year. It was the largest top-line growth we've experienced in two decades," said Tony Bendana, restaurant industry veteran and current Chief Operating Officer of The Original Mel's which is listed in four third-party delivery apps today — Doordash, Uber Eats, Grubhub, and Postmates.

"But when we looked at how much profit we were making, it hadn't moved."

Tony Bendana, COO at The Original Mel's

What follows is an in-depth study of the massive disruption facing restaurants today, broken into the following sections:

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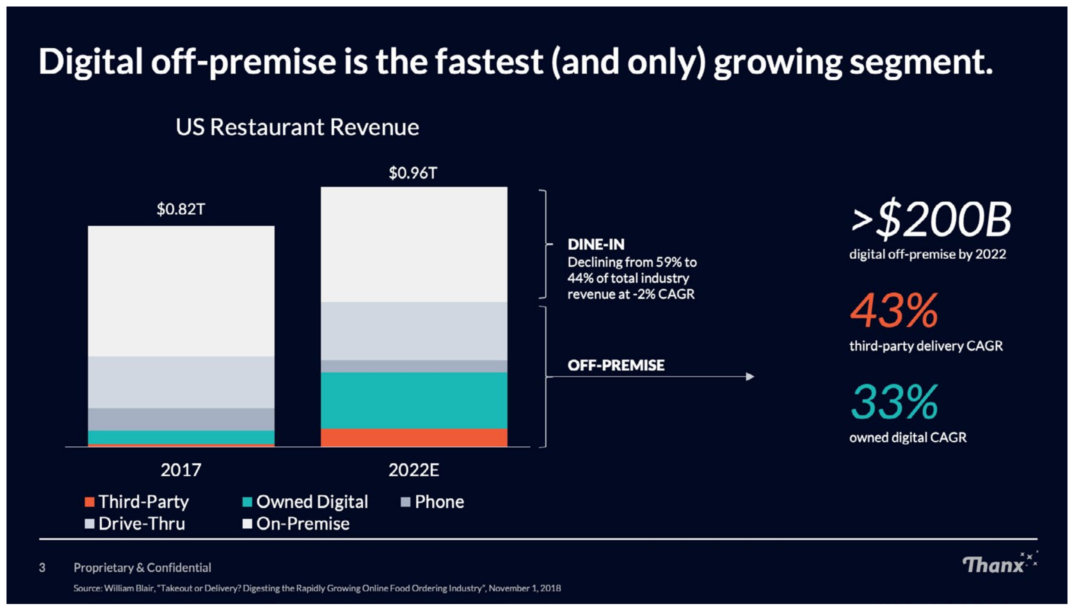
Restaurants Are Digitizing

Off-premise sales (food not consumed in the restaurant) are the fastest and (by some estimates, *only*) growing segment of restaurant industry revenues. Combined, delivery and pickup (including drive-thru) are expected to eclipse $400B in the US by 2022 with third-party delivery (3PD) representing more than 10% of the total and growing in excess of 40% year-over-year, according to a 2018 William Blair analyst report. Dine-in revenues, by comparison, are forecast to decline 2% year-over-year.



So restaurants continue to pursue growth where they can readily find it, but at what long-term cost?

> "Annual profitability for restaurants across all segments in the US is considerably less than 10%; losing up to 30% of top line revenues is not a path to a successful future even if total sales increase by 20%,"

assessed Boston University professor Christopher Muller, Ph.D., a leading academic expert in the field of restaurant management.

Everything certainly appears on track for a successful future for the delivery marketplaces themselves — the top four in the US are flush with billions of dollars in capital investment. Uber and Grubhub are already public; Doordash and Postmates are expected to join them soon. But are these rapidly-growing delivery juggernauts technology partners ushering in a new era of restaurant innovation or are they the Four Horsemen of the restaurant apocalypse (at least for restaurants as we know them)?

The Question of Incrementality

Michelle Gauthier, CEO of NYC-based Mulberry & Vine, did the same math as Muller. "We are losing money on delivery orders, or, best-case scenario, breaking even," she told The New Yorker last year, citing the 30% surcharge levied by the delivery giants. Her math puts her at odds with that of the delivery apps themselves.

According to the 3PD marketplaces, restaurants are already burdened with costs that do not increase at additional order volumes — overhead (including facilities, insurance, etc.) and labor (presuming the kitchen is not already operating at max throughput). Therefore, a single additional order fulfilled by a restaurant incurs food cost (generally 30–35%) but no other added spend; even after the 3PD takes 15–45% off the top, restaurants are still left with plenty of profit to justify the delivery. The argument holds up with a single order from a net-new customer — its gross profit that flows straight to the bottom line. But the numbers morph into a far less rosy picture if the transaction is instead from a customer who would have visited the restaurant (to dine-in or pickup). This potential cannibalization comes in two forms: direct and indirect.

Note: Food margin is 67%, compared to 85% for beverages. Packaging cost is 3.5% of total check; delivery fee: 25% of total check.

Source: Pentallect

Delivery orders show considerable downward pressure on gross margin but are still profitable if you count costs of goods sold (COGS) only and attribute none of the operating costs of running a restaurant (e.g. facilities, insurance, taxes, managers, and other overhead). Source: Wall Street Journal, "Consumers Love Food Delivery. Restaurants and Grocers Hate It," March 9, 2019

A 3PD order that would have come to the restaurant for that same dining occasion creates **direct cannibalization**. For example: a mom who would have stopped by Popeye's (or picked up drive-thru) with her family on the way home from work, but instead ordered via a delivery app. In the case of a $40 family dinner (assuming she orders the same items), the restaurant trades $40 in revenue and a $4 profit for $30 in net revenue (after 25% delivery fee) and a *$6 loss* (if all other contribution costs are held constant). According to a 2017 Morgan Stanley report, 43% of delivery customers say it replaced a meal at a restaurant (up from 38% the year before). Even with a 15% price increase on the delivery passed on to consumers (on top of the $5+ in fees also charged to the consumer), Popeye's still makes no money.

Order Ticket	$40.00
Food/Packaging (35%)	-$14.00
Labor (30%)	-$12.00
Facilities (15%) e.g. Rent, Insurance	-$6.00
Variable costs (10%) e.g. Marketing, Repairs	-$4.00
Total Restaurant costs	-$36.00
Restaurant Profit	$4.00
Third-Party commission (25%)	-$10.00
Restaurant Loss	-$6.00

But when considering the net operating margin of the restaurant as a whole, each delivery could be a money-losing proposition.

Indirect cannibalization is harder to measure, coming in the form of delivery orders which eliminates a dine-in meal at the same restaurant another time. For example: a millennial who orders Shake Shack on Wednesday with his roommates and decides to readjust the location of his date on Friday because he "just had Shake Shack on Wednesday." Indirect cannibalization has a similarly problematic economic impact but requires far-longer to observe.

Gauthier's experience has shown these indirect, harder to measure costs to be just as big of challenge as the 3PD fees. "On paper, delivery costs 30% per order. But that's not taking into account the other costs of delivery," Gauthier told me a year after her New Yorker interview. "The amount of money spent on re-sends or refunds (for missing items, spilled items, etc), the amount of time spent fielding calls about those issues or customers wondering where their order is, plus the negative reviews we get due to the deliverer, not us. It's far more costly than most operators even realize."

The question of incrementality is core to the raging debate over whether restaurants (in their current form) can sustain the cost of third-party marketplaces. Earlier this year, Wingstop's CEO Charlie Morrison said he believes 80% of the chain's delivery business to be incremental. How he arrived at that number is a little less clear, but that would be strong; most brands would need 70% of third-party orders to be truly incremental for a third-party relationship to

be margin neutral. For smaller or higher-end brands with increased costs (such as Gauthier's Mulberry & Vine) the number may be higher. But even for those making it work today, can they sustain it? And what happens once restaurants cede control of the customer and dining experience — customer lifetime value (LTV) may be even more encumbered than single-visit profit margins.

Two statistics suggest any existing incrementality is short-lived. First, "U.S. consumers spend more at restaurants as a percentage of their food dollar than any other country on earth. While that doesn't necessarily mean that it won't continue to increase, there are limits" (Restaurant Business). Furthermore, in-store traffic has been steadily declining in most restaurant segments for years (down 4% in the most recent TDN2K Black Box research). So where's all this incremental spending supposed to come from — do we really believe delivery will result in consumers eating more or that's it's all coming at the expense of grocery?

Greg Flynn, CEO of Flynn Restaurant Group, the largest restaurant franchise company in the country, recently ran a test eliminating delivery at some of his Applebee's locations. The results suggest delivery was already cannibalizing sales: "So far, we're seeing our dine-in and carside-to-go business rise faster in the markets where we canceled delivery than in markets where we still maintain it," said Flynn.

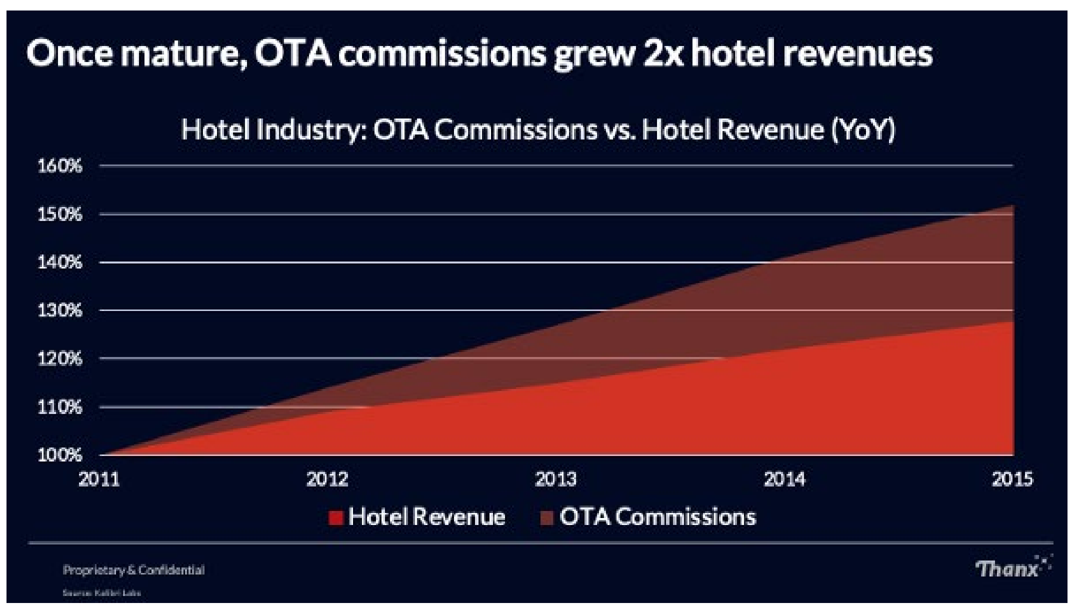
"[Online travel agencies] permanently took 10% out of the profit structure of the hotel industry as traffic came through their channel. I believe the restaurant industry is at [a similar] inflection point," Flynn said in May.

