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goodfood

August 27, 2021

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Goodfood ("GF") is a Canadian online grocery delivery company. It was founded out of a Montreal apartment in 2014 by two former investment bankers and self-proclaimed "foodies"[1], CEO Jonathan Ferrari and COO Neil Cuggy (a third cofounder joined shortly thereafter). The initial product offering was meal kits and the target customer was the busy professional that didn't have time to shop for groceries but still preferred to eat home over going out.

There are a few things I like about the founders' investment banking background. First, they were smart enough to leave. Second, they likely have a good grasp of economics and return on investment which is very important in a capital-intensive business such as online grocery delivery. Before you write off investment banking and online groceries as a poor match, you may have heard of another reasonably successful e-commerce company called Amazon whose founder also used to be an investment banker before he decided to go try his luck selling books online instead.

In six short years, GF has grown from a standing start to serving more than 300,000 households, a revenue run rate in excess of $400 million, and more than 4,000 employees. They achieved all this while raising around $140 million of equity capital, and today they have $130 million in net cash. It's fair to say they've been productive.

Online grocery delivery is the real price

While GF started out as a meal kits company, the long-term vision has always been to become Canada's leading online grocery delivery company. In the words of CEO Jonathan Ferrari, *"Meal kits, for us, are what books were for Amazon."*

Meal kits is a complex business, but a couple of companies such as for example the global leader HelloFresh and Sweden's Lina's Matkasse have proven that meal kits can be a good business if executed well, both sporting around 10% operating margins along with healthy growth. GF has also proven its ability to be profitable in the past year despite large investments into its grocery offering and logistics network.

While GF's meal kits business is pretty good – it has competed successfully with HelloFresh in Canada for five years now and they're still essentially neck-and-neck which to the best of my knowledge is the only market HelloFresh has entered and been in for a number of years where

[1] Food nerds – Jonathan confessed to having cooked Gordon Ramsay cookbooks from cover to cover

they are not clearly winning – it is not a great business with its commoditized nature and relatively high "on-and-off" churn.

My real excitement here is centred around GF's recently launched grocery offering which is another step in the founders' original vision to become Canada's leading online grocery delivery company. I am also excited about the entrepreneurial company culture and their history of great execution.

A few years ago, yours truly was in the camp that said people would never want to shop clothes online as it was hard to know how the clothes would fit unless you physically tried them on, what the color would really look like, etc. But the industry adapted and solved this problem by offering fast delivery along with easy and free returns.

While online penetration of groceries in Canada is low today, I believe few people will be eager to do their weekly grocery shopping in stores if there are good online alternatives that can be relied upon to deliver fresh groceries with same-day or next-day delivery at reasonable prices[2]. Although it will probably take a longer time, it seems likely that grocery stores will meet a similar fate as clothing and electronics stores have done in recent years.

Online grocery shopping is one of the fastest growing industries in the world, and as many other online categories its adoption has been accelerated by the pandemic. Canada's total grocery market is estimated to be around $130 billion today with online share at around $10 billion. The total grocery market will most likely continue to grow at low single-digit rates, while I believe the online share, which grew 150% in 2020, will continue to grow at very high rates. This will result in tens of billions of growth over the coming decade. GF is investing heavily in their own delivery network and private label grocery brand to be optimally positioned to capture some of this growth.

Same-day delivery

Most people decide what they want to eat for dinner less than three days in advance with a majority deciding in the afternoon on the day of eating. Being able to offer same-day delivery for any product is always appreciated by consumers; looking specifically at meal kits subscribers in Canada, more than 80% of them say they would choose faster delivery even at a higher price point[3].

With this in mind, and considering Canada's vast land (by area, it is actually the second largest country in the world after Russia) and relatively cold climate which makes delivery logistics difficult to do well, it seems like a particularly attractive proposition to be able to offer same-day delivery for groceries across all of Canada.

[2] In a 2020 survey by PwC, only 7% of Canadians said they think grocery shopping online is easier.
[3] Blue Apron research & GF surveys and research

Most Canadians live in the south in the vicinity of the largest cities. Thanks to its current footprint of nine fulfilment centres across the country which have all been built since 2017, GF is already today able to reach 95%+ of the population with at least next-day delivery.

