Executive Insights

Quick-Service Restaurants in Southeast Asia — Quickly Bracing for a New Normal

The Southeast Asia 6 (SEA6) block comprising Indonesia, Malaysia, the Philippines, Singapore, Thailand and Vietnam is an important consumer market. These developed and developing countries are composed of a large and growing aspirational middle class that drives consumption growth. Rising incomes, young populations, growing urbanization and the growing influence of Western lifestyles have combined to fuel growth of both homegrown and international quick-service restaurant (QSR) players.

The SEA6 represents a large market for global chains such as McDonald's, KFC, Subway, Pizza Hut, Domino's and Burger King, in addition to homegrown chained QSRs such as Jollibee and Lotteria and several independent QSRs.

Changing demographics and income levels have driven per capita QSR spend in the SEA6. Yet it remains a fraction of other Asia-Pacific countries such as Japan, Australia and Hong Kong, or even China. Barring Singapore, which has an annual per capita spend of $1,100 on eating out and $300 on QSRs, this region has some way to go in QSR spend as well as in penetration. Based on benchmarks from other Asian markets, the SEA6 QSR market has significant room to grow, driven primarily by income growth.

COVID-19 impact

COVID-19 has had a disproportionately large impact on consumption related sectors as average monthly incomes reduced by ~20%-30% across the SEA6. Since QSR spend is sensitive to income levels, the large reductions seen in household incomes have predictably led to revenue losses for QSRs.

Apart from income loss, lockdowns and customer risk aversion also impacted revenues negatively. L.E.K. Consulting's survey of consumers across the SEA6 indicated that lost dining-out demand due to movement restrictions and fear factors was mostly replaced by home cooking and only to a limited extent by increase in take-away or deliveries (see Figure 1).

Postlockdown trends

Country differences

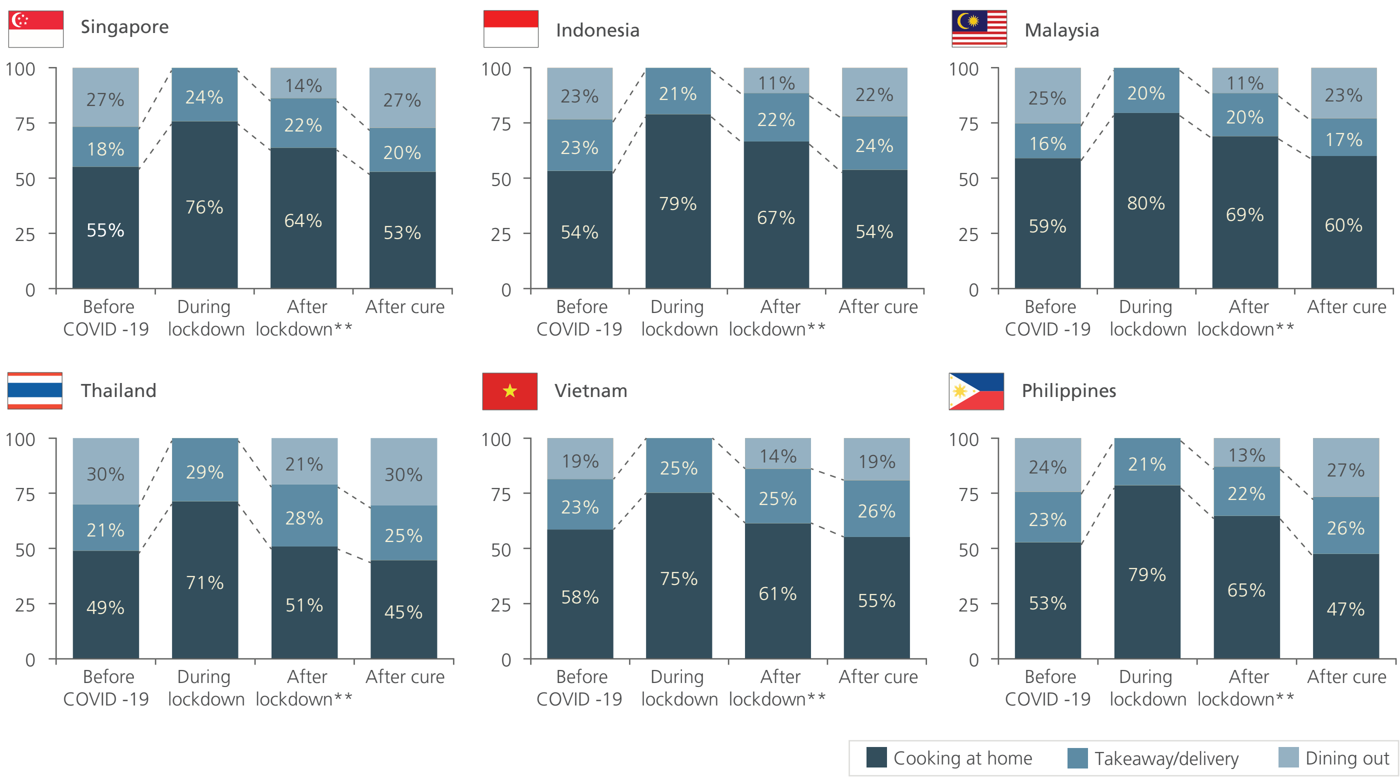
The various SEA6 countries have demonstrated differing abilities to cope with the pandemic. While Vietnam, Thailand and Malaysia have been very successful in containment, the Philippines and Indonesia have struggled to manage case counts and casualties (see Figure 2). Singapore has been quite successful despite a high number of confirmed cases. The relative success has determined the intensity of restrictions governments have imposed, with Vietnam and Thailand in particular enjoying benign lockdowns and the Philippines and Indonesia imposing strict or on-and-off restrictions.