He's right — though the impact was likely even larger.

We've Seen This Story Before: Hotels and Online Travel Agencies

In the early days of online travel agencies (OTAs), commissions typically averaged 5–10% and the partnership was a no-brainer way for hotels to sell excess inventory. Hotel rooms and airlines seats are perishable; an unused seat or room is meaningful lost revenue in a highly fixed-cost business so a new channel to ensure peak utilization was welcomed by the operators. But instead of being a source of supplemental income that had no impact on the core business, the ease offered by OTAs rapidly attracted consumers who wanted to avoid calls with travel agents. In recent years, not only has the share of transactions booked through OTAs risen drastically, but so too has the commission rate, now as high as (an eerily-similar) 30%.

In the early-2000s, OTAs still represented a relatively small share of industry revenue (for an unbelievably-detailed narrative of the birth and evolution of OTAs, check out Skift's The Definitive Oral History of Online Travel). But starting in 2011, OTAs experienced a meteoric rise. Commissions captured by OTAs grew more than 50% over four years (2011–2015); hotel revenues grew at half the pace. OTAs were beginning to assert a stranglehold on the industry.



By 2015, the top four OTAs — Priceline, Expedia, Orbitz, and Travelocity — controlled 95% of the online travel market, each with multi-billion dollar valuations. **The first iteration of the Four Horsemen, perhaps?** Today, Expedia owns Orbitz and Travelocity; Priceline is under the Booking Holdings umbrella which also includes Kayak (and OpenTable) among others. Two Mega Horsemen. The consolidation only further strengthened their negotiating leverage with hotels and airlines. By most estimates, OTAs now control 40–70% of all hotel bookings in the US. Bookings Holdings and Expedia Group combined for more than $25B in revenue in 2018 and are collectively worth more than $100B. Marriott, the world's largest hotel chain, is worth just over $40B at time of publication. This follows so-called Aggregation Theory which describes how platforms "come to dominate the industries in which they compete in a systematic and predictable way" (Ben Thompson of Stratechery).

As their growth accelerated, the leading OTAs began to more aggressively court consumers, including through direct online advertising. "The concept promoted by the OTAs called the 'billboard effect' claimed the visibility given to hotels by listing with OTAs resulted in many more [direct to hotel website] bookings," according to 2016 Kalibri Labs study "Demystifying the Digital Marketplace". "The study indicates, unequivocally, this 'billboard effect' does not exist and it appears that the multibillion-dollar marketing spend by the OTAs has benefited the OTAs at the direct expense of [hotels]."

Not to skip ahead in our story, but the parallels are obvious with Grubhub's hijacking of search engine advertising for restaurants (e.g. buying ads against a restaurant's name which show up above the search results in Google), building Grubhub-owned websites that compete with a restaurant's own site in those rankings (New Food Economy), charging for non-delivery phone calls (NY Post) and recently conspiring with Yelp to expand on that practice (Vice).

The same Kalibri Labs report (2015, 2016) showed from 2014–2016, while guest-paid revenue grew 4–8% year-over-year, hotels themselves captured ~0.5% less of the net revenue (~$600M and $730M in lost net operating income each year). "This additional cost reduced the asset value of the overall hotel industry by at least $7.5B [in 2015 and $9B in 2016]," the report concluded; a major economic redistribution.

Greater supplier fragmentation = greater disaggregation.

	Top 10 Operators Market Share	Operator Power	Third-Party Share of Online Transactions
Airlines	89%	High	28%
Hotels	50%	Moderate	63%
Restaurants	19%	Very low	70%+

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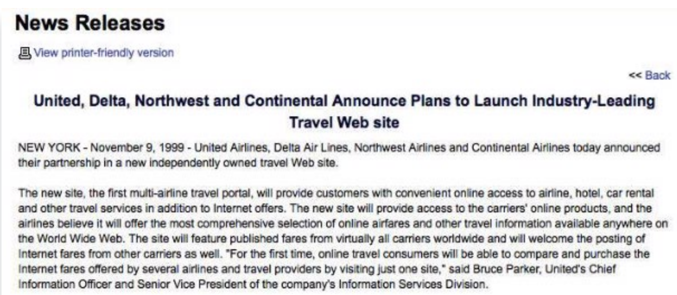
It follows logically from Aggregation Theory that industries with greater supplier fragmentation (e.g. more suppliers to be aggregated by a platform) experience more severe disaggregation. And so it was with OTAs. While online bookings spread rapidly through both the airline and hotel industries, the impact was not as severe for airlines; the top four airlines in the country (Southwest, Delta, American, United) control nearly two-thirds of the North American market, according to 2018 data released by Upgraded Points. The top-10 own 89% market share. As a result, airlines are able to drive nearly 70% of bookings through direct channels (largely as a result of their investment in loyalty programs that drive repeat purchasing), a mirror image of the ratio in the hotel industry where there is a far greater diversity of options and operators. **Restaurants face even more extreme supplier fragmentation.** In fact, this concentration in the airline industry allowed them to more actively fight back, launching a joint venture in 1999 — Orbitz.com — an airline controlled OTA to combat the risk of disaggregation from third-parties.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United, Delta, Northwest and Continental Announce Plans to Launch Industry-Leading Travel Web site

NEW YORK - November 9, 1999 - United Airlines, Delta Air Lines, Northwest Airlines and Continental Airlines today announced their partnership in a new independently owned travel Web site.

The new site, the first multi-airline travel portal, will provide customers with convenient online access to airline, hotel, car rental and other travel services in addition to Internet offers. The new site will provide access to the carriers' online products, and the airlines believe it will offer the most comprehensive selection of online airfares and other travel information available anywhere on the World Wide Web. The site will feature published fares from virtually all carriers worldwide and will welcome the posting of Internet fares from other carriers as well. "For the first time, online travel consumers will be able to compare and purchase the Internet fares offered by several airlines and travel providers by visiting just one site," said Bruce Parker, United's Chief Information Officer and Senior Vice President of the company's Information Services Division.

Announcement of Orbitz.com, a joint venture of leading US airlines.

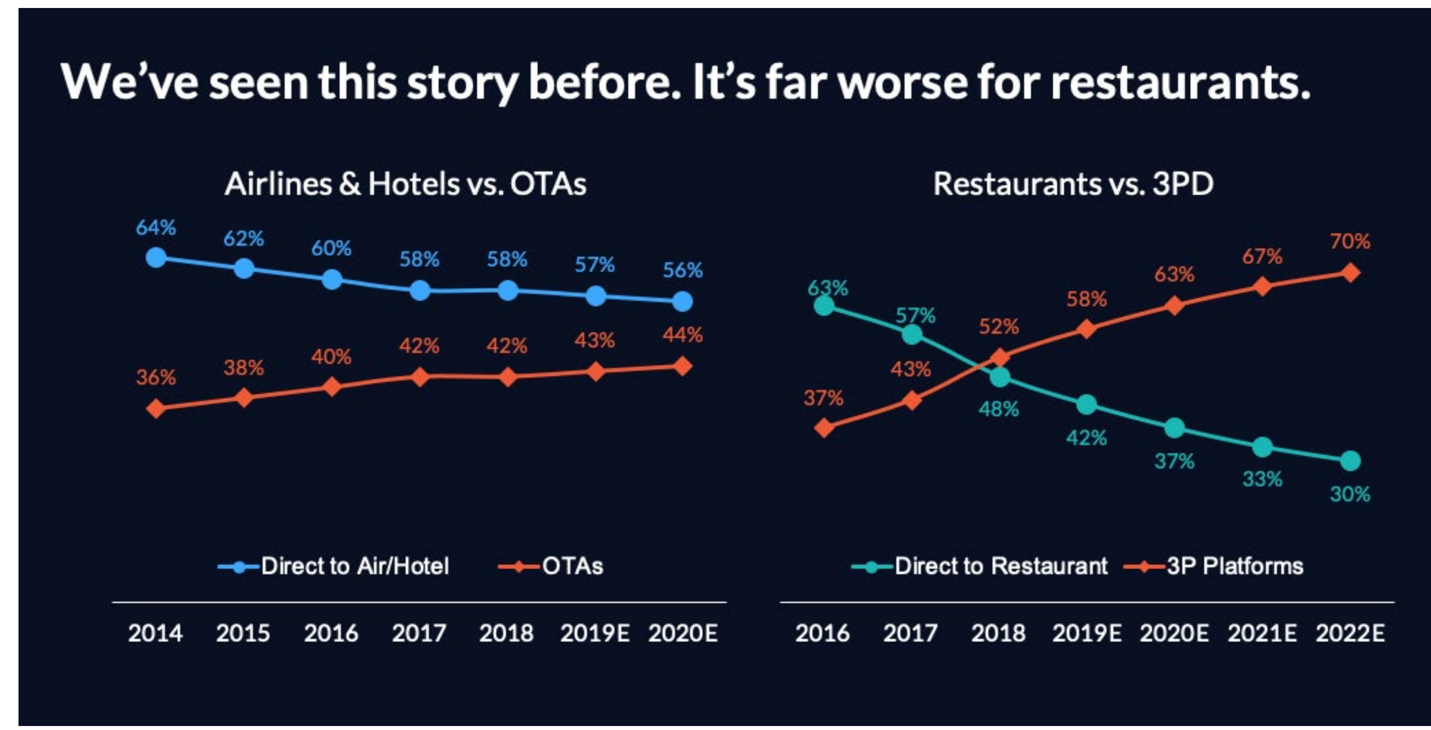
The rapid expansion of OTA market share from 2010–2015 had meaningfully slowed by 2017… 20 years after the launch of the first OTA (see chart at bottom of this section). The impact was already severe but hotels were ready to start fighting back.