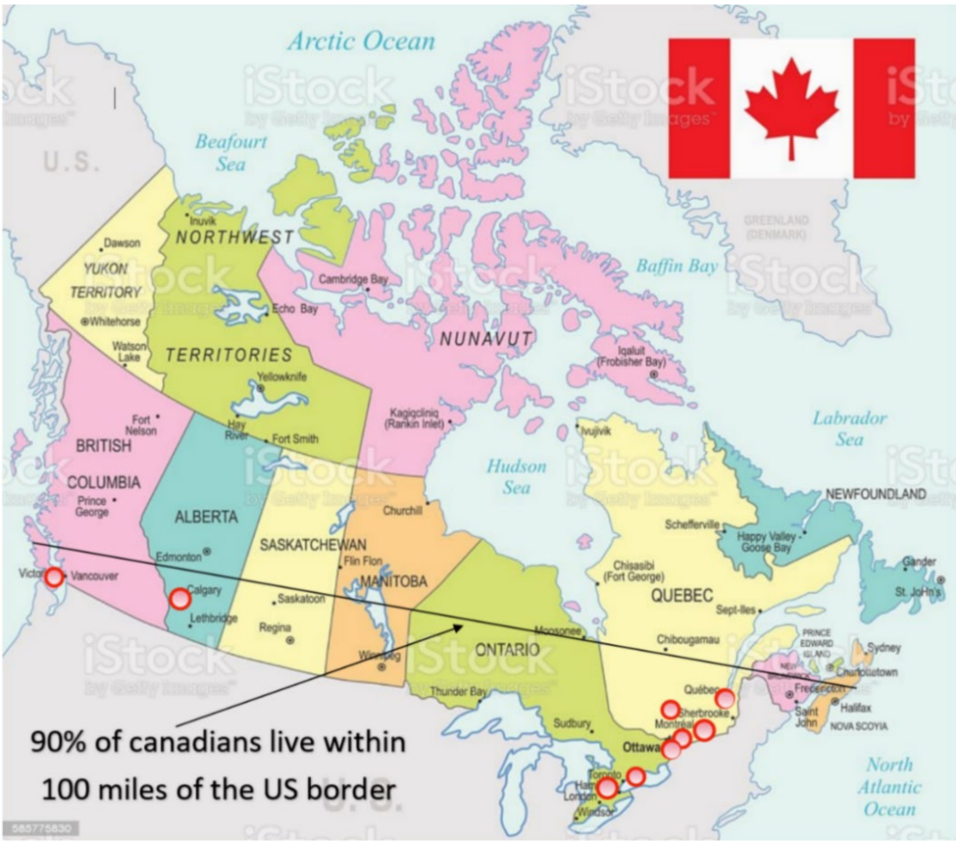

Figure 1. Goodfood fulfilment centers marked in red.

GF has recently launched same-day delivery in Montreal and Toronto where they reach a combined population of around 10 million (~25% of Canadians). It has been very well received with significantly higher NPS scores and more frequent orders compared to cities where they don't offer it. This is where GF is aiming to go for all of Canada, with plans to expand the same-day delivery service to Ottawa, Vancouver and Quebec City in the coming year.

Further along the lines of investing in the customer experience, GF also has its own delivery fleet called Goodcourier. It was launched from a standing start in 2019 and now delivers more than 65% of all orders. This has enabled GF to reduce their overall delivery cost by more than 30% since Goodcourier's launch and take control over the full delivery experience from order to the customer's door.

Private label groceries

GF launched their own grocery brand from a standing start in 2019 as well. Like most of their new initiatives, the execution here has been equally impressive. They already offer more than 1,000 different grocery items ('SKUs') and their ambition is to reach 4,000 SKUs in the coming years. A couple thousand items may seem thin compared to the average grocery store that offers 20,000-40,000 SKUs, but most of an average grocery basket is actually covered by relatively few SKUs. The idea is that a smartly curated smaller selection of SKUs will cover most of people's weekly grocery needs while allowing for faster delivery times without making it a too complex operation.

Management believes that an inflection point will be reached somewhere between 1,500 to 2,500 SKUs when people will be able to do most of their grocery shopping online at GF with little or no need to complement in physical stores. As a lot of the heavy lifting in terms of building the private label infrastructure has now been done, it is likely that future additional SKUs will come online a lot faster than the initial 1,000 did.

GF aims to price its private label groceries 10% to 15% cheaper than the national brands. This is made possible by having less waste throughout their supply chain, and by having their own producers and then cutting out the intermediaries that are normally present in grocery supply chains such as wholesale distributors and physical retail stores.

GF currently has $160 million in cash (and another $40 million in available credit) to spend on their logistics network and private label buildout. As their offering becomes more complete, they plan to go after grocery-first customers more aggressively starting in the coming year.

Goodfood WOW

The recently launched Goodfood WOW subscription service combines the above initiatives with meal kits into one offering. It costs $9.99 per month and gives customers the flexibility to freely mix groceries and meal kits in their orders as they wish (no meal kit subscription required) with unlimited same-day delivery. It is quite similar in principle to Amazon Prime.