Consequently, markets that have managed the pandemic well, such as Malaysia and Thailand, have seen a bounce-back in QSR demand. These two countries saw a 30%-35% decline in demand at the peak of their lockdowns and are now at nearly 85% of pre-COVID-19 levels. On the other hand, Indonesia and the Philippines, which have not done as well in the COVID-19 battle, saw a 60%-65% demand decline during the lockdowns (see Figure 3) and have managed to reach only about 65% of pre-COVID-19 revenues.

Quick-Service Restaurants in Southeast Asia — Quickly Bracing for a New Normal was written by **Manas Tamotia**, Partner, and **Bhushan Bhutada**, Senior Manager, in L.E.K. Consulting's Southeast Asia practice.

For more information, please contact **sea.marketing@lek.com**.

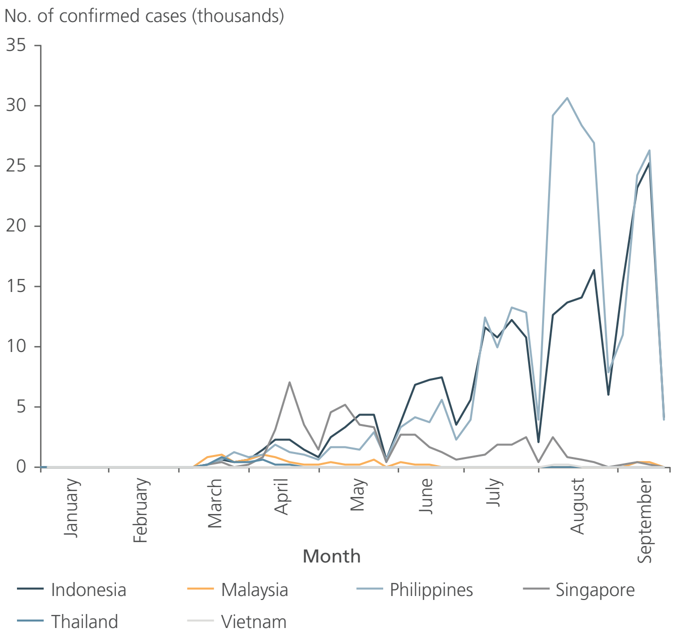
Figure 1
Impact of COVID-19 on dining out and takeaway/delivery meals (% of meals consumed per week*)