In 2016, many major hotel chains spent hundreds of millions on marketing campaigns encouraging customers to join their loyalty programs and "Book Direct." Major hotels had invested meaningfully in loyalty incentives and modern booking experiences on their websites ("owned" channels). Hilton's "'Stop Clicking Around' campaign contributed to a 60% increase in HHonors enrollments and a shift toward direct channels in the third quarter of 2016" (McKinsey).

Marriott started promoting "Book Direct" in 2016.

The investments paid off as the period from 2016 to 2018 saw the exact opposite trend of the previous five years: "The increase for [direct to hotel booking] is 50% more rooms sold per month on average compared to OTA rooms sold per month during the same period," (Kalibri "Book Direct Campaigns 2.0"). Furthermore, loyalty member direct bookings were able to drive a 9% price premium to OTA bookings, in large part due to upsell opportunities in the owned booking experience (in spite of most hotels guaranteeing lowest prices on their sites). Many analysts believe the industry has stabilized and a new equilibrium reached; but the impact of OTAs was permanent and had significant knock-on effects.

As the expected return on invested capital in the hotel industry declined in the face of decreasing profitability, hotels built fewer new rooms. Some analysts believe this under-investment in additional supply was instrumental in creating the opportunity for AirBNB to grow rapidly and become a massive new threat to hotels — recent estimates by Morningstar Equity Research suggest AirBNB could be worth $53 to 65B, making it far larger than Marriott.



Source: William Blair, "Takeout or Delivery? Digesting the Rapidly Growing Online Food Ordering Industry", November 1, 2018

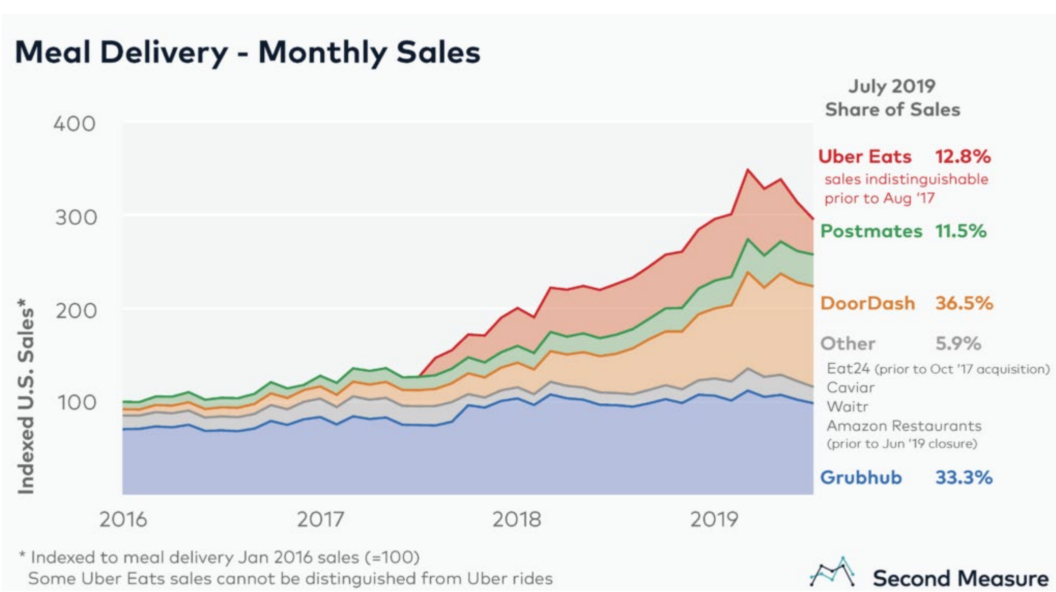
The Four Horsemen of the Restaurant Apocalypse?

“This model is leading to [restaurants’] slow death.”

Mark Gjonaj, chairman of New York City Council’s Committee on Small Business

If Aggregation Theory wins out, restaurants are in for a world of trouble. Played to its logical conclusion, third-party aggregators will commoditize the industry in much the same way Amazon eliminated entire categories of consumer product companies with the launch of Amazon Prime; consumers opted for the convenience of free two-day delivery and the comfort of the Amazon Prime logo over the differentiation of the products themselves. Certainly the 3PDs are amassing war chests and scale far faster than OTAs ever did; and the consolidation has already begun as well.

Even before Doordash’s recent acquisition of Caviar, the top four third-party delivery players controlled (a very familiar) 95% of the market. And like the Four Horsemen before them, they have already rocketed to massive valuations with billions of venture dollars invested in their success. Grubhub — the first to go public — is worth more than $5B. UberEats is estimated to be worth $15B based on its revenue share at now-public Uber (it’s also the fastest-growth part of the business). Doordash — the market share leader — has individually raised over $2B with a recent valuation of $12.6B, while Postmates has quietly filed for IPO expecting a roughly $2B valuation.



The growth shows no sign of slowing down. In fact, only 24% of Americans have ordered delivery via a third-party marketplace, according to analysis from Second Measure. But being large is not a threat in-and-of-itself. And there’s no doubt that the massive investment in delivery technology and infrastructure unlocked very real latent market demand for off-premise food.

Panera saw the writing on the wall and invested ahead. The national chain employs its own drivers to handle deliveries directly in many markets. “The chain spent six years and an estimated more than $100 million to develop the technology to process its own online orders. Its investment cut into profits for three years, until the effort began to pay off in 2016” (Wall Street Journal). The company now drives as much as 15% of revenue from owned delivery in mature markets and Chief Executive Blaine Hurst said, “We are substantially better off doing delivery than not.” But even in spite of that success, Panera announced last month that it too will be listing its food on 3PD apps, perhaps signaling that the marketplaces have become black holes — so large that they have their own gravitational pull (a captive customer base otherwise unreachable). Surely Panera is hoping that existing customers are already hooked on ordering direct from Panera and that the marketplaces attract net-new, strictly incremental Panera lovers.

It’s a battle for who is the sun and who is the planet circling it. Are restaurants the center of the consumer’s dining solar system and third-party marketplaces a satellite that circles the restaurants offering on-call convenience? Or vice versa — when consumers want to eat, they think of Doordash, Uber Eats, etc., and the food preference itself is a secondary criteria? The later would be a dangerous state of affairs for the trillion-dollar restaurant industry.

In China, the answer is already clear. “In Beijing, it’s often cheaper to have food delivered than to get it yourself. Like, way cheaper. Abey Lin, a 19-year-old Californian studying at Beijing Film Academy, uses his smartphone to order a local restaurant’s roast duck dish for 20 yuan ($2.99), about 80 percent less than it costs at the register, via delivery app Meituan” (Bloomberg). Sure, part of this is the fierce battle for market share between Meituan and Alibaba-owned Ele.me resulting in heavily-subsidized delivery cost (none of the US 3PDs are anywhere near profitable). But its hard to ignore that this might be a window into the future for US-based restaurants — when food becomes commoditized and convenience takes precedent, one restaurant can close and another can pop-up in its place to fulfill the niche in demand. Long-term customer loyalty is eschewed for “how fast can I get it,” “how cheap is the delivery fee,” and “is it at least adequately tasty.”

Enter virtual restaurants. With billions in his pockets after founding Uber, Travis Kalanick could have sat on the sidelines after being pushed out of the ride-hailing giant. But with a front-row seat into the growth of the 3PD category, Kalanick wasn’t out of the game for long; he invested $150M to gain a controlling stake in CloudKitchens, one of a new generation of “restaurants” without a physical storefront and which exclusively promote themselves through third-party marketplaces. “Ghost kitchens” offer some significant advantages to incumbent restaurants including the ability to fulfill a far greater demand of delivery orders from a lower cost "make line". But they also represent a new wave of competition into an already cutthroat business. Since 2017, the New York Times reports Uber has helped start 4,000 of these virtual restaurants. In the realm of delivery, new virtual restaurants and ghost kitchens have significant cost advantages over already-in-place restaurants with large physical footprints and decade-long leases, which means just as leading restaurants are raising prices to offset the margin hit, these virtual restaurants are well-positioned to lower theirs to win marketshare. The margin eaten up by a physical storefront — which is often a restaurant's #1 marketing channel — can be more sustainably passed on to delivery marketplaces and consumers instead.

A collection of Grubhub-exclusive "virtual restaurants" operating out of a ghost kitchen parked in a San Francisco parking lot.

"Ingrained habits and the cost of delivery, particularly in the West, means that it will take several years for restaurants to feel the pinch. But as cloud kitchen companies proliferate, and the cost of delivery declines, consumers will eventually find they can have their favorite meals delivered within 30 minutes at the same price, or conceivably lower, than a restaurant now charges. The local *trattoria*, *taqueria*, curry shop and sushi bar will be pressed to stay in business," Sequoia Capital legend Michael Moritz wrote in the Financial Times. It may be that those "years to feel the pinch" correspond to an upcoming recession which could further amplify the shift. The OTA boom in the travel industry launched as the economy emerged from the last recession and consumers embraced new spending behaviors.