While this is a great value proposition for consumers, it is also a large undertaking for GF, especially the addition of thousands of new SKUs and the complexities that come with that. There will no doubt be bumps in the road but given their operating record in meal kits with its inherent challenges such as changing menus every week, they seem well equipped to handle the expansion into groceries.

The big question is if more and more consumers will be willing to gradually swap out some of their regular brands in exchange for the Goodfood brand. The quality of the products will likely be the most important factor, but there are also some enticing incentives for consumers to switch such as same-day delivery and lower prices in many categories.

There are some promising signs so far. Groceries currently account for around 10% of GF's total revenue. Based on how the WOW offering has been received with typical WOW baskets being split close to 50/50 between groceries and meal kits, management expects groceries to increase to become 20% of its total revenue within the coming year, which implies 100%+ growth for the grocery business. If GF can successfully roll out WOW across its customer base with a similar 50/50 split, groceries will go towards becoming 50% of GF's total revenue and potentially larger over time as they start marketing the offering more aggressively.

Some success in the grocery offering is also reflected in that revenue growth has steadily been outpacing subscriber growth in the past 18 months. Recently, the difference has been particularly large with revenue growing 2x the pace of subscribers.

Operating leverage

While revenue growth has been outpacing subscriber growth, gross profit growth has been even better. Due to continuous efficiency improvements in their logistics network and reduced incentives when acquiring new customers, GF's gross margin has improved like clockwork, going all the way from 18% in 2017 to above 35% today which is an impressively high level given that this is after fulfilment costs. As a result, in the past two years gross profit dollars grew 280% while revenue grew 180% and subscribers grew "only" 68%.

GF's longer-term gross margin target is 45% which they aim to reach by continuing to invest in automation and becoming still more efficient in the overall delivery chain which should be possible with increasing scale. I'm not counting on a continued reduction in incentives when acquiring new customers given the competitive landscape.

There is a lot more potential here if the grocery offering is successful. Over many years now, large investments have gone into building out GF's logistics infrastructure, and there are fixed costs associated with the packing and shipping of one box to a customer. If you can add grocery items in the boxes you are going to ship out anyways, the incremental margin on those additional (and mostly private label) grocery items should be very high.

Competition

In terms of meal kits market share there are no official numbers but based on comments by both CEOs it seems that GF roughly splits the market leadership with HelloFresh today at around 40% share each. HelloFresh recently acquired Chef's Plate, a lower-cost offering that is kept as a separate brand, which gave them another 10% to 15% market share. The next player is Cook It which is way behind at around 4%. This effective duopoly is quite a contrast to the US market, where the spectacular IPO failure of Blue Apron took place a few years ago, where there are more than 100 meal kit companies with the top 5 commanding around 80% market share.

In meal kits, the dominant positions of GF and HelloFresh in Canada gives them scale advantages vs the competition such as better purchasing terms and more cost-efficient logistics. When it comes to the threat of the largest Canadian grocers entering meal kits, in fact both #1 player Loblaws and #3 Metro have tried their own meal kit offerings in recent years without success and both have now been discontinued. At this point, we are unlikely to see any more successful meal kits newcomers in Canada.

It is important to remember that the main price for GF is online groceries. The competition here is mainly with the largest Canadian grocers along with Walmart and Amazon Fresh. Given that Canada's online grocery market today is around $10 billion and we may have another $10 to $20 billion coming online in the next five years, and maybe as much as $50 billion in the next decade, there should be plenty of room for both Goodfood, HelloFresh and a handful of other players to do very well online.

Competitive advantages

On the grocery side, there are obvious advantages vs grocery store chains such as fewer needed warehouses, and they can be in cheaper locations as they don't need to attract customers. There is also a strong case to be made for freshness and product quality when you manage the groceries at fulfilment centres with robots and people wearing protective gear whereas in the supermarket you need to have everything in open display for shoppers to choose from. It is also worth mentioning GF's own grocery brand. While it remains to be seen how successful it will be, it could potentially become a meaningful differentiator, both in terms of uniqueness and its direct-to-consumer model which enables higher quality and lower prices compared to regular grocers.

Furthermore, similar to StoneCo's advantage vs the incumbent banks in Brazil and Fortnox advantage vs the incumbent accounting firms in Sweden, GF built all its software and technology infrastructure to be optimized for online-only from Day 1 giving them no legacy technology "debt". GF's systems have also been optimized for its "just-in-time" business model. This enables GF to be more efficient and have a minimal amount of waste throughout its supply chain. Its total waste was last stated to be around 1% which compares to 10% and often much more for regular grocers. In fact, food waste is a particularly big problem in Canada. A large 2019 study found that more than half of all food produced in Canada is either lost or wasted compared to around 30% worldwide[4] (it should be noted that GF's countrywide expansion of same-day delivery and thousands of additional SKUs will make it more challenging to maintain its impressively low food waste numbers).