*Average number of meals assumed to be 21 per week; **Before cure is found

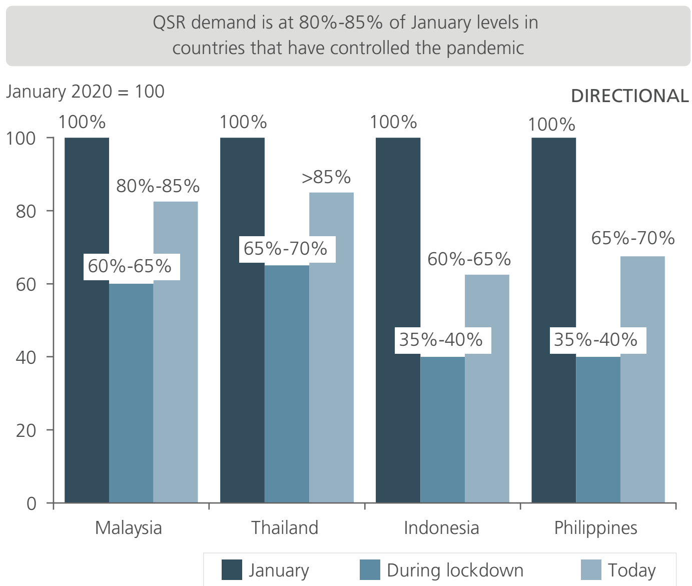
Source: L.E.K./Lucid consumer survey in SEA6, May 26-30, 2020 (N=3,165); L.E.K. research and analysis

Figure 2
Confirmed cases for SEA6 countries (January-September 2020)



Source: European Centre for Disease Prevention and Control; L.E.K. research and analysis

Figure 3
Impact of COVID-19 on QSR demand



Source: L.E.K. analysis

Advantage chained QSR

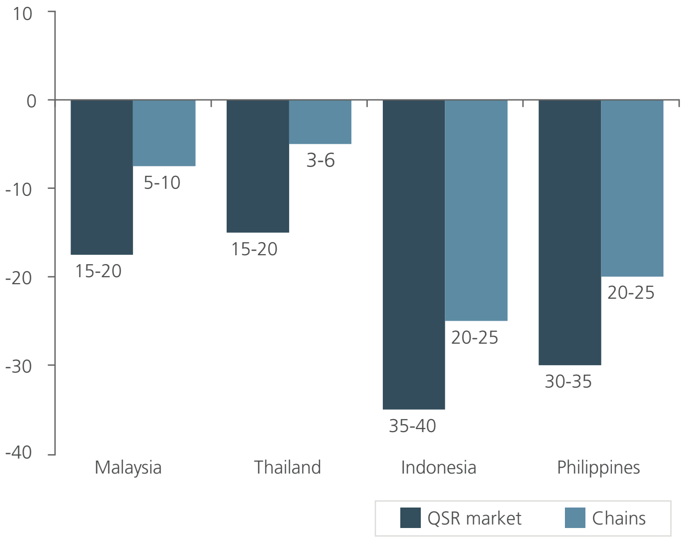
Another clear post-lockdown trend across the countries has been the favorable position of chained QSRs. This follows from fundamental advantages that include:

- Smaller stores were forced to shut down as business slowed, whereas chained QSRs with their deeper pockets could stay open
- Wary consumers perceived chained QSRs to be a safer proposition
- Chained QSRs were better positioned to pivot toward takeaway and delivery demand, which has been more resilient than dine-in demand (see Figure 4)
- Chained QSRs had historically avoided delivery platforms but aggressively expanded into them, creating a channel during COVID-19 of increasing competition for the standalone players already on these platforms

Figure 4
Impact of COVID-19 on QSR demand, by type

Chained QSRs fared better in Malaysia and Thailand, and an increase in consolidation is expected