But even absent a nightmare recession, some restaurants are optimizing for near-term speed-to-market at the expense of long-term control of the customer. It has been widely reported that the Uber Eats take rate on its formerly-exclusive partnership with McDonald's was well below the 30% norm: "We charge a lower service fee to certain of our largest restaurant partners... to grow the number of Uber Eats consumers, which may at times result in a negative take rate" (Uber S-1, page 27). It's a troubling revelation, in part, because there is no way smaller restaurant operators would get the same consideration. But it's even more concerning because Uber and their fellow horsemen are playing a long game, investing in customer acquisition at a short-term loss because the long-term lifetime value of a consumer is far greater — the lifetime value to the marketplace, that is, not the restaurant. 3PDs openly acknowledge leveraging national brands to expand their consumer database, expecting to profit later (unfortunately, at the restaurant's expense). In this model, 3PDs are quite literally taking ownership of a restaurant's customer and selling the customer back to them at 70 cents on the dollar for future purchases.

Lest you think, "well delivery is only a fraction of the market," 3PDs have their sights clearly set on every dining occasion. The major players have all added pick-up options — free for now, but ultimately a channel for additional fees. And "Uber Eats is taking things to the next level by testing a new feature: order-ahead food that you can then eat at the restaurant like a normal customer" (Eater). If the customer becomes trained to default to a 3PD when hungry (instead of a restaurant), regardless of dining occasion, restaurants will become irreparably disconnected from the consumer. Delivery companies are counting on it; and it shouldn't surprise restaurants, because OpenTable has held table-service restaurants in a similar vice (charging per reservation even when the customer already knew where they wanted to dine).

But is it really "demand generation" when sometimes the customer already knew they wanted food from a specific restaurant? Grubhub and others charge restaurants as if what they deliver is 100% incremental. Maloney gleefully — and on national television — announces himself to be a competitor to restaurants for customer lifetime value, insinuating they have no choice but to partner with him because they can't organize to resist. But restaurants do have a choice — they can prioritize (and incentivize) direct relationships with their customers, capturing data that can be used to drive repeat direct purchasing and thus driving 3PDs back into the Maloney-maligned logistics business.

> "We know the lifetime value of our customer. Once they start ordering, we know they are on forever," Matt Maloney, CEO of Grubhub, told Jim Cramer. "The gross margins on logistics are not fabulous. The gross margins on demand generation are fabulous. If you're selling consumers, if you're selling growth, you can charge a lot for that."

Disaggregation and Customer Lifetime Value

It's not hard to see that Uber (and the other 3PDs) are running the exact playbook learned from the OTAs — but this time with some far more beneficial tailwinds. Uber's CEO was transparent about how he saw the world in his previous role as CEO of Expedia: "You guys all criticize me for how much I charge you for guests to come to your hotel. I think you're looking at it wrong. Look at us as the cheapest source of referrals that you could imagine. If they come through me, you pay me once, and if they come back to me again and again, shame on you. You should make them a loyal customer" (Skift).

But in most cases, once the marketplace owns the customer relationship, it can be very hard to win them back. Take a satisfied Glad (trash bags) or Energizer (batteries) customer who returns to Amazon to re-buy from that brand only to be intercepted by Amazon selling its own competitive product, as detailed in a recent Washington Post article "Amazon wants you to buy their brand before you checkout". It's a story all-too-familiar to restaurants now competing in a digital marketplace with misaligned incentives.

> "You guys all criticize me for how much I charge you for guests to come to your hotel. I think you're looking at it wrong. Look at us as the cheapest source of referrals that you could imagine. If they come through me, you pay me once, and if they come back to me again and again, shame on you. You should make them a loyal customer.

Former Expedia CEO Dara Khosrowshahi speaking to hoteliers.
Khosrowshahi is now CEO of Uber. Uber Eats is the #3 delivery provider in the US.

I fell into the trap unconsciously last week. I ordered a salad from a popular San Francisco lunch spot Split Bread via Uber Eats. I wasn't sure how well the food would travel but I was delighted to receive the meal so quickly that the rotisserie chicken was still warm. Having had a great experience, I opened the Uber Eats app later in the week intending to reorder the same salad; the first screen I saw was for free delivery from a different restaurant featuring an eerily-similar salad. I scrolled past the advertisement found Split Bread and discovered a $5 delivery fee if I wanted the same exact lunch. So I ended up ordering from the new place — it had five stars in Uber Eats and the savings on the delivery fee was equal to 30% of the cost of my lunch. Sorry Split Bread. Uber wants consumers to order from multiple restaurants — this maximizes lifetime value (to Uber) by demonstrating a broad offering, thus creating more opportunities for repeat purchasing. But it reduced my personal LTV for Split Bread, even though they had done everything right… which makes that 30% "referral" fee even more expensive.

The challenge boils down misaligned incentives in customer lifetime value. Hotels had a chance to woo the customer following an OTA booking; a well-honed sales pitch on the benefits of the hotel's loyalty program at check-in had a chance of converting the customer into a future "direct booker". Because it's 5x more cost effective to secure an incremental purchase from an existing customer than it is to acquire a new customer, this was a sound strategy. As Khosrowshahi points out, OTAs offered cost-effective lead generation for high LTV customers who booked subsequent direct stays. Research done by Frederick Reichheld of Bain & Company (the inventor of the net promoter score) calculated that increasing customer retention rates by 5% drove up to 95% increases in profits.

Loyalty Booking vs. OTA Booking

Hotel industry: A single "loyalty" customer booking direct may be lower margin on the first visit, but significantly higher margin on subsequent visits. The result (as measured across four visits relative to four different OTA guests), is 12% higher net revenue from the loyalty guest. Source: Kalibri Labs.

This strategy is not viable for restaurants who receive no data about the customer they are serving and have no direct interaction with that customer. **Restaurants have been completely disintermediated from their buyer.** In fact, except in the case of one smaller delivery player (Waitr), the actual customer interaction is outsourced to contract workers who aren't even technically employees of the delivery company, let alone the restaurant (no wonder fry theft is rampant). Restaurants are left to try to intercept the customer with bag inserts or other tricks — tactics that the delivery companies actively combat (because they think restaurants are trying to steal "their" customer).

With restaurant customer LTVs as much as 5–20x the value of a first purchase, long-term ownership of the customer far outweighs the impact of a single transaction — whether profitable or not. And the delivery providers aren't backing down. "Of course we own the customer; we spent the money to acquire them," said Scott Leffel, Director of Restaurant Acquisitions at Waitr Holdings, a regional 3PD provider at a recent industry conference in Tampa. Which is, perhaps, a fair perspective given they've poured billions into consumer incentives through subsidized deliveries to drive adoption and need to ultimately make up that investment.

It all "points to a fierce battle ahead, as restaurants try to keep the upper hand and avoid becoming the victims of new digital aggregators, like music companies, retailers or newspapers before them" (Financial Times, "Food delivery wars are just beginning", August 1, 2019). You'll notice hotels are not on that list — they've staved off complete annihilation. Restaurants can too.

Winning Strategies for a Digital (and Delivery-Enabled) Restaurant

Consumers are demanding food delivery; it's not going away. I wouldn't want to be misinterpreted five thousand words in: delivery itself (and digital more broadly) is not some evil to be scared of. Rather, restaurants must embrace delivery as a new reality; soon **the majority of a restaurant's business will come from consumers who order (and eat) outside the restaurant.** But the 3PDs — at least in the current form at current rates — must be treated as both partners and competitors. We can learn much from the OTA disruption; McKinsey identified three characteristics of winners in the hospitality space:

- Harness advanced analytics to understand the customer better (**loyalty and personalization**)
- Adjust mobile offerings to capture, secure, and serve the customer (**modern user experience**)
- Safeguard against future disruptions: "Most big companies are playing defense — reacting to established competitors and upstarts — instead of thinking about how they can identify and solve customer needs before somebody else does" (**investing in innovation**)

The same conclusions roughly hold for restaurants. Here are four restaurant-specific strategies for gaining the upper hand:

01 **Invest in "owned" digital channels (ordering)** to maintain direct relationships with customers and maximize repeat purchases. Third-party apps are simple and beautiful; your consumer experiences must be as well.

02 **Build CRM and true customer loyalty.** Rote rewards and blanket email marketing are not enough; consumers expect data-driven personalization.

03 **Simplify operations** to minimize disruption.

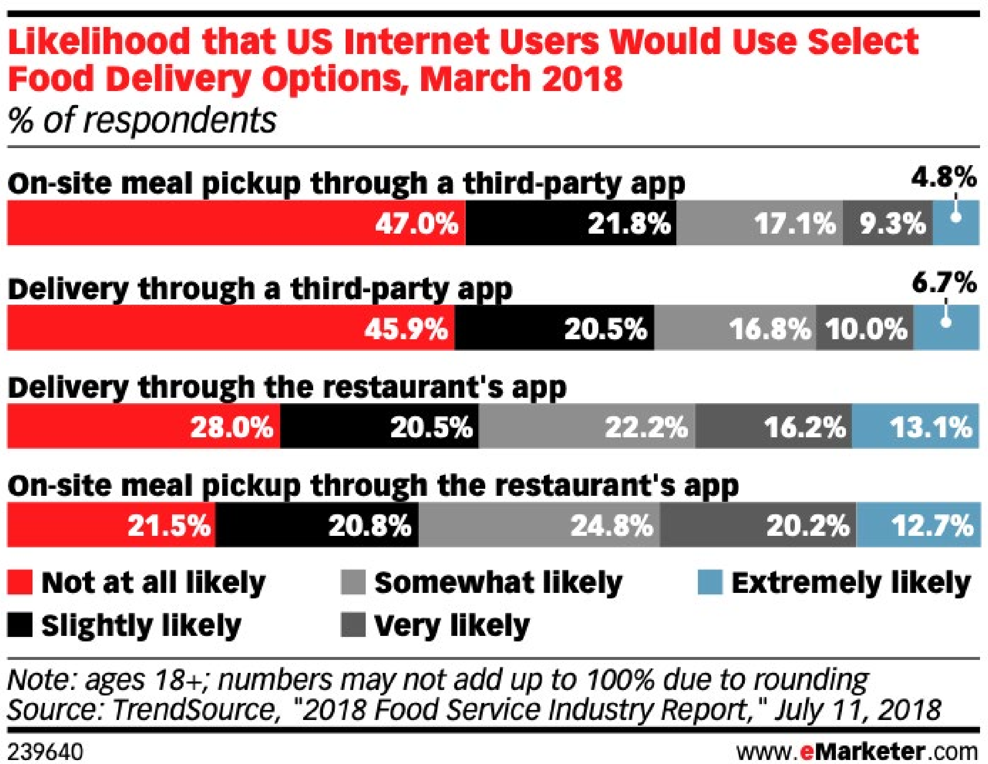
04 It takes money to make money. **Invest ahead or get left behind.**

01

Invest in "owned" digital channels (ordering) to maintain direct relationships with customers and maximize repeat purchases.

