Executive Insights

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Why a Shakeout in the Meal Kit Industry Is Likely

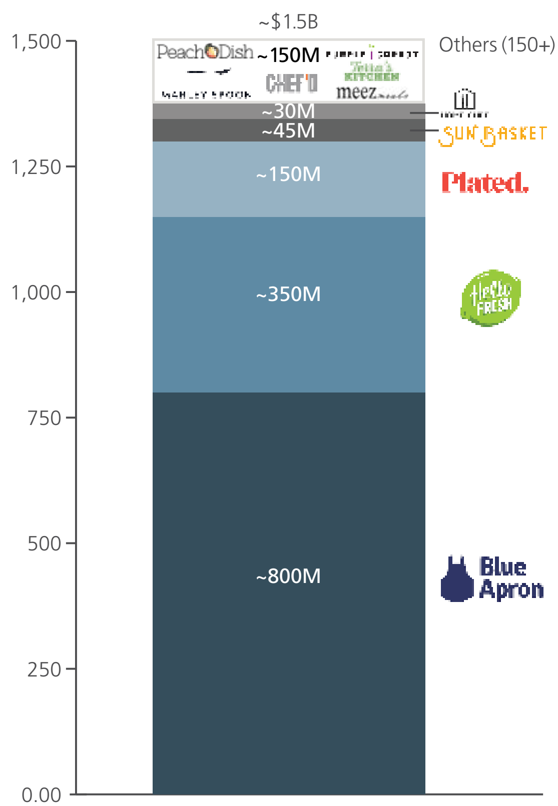
Meal kits have emerged as one of the hottest topics among food and beverage executives. That's because in the past few years, more than 150 companies have jumped into the meal kit game in the U.S. Industry leaders include Blue Apron, Plated, Home Chef and HelloFresh, followed by a long line of specialized and regional players.

But while the industry is experiencing explosive growth — and, in the process, garnering a lot of attention — its poor economics mean a shakeout is likely.

The explosive growth of meal kits can be attributed to their ability to satisfy three of consumers' core desires: predetermined portion sizes, the convenience of home delivery, and the promise of interesting and/or on-trend recipes.

The result is a meal kit delivery market worth approximately $1.5 billion in the U.S. alone (see Figure 1) and annual growth of 25%. Indeed, some newer players have achieved run-rate sales of $100 million in as little as 15 months. Blue Apron, for example, has seen sales surge from roughly $80 million in 2014 to $800 million in 2016, an annual growth rate of 215%. In the food category, such growth is unprecedented.

Figure 1
Estimated U.S. meal kit delivery market (2016)
$M (RSP)



Sources: Packaged Facts, Technomic, Washington Post, Eater, TechCrunch, company websites, L.E.K. interviews and analysis

Why a Shakeout in the Meal Kit Industry Is Likely was written by **Rob Wilson** and **Maria Steingoltz**, Managing Directors, and **Justin Craigwell-Graham**, Manager in L.E.K. Consulting's Food and Beverage practice.

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Food and beverage ecommerce, which includes meal kits among its various verticals, makes up a mere 1% of overall food sales. That compares with roughly 6% ecommerce penetration in health/personal care and approximately 20% in clothing, furniture and home furnishings. And while, according to The NPD Group, some 20% of U.S. consumers have a strong interest in trying meal kits, just 3% of all U.S. consumers have ever done so.

In order to truly understand the opportunity, the $1.5 billion U.S. meal kit delivery market value must be considered against the backdrop of the U.S. food and beverage market overall — worth an estimated $1.6 trillion. That includes the online prepared meals market (Freshly, Weight Watchers, etc.), itself worth approximately $10 billion, or five to six times more than the meal kit market. So there is ample runway left for growth.

Fragmentation and competition abound

The combination of rapid growth and low barriers to entry — neither capital assets nor retail relationships are necessary to enter the meal kit industry, for example — has resulted in a significant number of U.S.-based players.

The number of consumer segments these suppliers are targeting, while not as long, is ambitious. It includes everything from paleo diets to baby food to regional specialties like Southern; there are even meal kits for pets. And, of course, no fast-growing industry would be complete without a celebrity endorsement: In this case, quarterback Tom Brady has thrown his helmet into the ring with a vegan meal kit that he's offering in partnership with Purple Carrot.

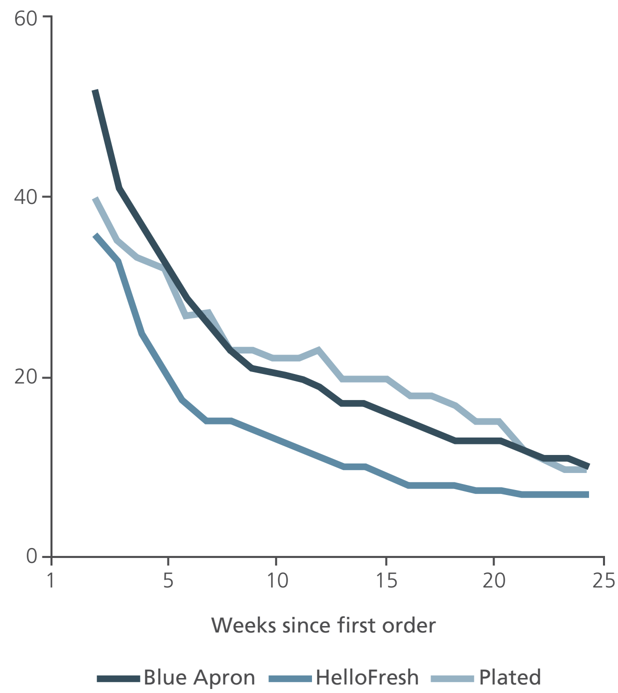
Celebrity involvement can be an indication that a market is overheated, with too many players to sustain, so it's important to identify that market's leaders. Among the various meal kit suppliers, Blue Apron is currently out front. It makes an average of approximately 8 million deliveries every month, generating revenue of some $800 million a year and garnering a valuation of about $2 billion. Other industry leaders include HelloFresh and Plated.