Their modern and online-optimized systems combined with large investments into their logistics network should give GF an advantage here vs the incumbent grocers at least for some time to come.

When it comes to company values, CEO Jonathan Ferrari has taken a lot of inspiration from Zappos, the shoe e-commerce success story which is well-known for its customer-centricity, as well as Amazon. Together with his cofounders he instilled the customer-first ethos as a

[4] The avoidable crisis of food waste: Technical Report. Published in January-2019 by Second Harvest and Value Chain Management International Inc.

core value from Day 1. While all companies *say* they are customer-focused, few truly are. Many former GF employees describe customer service and customer focus as areas where GF really goes the extra mile and sticks out compared to the competition.

Finally, and maybe most importantly, GF's ability to execute. The two initial cofounders still own 28% of the company and GF is really #1 for them in their lives. Notably, while both took some chips of the table at the IPO at $2.50/share and subsequently at bought deal public offerings up to $6/share, in the last public offering in Feb-21 which was done at $12.5/share, none of them sold a single share. Employees seem inspired by the missionary founders and to be working at one of Canada's fastest growing public companies. The result has been very impressive execution which I believe is an underappreciated competitive advantage in today's fast-changing world.

Make no mistake, online grocery delivery is a very complex business, but *within* the industry I think this is one of GF's advantages. GF has proven itself to be a very strong operator and the tougher the business, the bigger the difference a strong team can make.

Growth drivers

GF's future growth can come from many places: new subscribers, order frequency and average order value.

First, there is the overall low penetration of online grocery shopping in Canada which should serve as a tailwind for new subscribers. For perspective, GF currently has 317,000 subscribers which compares to Canada's ~13 million urban households.

Second, the average Canadian visits a grocery store 2.5 times per week compared to the average GF customer which shops at GF just 0.5 times per week.

Third, the average Canadian household spends $150 per week on food from stores whereas GF's current revenue per subscriber is $25 per week.

I expect future growth to come from a combination of these levers (which is the best type of growth) as GF's same-day delivery capacity and grocery offering expands and hopefully becomes attractive enough to capture a larger share of Canadians weekly grocery budgets.

Main risks

HelloFresh is a formidable competitor. It is possible that they will take market share from GF on the meal kits side and be a challenger in groceries as well. While it would be preferable to have a weaker competitor, it's not necessarily all bad as it also forces GF to constantly get better. GF has a culture that is up for the challenge and as mentioned they have so far managed to keep an even footing with HelloFresh in Canada. This is however something I'm keeping a close eye on.

On the grocery side, there is the chance that GF's offering doesn't prove strong enough compared to the competition and thus is not able to achieve any meaningful traction. Groceries is a notoriously low-margin business. A limited private label assortment will help GF's margins and reduce complexity but increasing competition online could prove overwhelming. This would take away much of the potential margin expansion as well as the truly big market opportunity.

Mitigating both these risks is GF's strong operating history. I do believe GF will successfully adapt and course-correct along the way when necessary.

Our investment

We invested at an enterprise value of around $600 million. As the price for meal kits is prohibitive for a large part of the population, we will just assume that GF's meal kits business grows in line with the industry at modest rates from its current ~$360 million revenue runrate. At 10% EBIT margins in line with its peers if we normalize for less growth investments, this part alone should justify the price we paid.

Whatever success GF has with Goodfood WOW and its private label grocery offering should be added value on top.

Given the massive expected increase in online grocery shopping in Canada over the coming decade and given that GF already today has fulfilment capacity to handle over $1 billion in sales, they should be very well positioned to take some piece of this growing pie. If GF is able to maintain anywhere near its current 4% share of the total online grocery market, GF's business should be magnitudes larger in a couple of years.

As GF's grocery business is in a relatively early stage in terms of proof of concept, the weight in our portfolio is closer to the lower end of our normal 7% to 30% starting position size. I will be looking to increase our investment if there are signs that the grocery offering is gaining traction.

To be clear, we would not invest in an average meal kit company, it is simply a very tough business. This is primarily an investment in continued execution by a mission-driven company and the huge online grocery opportunity that they have in front of them and have long prepared for.

This investment also aligns very well with our preference for backing entrepreneurial high-performing and fast-moving companies that are disrupting less agile incumbents and providing a better service for customers. It's very fun and inspiring to be able to back companies like these. I look forward to seeing what the Goodfood team will be able to achieve in the coming years.