Third-party apps are simple and beautiful; your consumer experiences must be as well.

Consumers cannot give you their digital ordering revenue if you don't make it possible for them to order directly from you. This is the most important takeaway from the success of the "Book Direct" counterattack against OTAs — hotels created easy-to-use booking experiences directly on their websites and in their mobile applications. And as it turns out, most consumers would indeed prefer to order directly from the restaurant.



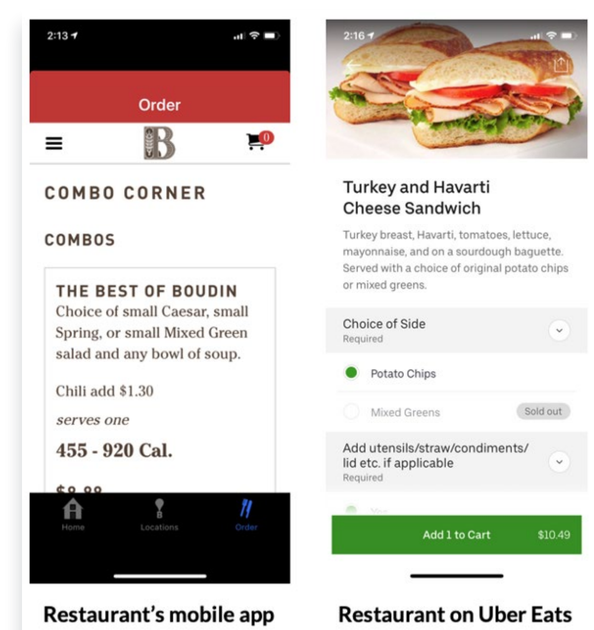
Consumers are more likely to order directly from restaurants when given the opportunity. Source: TrendSource, July 2018

"The measure of success in the years to come will be a restaurant's percentage of direct digital sales,"

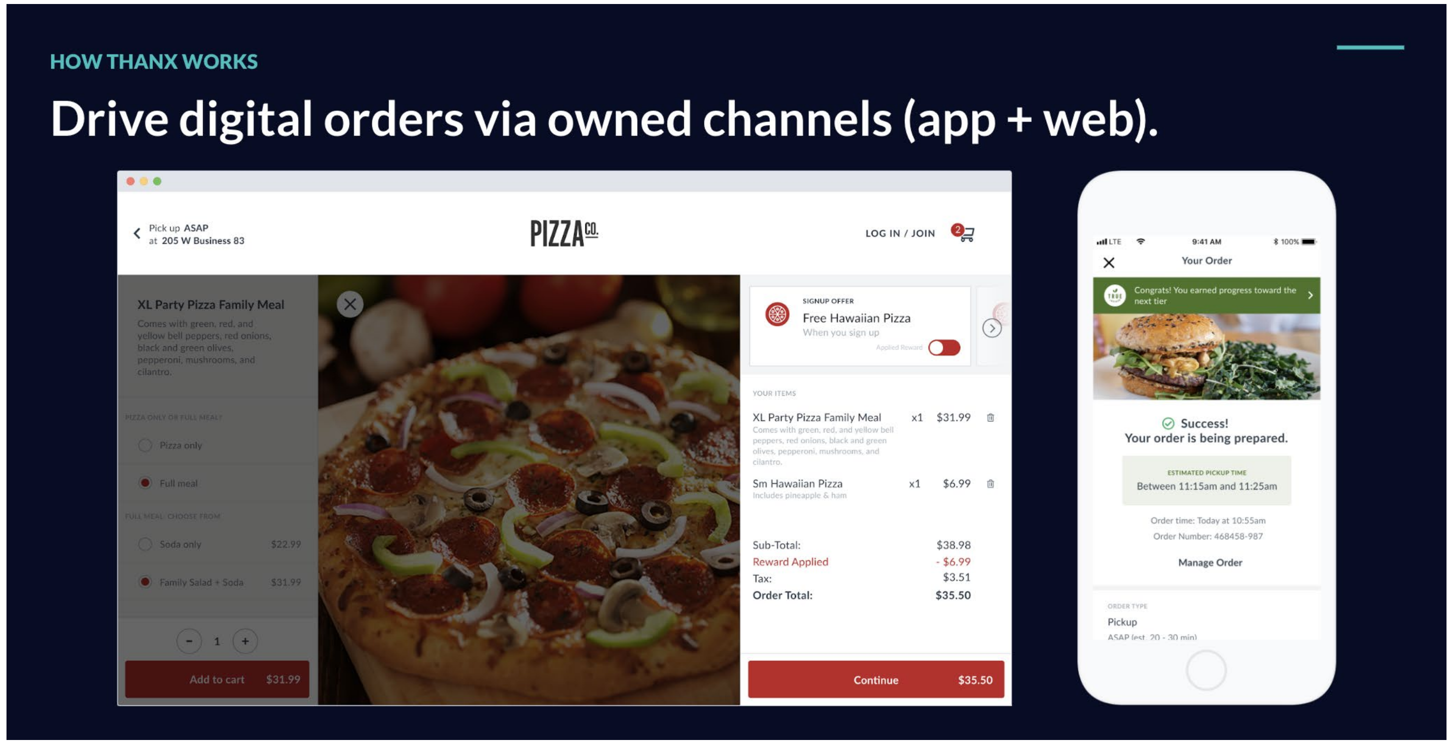
says Olo CEO Noah Glass. "Those restaurants that will stand the test of time and excel in the era of food on-demand are those that will master meeting the needs of the on-demand consumer with digital ordering and delivery. Restaurants must harness their natural assets like their four walls, their takeout packaging, their websites and other owned media to engage the natural affinity group of existing loyal customers and enroll these customers in their digital channels."

Unfortunately, capturing digital ordering volumes is much harder than "if you build it, they will come." A LinkedIn search for "designers" at Doordash yields 374 results — that's more people focused on beautiful menus, easy customizations, one-click reordering, and the generally engaging look-and-feel of the industry-leading delivery app than who work at most restaurant corporate offices in their entirety. In order to draw in consumers to a direct ordering experience, you need to make it easy and familiar. Far too often the restaurant industry tolerates two-star app ratings, broken links, 15-field signup forms that take 10 minutes to complete, and websites that look like they're from 1999. And then restaurants wonder why even with their own ordering channel technically operational, they "only capture two orders per location per week", as one QSR CMO recently told me.

In this case, great design isn't about doing something the industry's never seen before — in fact, at Thanx we believe that you can piggyback off the excellent iteration that the hundreds of designers at 3PDs have already toiled away on. In the case of capturing owned orders, great design is simple: Instagram-worthy photos, clean user experiences that minimize clicks, simple reordering of items the consumer already knows they like. Once the status quo is out of the way, that's when the fun starts — suggestive selling directly in the checkout flow ("Have you tried out chocolate chip cookie?"), for example. Remember that unexpected conclusion from the travel industry research — in spite of promising "lowest rates when booking direct", hotels actually saw higher per night average revenue than they saw from the OTAs. The secret sauce was well-honed upsell that utilized loyalty data and previous hotel stays to personalize the promotion.



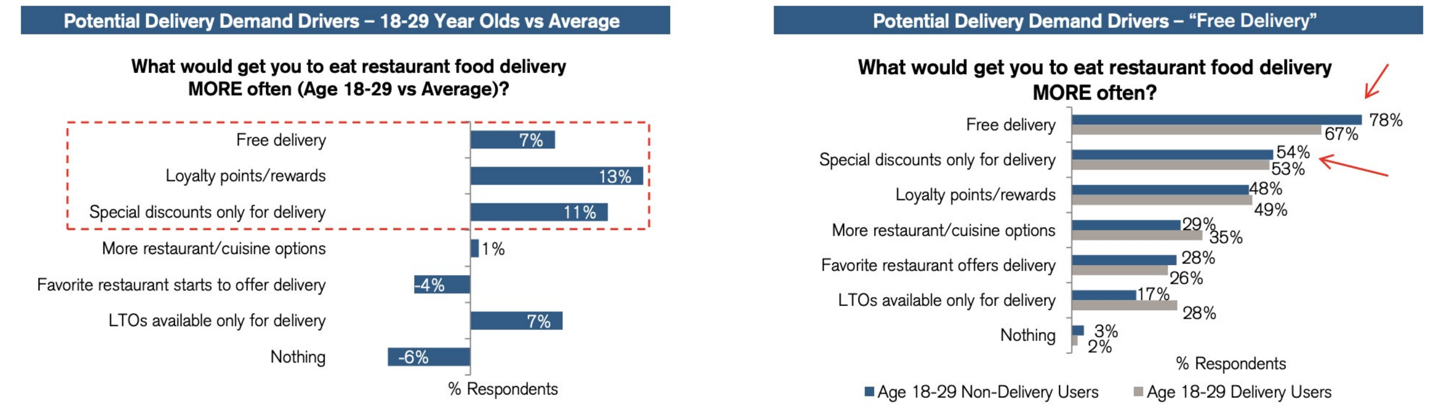
Which consumer experience is more likely to draw you in?