Percentage change in demand (June-July 2020 vs. July 2019) DIRECTIONAL



Source: L.E.K. analysis

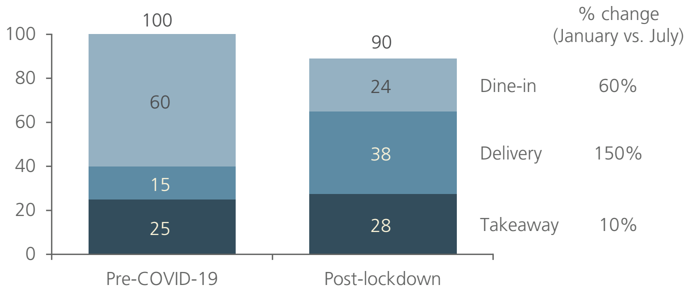
Shift in channel mix

Despite the selective recoveries in volume and the advantages enjoyed by chained QSRs, like-for-like sales are estimated to be down ~10% from pre-COVID-19 levels (in Malaysia and Thailand). Dine-in sales account for the entire decline, as deliveries and takeaway sales have grown (see Figure 5).

- Social distancing rules have shifted demand to delivery
- Even in areas without social distancing rules or lockdowns, consumers are avoiding dine-in
- Online ordering has been a winner, with demand for deliveries increasing two to three times

Figure 5
Impact of COVID-19 on same-store sales, by channel

Percentage change in sales compared to pre-COVID-19



Source: Euromonitor; L.E.K. analysis

Change in buying patterns

Interestingly, there has also been an increase in average ticket size as the proportion of bulk orders has increased. Average ticket size for deliveries increased by ~10%-15% during lockdowns because people were ordering in bulk, and that has reduced by 5% post-lockdown. For takeaway, ticket size increased by ~30%-35% during lockdowns and has reduced by 10% post-lockdown.

The large increase in takeaway ticket size is partly due to discounts offered by stores. The other factor could be prudent behavior by consumers who preferred to send one individual to buy for the entire family and even for friends/acquaintances, rather than risking exposure through multiple trips or buying in larger groups.

Quo vadis QSRs?

Given that the pandemic continues to influence consumer behavior and channel mix even after lockdowns have been lifted, there will be fundamental changes to how QSRs are run. We expect a higher emphasis on online channels and independent/in-line stores as providers move to focus on delivery and pickup services.

Impact on new store openings

New store additions were growing at a rate of 4%-6% per year since 2018. With cash flow challenges and lower demand, this is expected to reduce to 1%-2% for the next year at least. Markets such as Indonesia have also seen a decrease in number of stores as those in malls were closed.

Focus areas for growth

- Investment in delivery channels
  Large, chained QSRs are focusing on ramping up the delivery business in response to changing consumer preferences. In-house capability to serve this channel is currently limited,

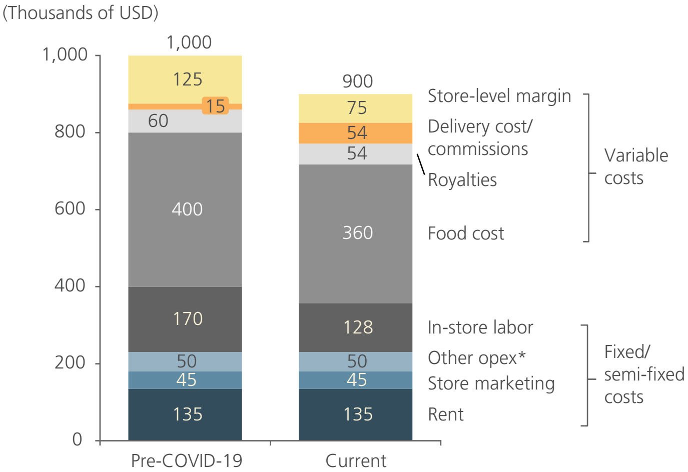
with most growth driven by aggregators — an expensive option because of their high commissions. Chained QSRs have started investing in fleet management systems to be able to service larger orders in-house and leverage aggregators for smaller orders.

