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Toast – serving up a side of profits

Innovation cash kings of the next decade - *In this series we look at the standout companies that are 'pivoting to profit' and are at an inflection point of converting customer-driven innovation into shareholder value. In the next of this series, we take a closer look at Toast.*

Running a restaurant is no cakewalk, fraught with hefty fixed costs, wafer-thin margins, fickle customers, and high staff turnover. Efficiency challenges add spice to the mix: inventories are perishable, patrons are hungry, and food quality is often temperature dependent. Top it off with complex omnichannel management – servicing dine-in, takeout, and delivery customers simultaneously – and restaurateurs are faced with an operational 'dogs breakfast'. It is little wonder that the shelf-life of a restaurant is typically short (nearly a third of restaurants shut shop each year), nor that software developers have had little taste for the space: volatile demand, low margins, and high churn are not ideal ingredients for developers seeking dependable, repeat customer contracts. As a result, the restaurant industry has long remained underserved from a digital penetration perspective.

Enter **Toast** –a cloud-based vertical market software platform with the restaurant business as its bread and butter. Toast provides a single end-to-end platform of hardware, SaaS products and financial technology solutions that give restaurants all the tools they need for running their business in one place. Its cloud-based platform spans point-of-sale, operations, finance, supply chain management, and much more, and is importantly easy to use, reliable, and flexible, integrating well with third-party APIs (think *Uber Eats* or *Deliveroo*). Toast's operating system acts as the "brain" of the restaurant across all service channels, generating significant value for restaurateurs by streamlining operations, unlocking efficiency bottlenecks, enhancing guest experiences, and ultimately improving volumes.

Toast is able to dine out on this value creation too. A majority of Toast's revenues stem from repeat transactions such as payments (taking a clip of each payment through one of their terminals) and SaaS (paid on a monthly basis); more efficient, profitable, and financially robust restaurateurs means increased lifetime contract values for Toast. Additionally, by offering a range of bolt-on solutions across its all-in-one platform Toast is able to capture a growing share of restaurant spend via targeted sales efforts. This expansion helps further entrench Toast across restaurant operations, creating switching costs which help Toast mitigate the long-standing issue of industry churn. Further, Toast's narrow industry focus and deep customer relationships generate significant internal IP, increasing with scale and enabling continued targeted innovation. All of these factors mean that Toast is able to grow hand-in-hand with customers, supporting powerful network effects in an industry where word-of-mouth is a key driver of digital adoption and platform choice.

The market opportunity for Toast is appetising. To date Toast has primarily targeted the SMB end of the spectrum in the US where it is the dominant player used in over 90,000 restaurants nationwide. The real opportunity, however, remains in increasing market penetration, with restaurants still drastically under-spending on software compared to other industry verticals (only around 3% of sales as of 2019). Management sees a potential addressable market of $55 billion in the US alone, and over $110 billion globally, of which it has tapped a mere $1.1 billion in annualised recurring revenues as of its latest update. It is understandable, then, that to date Toast has primarily been focused on investing for growth, including a notable recent expansion into the enterprise market thanks to a sizeable contract win with Mariott Hotels. However, as with other names that we have covered in this series, this is not a "growth at all costs" story, and Toast is currently transitioning towards a more profitable business model.

Toast has already served up a profitability entree, positing positive adjusted EBITDA and free cash flow in its latest quarterly update. This is not a simple flash in the pan, with the company expecting 2023 to be its first full year in the black. However, this transition hasn't so much been a radical pivot but more a slight tweak to its operating recipe, with the company placing renewed emphasis on cost discipline and operational efficiency, allowing gross margins to expand alongside revenues. Indeed, its recent profitable shift is largely due to continued growth in recurring revenues from its maturing installed base. Gross payment volumes via its terminals continue to climb, and the company is increasingly capturing more share of customer wallets with 43% of customer locations now using six or more elective Toast products.

Importantly, however, Toast is keeping the burners on, and its shift to profitability has not come at the expense of future growth. R&D continues to scale with revenues, and management has maintained targeted sales and marketing efforts. As a result, the top of its customer funnel remains healthy, with the company adding a record net 7,500 locations in the most recent quarter. As the company scales, its growth flywheel is starting to whip into gear, and network effects are increasingly evident – three quarters of its latest new adds came from inbound customer queries, and one fifth from direct customer peer recommendations. This improving growth algorithm means the company is better positioned than ever to focus on product-led growth and efficient sales and marketing efforts – all in all making a much more profitable recipe for future success.

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Key Risks

Past performance does not predict future returns. You may get back less than you originally invested.

We recommend this fund is held long term (minimum period of 5 years). We recommend that you hold this fund as part of a diversified portfolio of investments

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