The "Low Price Guarantee" was another tool that allowed hotels to turn the tide and it has clear relevance for restaurants. Under the weight of 30% delivery take-rates, many restaurants have already concluded that they needed to raise the price of delivery orders. Once a non-starter for delivery companies, most have now relaxed their rules and are allowing restaurants to increase prices in their marketplaces (we see a $1–2 surcharge per item or 10–30% price increase most commonly). As a result, restaurants with owned channels can offer (and promote) their own "Low Price Guarantee" reminding consumers that it will always be cheaper to order direct through their website or app than through 3PDs. Even a few dollars can make a big impact on incentives and if the digital experience that greets the consumer is easy-enough to use, its more likely than not that they'll return to a direct channel over a 3PD the next time. This is an even more powerful strategy (a la hotels) when loyalty incentives are piled on top.

Examples of restaurants doing this well: Shake Shack, Bareburger, Pincho

Technologies that can help: Thanx, Olo, ChowNow, Brandibble, *etc.*

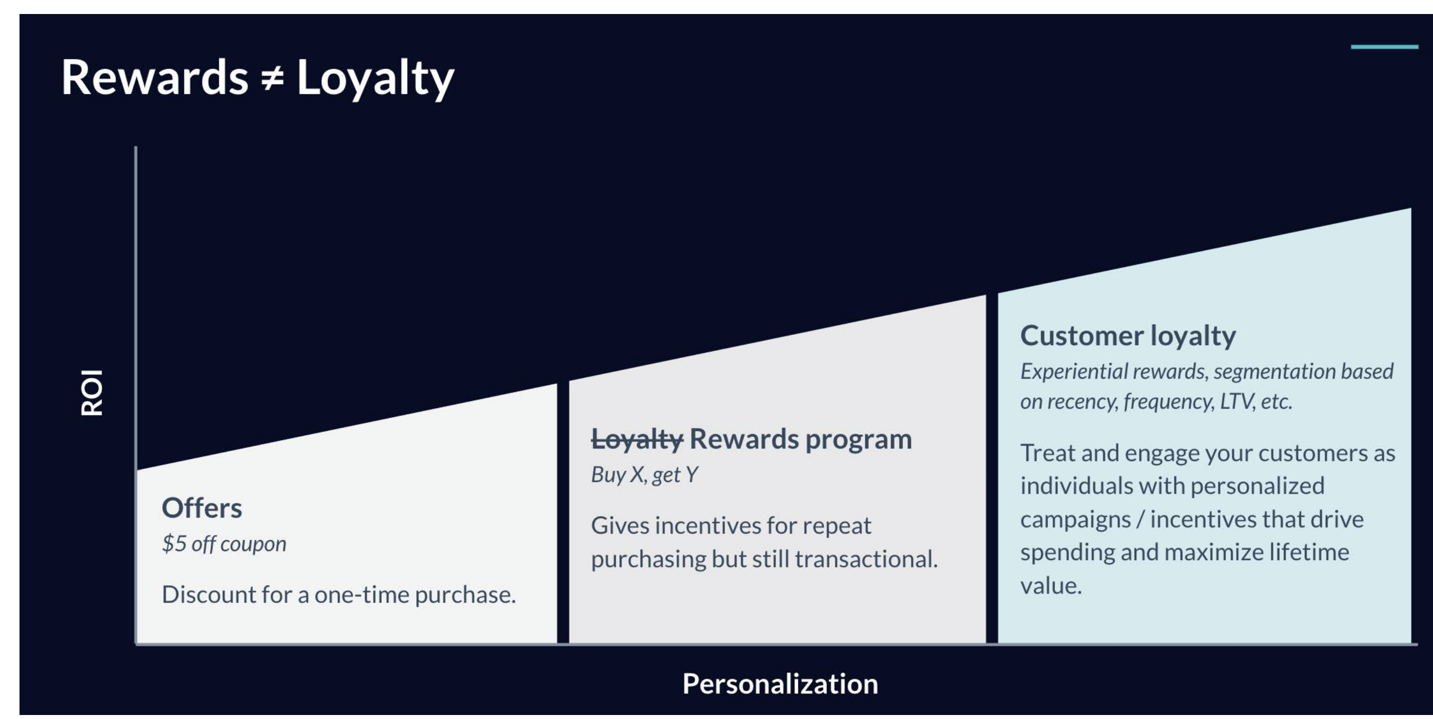


Source: Credit Suisse, "US Restaurants Phone To Table: Digitizing Restaurants", June 25, 2019

02

Build CRM and true customer loyalty. Rote rewards and blanket email marketing are not enough; consumers expect data-driven personalization.

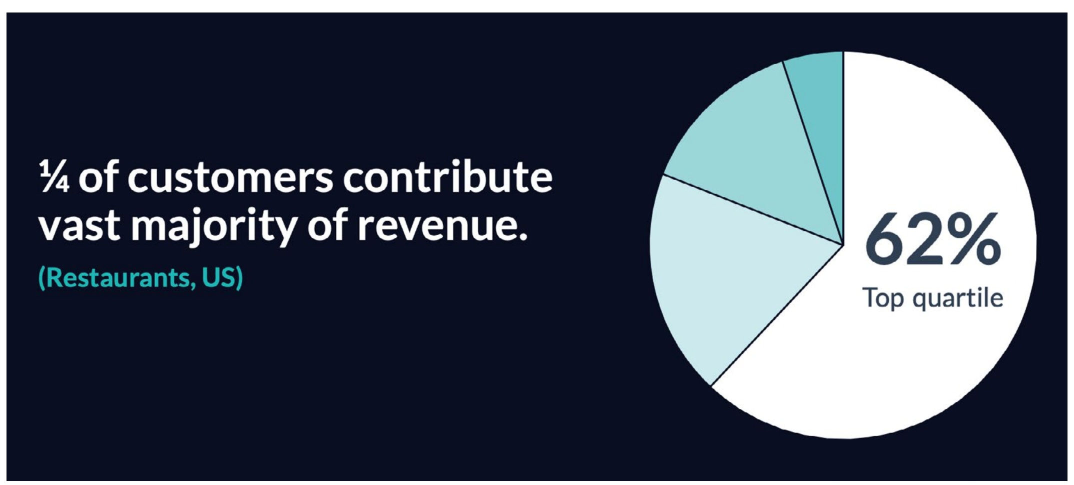
Restaurants have long been light on customer data; it was thought that great food and service were all you needed to be successful — hard enough in their own right. But as we've seen in e-commerce, winners in a digital world are defined by the depth of their customer database as much as for the quality of their product.



Today, most restaurants have taken a major step forward by investing in building email databases and social media followers so they can communicate with customers outside the four walls of the restaurant. However, these channels are largely used to push untargeted, **blanket discounts/offers** which can be effective at driving a one-time purchase but do very little to encourage repeat purchasing (customer lifetime value) or capture more information about that customer.

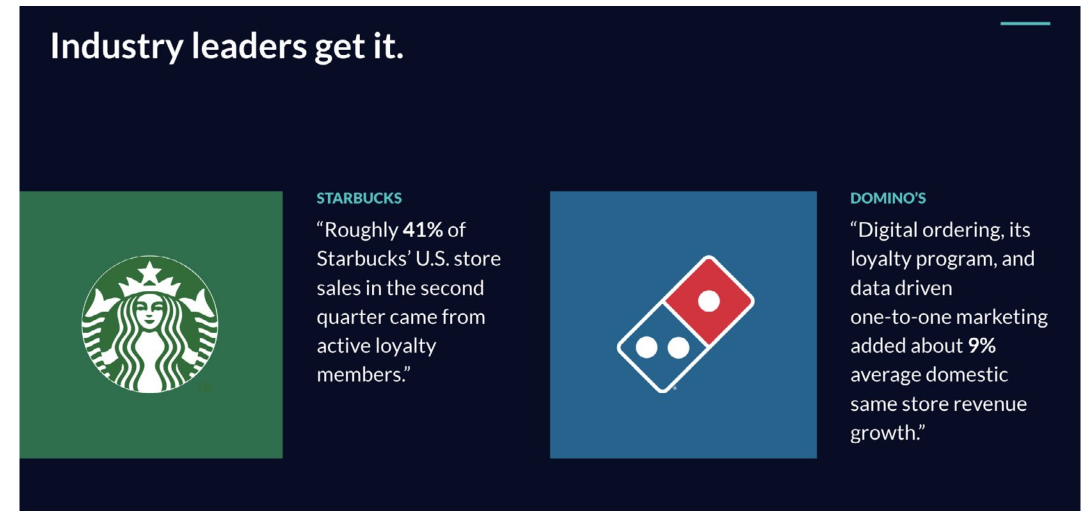
Many restaurants have taken this hunt for customer data further by launching a **rewards program**. In the most common of these models, consumers are rewarded for visit frequency, earning an incentive only after visiting or spending beyond a required threshold. The traditional reward program is one-size-fits-all (e.g. Visit 10 times, Get $10 off); but it generally results in discounts/rewards only being given to repeat, higher lifetime value customers and it comes with the quid pro quo of customer data. With knowledge about recency, frequency, lifetime value (and specific purchasing behaviors), restaurants are able to build a database that reduces their dependency on untargeted discounts for driving traffic, focusing marketing spending on higher LTV customers. The airlines perfected this model where the rewards earned (like free checked bags and seat upgrades) cost very little to fulfill but have a high perception of value, thus locking in VIP customers who might otherwise spread their spend across more carriers; most restaurants utilize a far more basic version of “loyalty.”