- In-line and freestanding stores
  Future expansion is expected to be in the form of in-line or freestanding stores with easy access from the street. This offers the advantage of lower investment, better reach and reduced reliance on vulnerable locations such as malls.
- Curbside pickup
  Although drive-through is a preferred model to maintain social distancing, the higher investment required in building driveways and other infrastructure makes it unattractive. Chained QSRs are thus exploring the curbside pickup model to manage cost while expanding the takeaway/pickup channel.

Financial Vulnerabilities

We have seen that like-for-like sales at stores have come down by ~10% on average in the well-managed countries such as Thailand and Malaysia (see Figure 6 as an example). While this does not seem like an existential impact for a business, it could render some food retail stores unviable. Store profitability is highly demand sensitive, and profits are estimated to have declined by nearly 50% due to the 10% drop in sales and increases in costs due to deliveries. This is because of the nature of operations, which involve significant fixed and/or semi-fixed costs.

Figure 6
Estimated unit economics at an average KFC store



	Pre-COVID-19	Current
Store level contribution margin (%)	~12%-15%	6%-8%

*Other opex includes utilities, A/C, repairs
Source: Company financials; L.E.K. interviews and analysis

While there have been some cost savings through layoffs, the consumer move toward deliveries has increased order fulfillment costs, since stores need to either maintain a delivery fleet or pay high commissions to third-party aggregators.

The cumulative impact of reduced revenues and the change in channel mix is estimated to have reduced average store-level margins from 12%-15% to 6%-8% currently, a 50% profit reduction.

Levers to manage profitability

- Rent reduction
  Large, chained QSR franchisees were able to negotiate rent reductions of ~30%-50%, particularly in areas where demand has been significantly impacted. This is an important lever, considering that to maintain a 12.5% margin, a store needs to reduce rental cost by approximately 30% for a 10% decrease in revenue.
- Labor cost reduction
  Chained QSRs can manage profitability by reducing labor cost in line with reduction in dine-in demand. To maintain margins at 12.5%, an approximately 20% reduction in labor cost is required for a 10% revenue reduction.
- Reduction in royalties
  A few large, chained QSRs have selectively provided relief on royalty payouts in addition to providing financing support to franchisees. Relief on contractual planned spend is also under consideration by some.
- Marketing and remodeling cost
  Franchisees are mandated to undertake minimum marketing spend and periodic store remodeling. Some providers are allowing franchisees to spend less on advertising than is stipulated in franchise contracts. A longer remodeling cycle is also being considered by certain providers to manage costs, given the evolving channel mix.

Challenges to manage profitability

- Maintenance/other operating expenses
  Maintenance of facilities and equipment is a significant overhead cost that cannot be reduced. More-intense cleaning requirements; less seating capacity, especially during peaks; enforcing social distancing rules; etc., have in fact added to costs.
- Aggregator commissions and delivery costs
  The shift from dine-in to delivery orders has increased commissions/delivery costs without any meaningful increase in revenue. The dependencies on aggregators will not decrease until stores can develop their own delivery capabilities and proprietary ordering platforms.

- **Expected pricing pressure**
  The impact on demand, especially in smaller chains/stand-alone QSRs, has forced providers to consider a reduction in pricing in order to win share. Significant promotion activity in the form of buy-one-get-one-free and similar offers has been seen across markets often led by smaller chains or stand-alone restaurants, which even large, chained QSRs have had to counter.

COVID-19 has upended the food retail landscape, with most participants impacted significantly. While profitability has been hurt, we believe that large, chained QSRs will survive the pandemic better with their greater financial resilience, brand power and operational capabilities. Moreover, the likely reduced competition in the short to medium term could provide enviable opportunities for chained QSRs to consolidate their market positions.

About the Authors

Manas Tamotia is a Partner in L.E.K. Consulting's Southeast Asia practice, and head of the firm's Singapore office. He has over 15 years of experience and has led several M&A and strategy projects for private equity clients and consumer businesses across Southeast Asia.

Bhushan Bhutada is a Senior Manager in L.E.K. Consulting's Southeast Asia practice. He has spent over four years working with prominent private equity clients and consumer businesses in the region.

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