High churn is hurting

In a bid to establish market share, the long list of suppliers is constantly offering promotions, which means consumers' loyalty to any one brand is low and churn is high. Just 20% of customers continue to order meal kits 10 weeks after their first delivery, and less than half of meal kit customers use a service more than three times (see Figure 2).

An L.E.K. Consulting survey of millennial consumers indicates that the top reasons they churn are price and taste. Other reasons

Figure 2
(Jan. 2014-Sept. 2016)
Percentage of customers still ordering



Sources: 1010 Data Market Insights, CBInsights; HelloFresh Financials; L.E.K. interviews and analysis

include meal plan options — in some cases, the recipes didn't adhere to their diet restrictions; in others, consumers learned how to make the recipes themselves — as well as excessive packaging and inflexible delivery (see Figure 3).

Profits remain elusive

In the meantime, most meal kit providers have low or, in some cases, negative profit margins. Contributing factors include:

- Consumer acquisition and retention costs
- Nascent operations know-how
- Excessive packaging costs
- Low buying quantity of food inputs
- High labor costs
- Last-mile delivery costs

Conversely, the inherent "pull" nature of the meal kit business means suppliers have a notable lack of "stales" compared with grocers, which experience significant perishable costs. But while

Figure 3

Top reasons why a former meal kit company customer decided to discontinue

Percentage of millennial respondents, N = 74

Source: L.E.K. 2016 Millennial Retail and Travel Survey. In Q56, respondents were asked, "What are the primary reasons you do not plan to continue purchasing from meal kit companies? Select up to 3 responses." Respondents have to have selected "I have purchased from a meal kit company, but am unlikely to continue"in a previous question

helpful, the dearth of stales isn't enough to offset the high cost of marketing meal kit delivery, which contributed significantly to HelloFresh's 2016 EBIT of negative $90 million and Blue Apron's negative $55 million.

In light of these economics, funding for meal kit suppliers fell significantly in 2016 from the prior year, to roughly $100 million for 20 transactions from an estimated $450 million for some 30 transactions in 2015.

What to look for next: high consolidation

When it comes to the number of competitors, the meal kit market has peaked; going forward, many companies will likely either be acquired or simply shut down. Others will differentiate themselves by evolving into providers of fully prepared meals, or at the very least will offer meals that require significantly less preparation on the part of the consumer than they do now.

In many ways, the meal kit industry is reminiscent of the daily deals site industry in the early 2010s. It started with a bang, with a daily deal site for virtually every consumer segment and type of business imaginable, from restaurants to yoga studios and everything in between. But eventually, the market evolved into what has become a largely two-player ecosystem consisting of Groupon and LivingSocial (and with the former buying the latter in 2016).

The meal kit industry is likely to have a similar outcome, with just two or three suppliers emerging as winners.

Sleeping giants remain a looming threat

In the meantime, grocery stores and other food retailers could be poised to move aggressively into the meal kit space as part of their ongoing battle over meal occasions — a battle that gets more challenging with every new adversary (including but not limited to traditional foodservice, food delivery apps, fully prepared food delivery and meal kits).

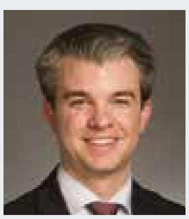
Nielsen Fresh estimates that grocery stores sold approximately $80 million worth of meal kits in the full-year period of March 2016-17. Examples include Publix, with its "Aprons," and Kroger, with its "Prep + Pared." Mariano's offers meal kits as well. And Whole Foods has partnered with both Purple Carrot and Salted to offer their meal kits in its retail locations.

But Amazon's recent agreement to buy Whole Foods for $13.7 billion is already having a disruptive effect on the meal kit industry, as the deal pairs the most marquee delivery service provider with one of the industry's most marquee food companies. Shortly after the merger was announced, Blue Apron slashed its IPO price by 34%!

To be sure, even before the deal was unveiled, Amazon Fresh had initiated a partnership with Tyson Foods to develop a premium, protein-based, chef-inspired meal kit called Tyson Tastemakers. With a combined Amazon and Whole Foods, however, a whole range of brands will have a direct route to the home consumer that they never had before. According to a recent techcrunch.com article: "Based just on trademark filings and reported plans, Amazon's potential entry into the prepared meal kit market has had a significant impact on freshly-IPO'd Blue Apron's stock price. Now, however, we know that Amazon is actually already testing its own 'Amazon Meal Kits,' thanks to a customer in Seattle who has already ordered and prepared one."

"Amazon's meal kit delivery service poses a major threat to Blue Apron," notes Cooper Smith, director of Amazon research at L2, adding that "the Blue Apron customer is also a Prime member." Amazon, meanwhile, has reportedly begun testing a selection of its own meal kits. So while everyone's ecommerce strategy will become more important going forward, meal kit suppliers will feel the pressure acutely.

About the Authors



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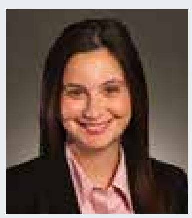

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