In fact, most reward programs do little to actually drive long-term **customer loyalty**. According



to Bain & Company, loyal customers demonstrate 1) increased spend, 2) decreased price sensitivity, 3) longer customer lifetime value, and 4) more customer referrals — but driving true loyalty requires more than frequency rewards. To achieve brand loyalty today, modern customers expect personalization, relevance and convenience. They want to know they are being treated differently than “that guy over there.”

As Olo’s Glass continued: “When customers become part of the digital database, restaurants can finally understand their lifetime value in general and as part of distinct customer cohorts, training their models to better target high-value customers in their marketing activities (and with a well-understood budget to spend on customer acquisition). Perhaps one day, we will witness restaurant brands providing user-level financial reporting, just like e-commerce companies do” (e.g. comparing the acquisition cost and lifetime value of individual consumers through well-honed marketing funnels).



We know this is what industry leaders like Starbucks and Domino’s are already doing with their well-entrenched loyalty/digital programs. And the result is industry-leading sales growth — to the tune of 9% average same-store sales for Domino’s from 2015 to 2018, according to Bloomberg.

These brands succeed by engaging customers personally. For instance, by **recognizing VIPs with special status, unique experiences, or exclusive promotions** to thank them for their loyalty. To “thank” VIPs, some Thanx restaurants invited top-5% revenue customers to an exclusive tasting of their new seasonal menu, gave special holiday gifts to their top-50 2018 VIPs, and comp’d a free dessert with every purchase for anyone who maintained a weekly visit frequency. Outside of restaurants, United will even hold a plane from takeoff for a delayed Global Services customer — their highest (and unpublished) loyalty status.

But personalization is about more than just VIPs. By understanding a customer’s dining preferences (e.g. vegan, family purchaser, weekend-only, always orders guacamole, low Net Promoter Score) sophisticated brands can leverage data to segment customers into cohorts and engage more personally to drive increased relevance and greater engagement. At Thanx, we find that personalized marketing drives as muchas 8x higher return on investment relative to generic “spray-and-pray” promotions. Our tools are designed to easily identify segments and deliver the right message to the right person at the right time.

In the context of digital ordering, loyalty provides an incentive that the consumer would not receive if they ordering through a third-party. And sure, that incentive can be as simple as $5 off after $100 in cumulative spend, but when done right, customers receive special promotions and recognition that matter personally to them — that's what keeps them coming back.

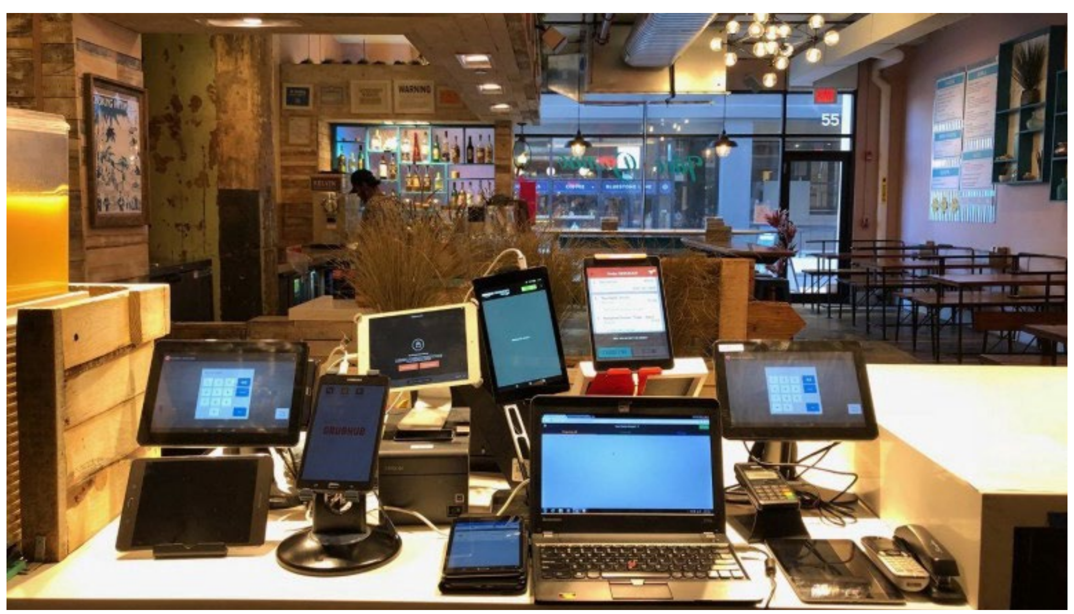
Examples of restaurants doing this well: Starbucks, Panera, True Food Kitchen

Technologies that can help: Thanx. A competitor, LevelUp, was actually acquired by GrubHub in 2018.

03

Simplify operations to minimize disruption.

Beyond the margin impact of a 3PD order, in-restaurant operations can feel the strain as well. With so many different marketplaces, restaurants have been thrust into "tablet hell", a new device for each marketplace that buzzes to notify the restaurant of each successive order. The operational burden can meaningfully increase labor costs as many restaurants have been forced to dedicate headcount to handling inbound orders and routing them to the kitchen display at the right time. But it's not just a challenge of labor allocation. I recently experienced an hour-long in-restaurant wait (for my first course) in San Francisco because, in the manager's words, "we're unexpectedly backed up with delivery orders." That one experience will result in me never returning to this neighborhood haunt — lost regular revenue is a deathblow for restaurants in competitive markets.



Restaurant "tablet hell"

As a result, high-volume delivery and pickup businesses are adapting. Many New York restaurants have opened separate food "make lines" just for digital orders (often in basements); Dig Inn launched an entirely new menu and their own delivery service called *Room Service* to avoid the disruption in-restaurant. San Francisco-based Souvla's newest outpost was "built to maximize to-go and delivery efficiency without jostling customers in the cozy, 400-square-foot dining room. That's less than a third of the restaurant's footprint: The rest is given over to kitchen, prep, and storage space, flipping a restaurant design maxim, that two-thirds of a business should be for dining, on its head. Out front, meanwhile, traffic has been white-zoned for quick drop-off and delivery to limit double parking" (Eater).

A new category of technology providers has also emerged to eliminate the overwhelming state of tablets — Chowly, ItsaCheckmate and others route 3PD orders directly into the POS, entirely eliminating manual effort and minimizing the risk of errors that result in inaccurate orders, fast becoming a must-have in any high-volume third-party delivery operation.

Examples of restaurants doing this well: Dig Inn, Five Guys

Technologies that can help: Chowly, ItsACheckmate, Olo, Omnivore, Ordermark, Kitchen United, etc.

04

It takes money to make money. Invest ahead or get left behind.

We often talk to restaurant operators who are hesitant to spend $4M, $1M, $500K, even $200K on an investment in digital owned ordering, CRM, and personalized customer engagement. They view loyalty and ordering as "check the box" functionality, not something to invest in. This perspective is unfortunately quite short-sighted.

Let's use the example of a 500-location restaurant doing $1M in AUV with 96% of revenue coming from in-store today. Given average expected growth in 3PD, and an expected flat/slight decline for in-store traffic, that business would be doing $1.02M AUV in 2022 net of 3PD fees with 87% of revenue coming in-store. Like it or not, the off-premise share of revenue is growing. Subtracting out 3PD fees, revenue would have grown at a mere 0.9% compound annual growth rate in-spite of otherwise-impressive top-line growth numbers.

Take instead the same business investing in the development of an owned ordering channel and CRM tools to drive repeat purchasing. With steady growth of owned orders up to (a still-conservative) ~7% of transaction volume, the business would have achieved $1.07M per store in 2022 (net of 3PD fees). Now just 83% of that would be in-store (due to a forceful push into digital), but nearly two-thirds of the out-of-store revenue is estimated in this scenario to be via owned channels. **The difference is more than 5% same-store sales (net of 3PD fees) and an increase in year-over-year growth rate to 2.6% (nearly 3x).**

The net result for this 500-location restaurant, according to the detailed model below, would be nearly $50M in incremental net revenue over three years — the only change being a concerted effort in owned digital channels at the expense of 3PDs. **It makes that original $200K to $4M investment seem like a no brainer, don't you think?**

ROI Model for Scenarios With and Without Digital Platform

Assumptions

Locations	500	Owned dig. $ / loc. / wk	$300	Owned orders / loc. / wk	10
AUV	$1,000,000	3PD $ / loc. / wk	$500	3PD orders / loc. / wk	17

		Current (annualized)	2020	2021	2022
Scenario 1 — Status Quo					
1 Store	3PD $	$26.0k	$41.6k	$62.4k	$87.4k
	In-store $	$958.4k	$939.2k	$920.4k	$902.0k
	Owned ordering $	$15.6k	$25.0k	$37.4k	$52.4k
	Owned orders / wk	10	16	24	34
	AUV	$1,000.0k	$1,005.8k	$1,020.3k	$1,041.8k
Metrics	Store rev. net 3PD fees	$993.5k	$995.4k	$1,004.7k	$1,020.0k
	% in-store (vs. digital)	96%	93%	90%	87%
	% of digital (owned)	38%	38%	38%	38%
Scenario 2 — Thanx Digital Ordering Solution		**Current (annualized)**	**2020**	**2021**	**2022**
1 Store	3PD $	$26.0k	$37.7k	$52.8k	$71.3k
	In-store $	$958.4k	$939.2k	$920.4k	$902.0k
	Owned ordering $	$15.6k	$39.0k	$78.0k	$117.0k
	Owned orders / wk	10	25	50	75
	AUV	$1,000.0k	$1,015.9k	$1,051.2k	$1,090.3k
Metrics	Store rev. net 3PD fees	$993.5k	$1,006.5k	$1,038.0k	$1,072.5k
	% in-store (vs. digital)	96%	92%	88%	83%
	% of digital (owned)	38%	51%	60%	62%
Results			**2020**	**2021**	**2022**
	Δ vs. Scenario 1 (store)		$11.1k	$33.3k	$52.5k
	Δ vs. Scenario 1 (system)		**$5,557,500**	**$16,672,500**	**$26,251,875**
	Annualized Avg. Same-Store Sales		1.11%	3.28%	4.99%

Not sure you buy the numbers? Download this Thanx-provided, publicly-available spreadsheet for yourself and play with the assumptions as you deem fit. Remember, it was the late arrival of Book Direct (at a cost of billions once hotels finally took the plunge) and the subsequent under-investment in new construction that resulted in first the rise of OTAs and then the window of opportunity for AirBNB — the two largest disruptors the hotel industry had ever seen. Will restaurants be able to overcome the same short-sightedness for the long-term benefit and survival of the category? Download the Thanx Restaurant Digital Model Template here.

Examples of restaurants doing this well: Panera is rumored to have spent $100M+ in their digital technology stack. As quoted above: "Its investment cut into profits for three years, until the effort began to pay off in 2016". The company now drives as much as 15% of revenue from owned delivery in mature markets and Chief Executive Blaine Hurst said, "We are substantially better off."

Technologies that can help: Unfortunately, no silver bullet here. A great CFO is your best hope.

Conclusion

"We need to [stop] focusing [so] much on what we get today and understand that [restaurants] have HUGE bargaining power as a collective," said one QSR digital executive.

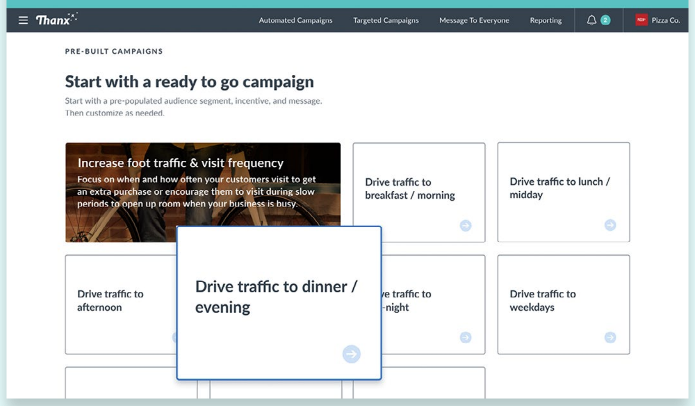
If the restaurants do start flexing their muscles, we will undoubtedly see meaningful changes in the status quo power dynamic. A recent deal struck by Grubhub to win an exclusive on Shake Shack's delivery business included industry-first data sharing rights that the restaurant can use to develop a 360-degree view of their customers and enable personalized marketing to woo repeat purchasing. That would be a huge boon to restaurants if others can secure similar terms. Likewise, rumors abound that some major chains are insisting on differentiated pricing between first-time (incremental) and repeat purchases. But while these advances could represent cracks in the armor of the rapidly growing 3PD behemoths, if the story of OTAs are indeed a reliable allegory, restaurants are going to have to take a far more combative role — viewing 3PDs as a direct competitor — before we see any material change in the current tidal wave sweeping them away. For the most part, the industry isn't there yet.

"Restaurant executives are racing to grow top-line sales and are engaging in haphazard, profit-eroding and often foolish behavior to do so," warns Glass.

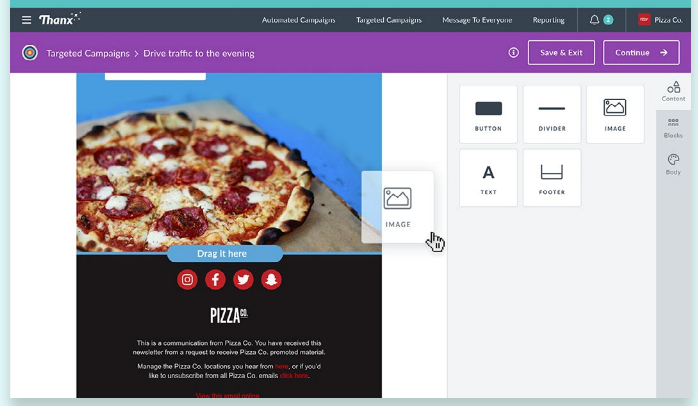
Perhaps in the future we'll see a kindler, gentler, partner-oriented version of the Four Horsemen? Image credits: Brennan Gilbert, Thanx.

How Thanx Works

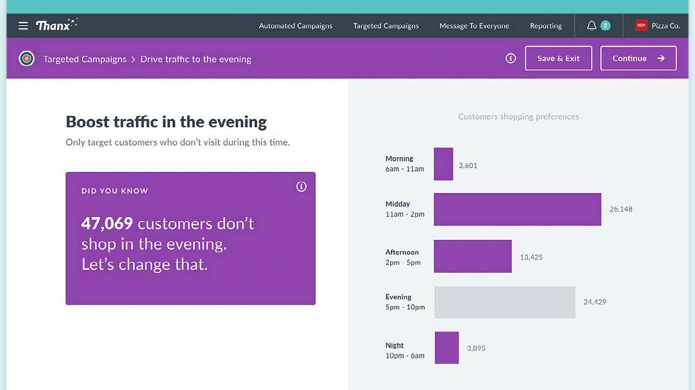
1. Target



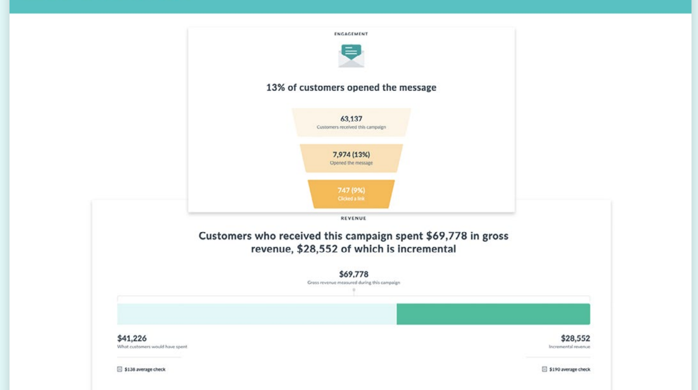
4. Design



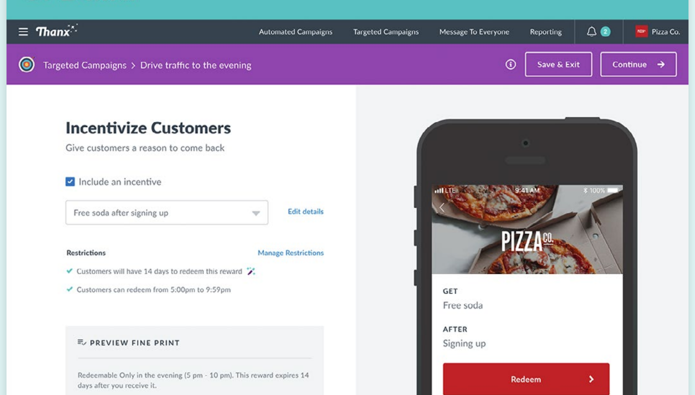
2. Refine



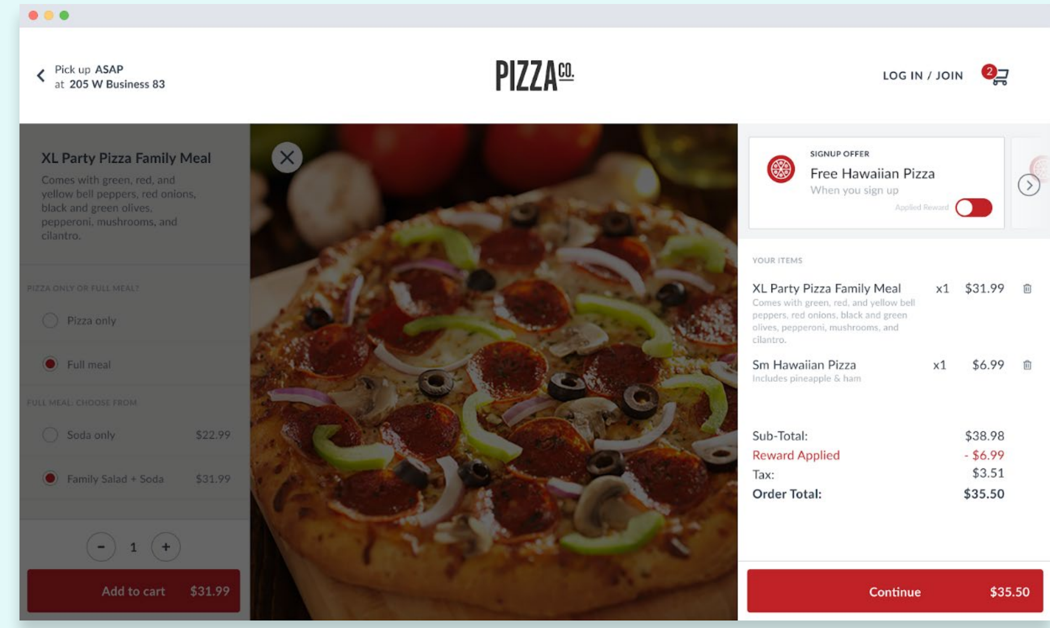
5. Measure

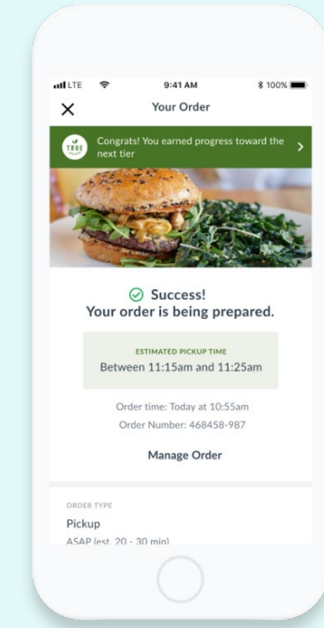


3. Build



Digital Ordering





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