# BRIDGING THE GAP

## The Rise of Direct to Consumer

OC&C
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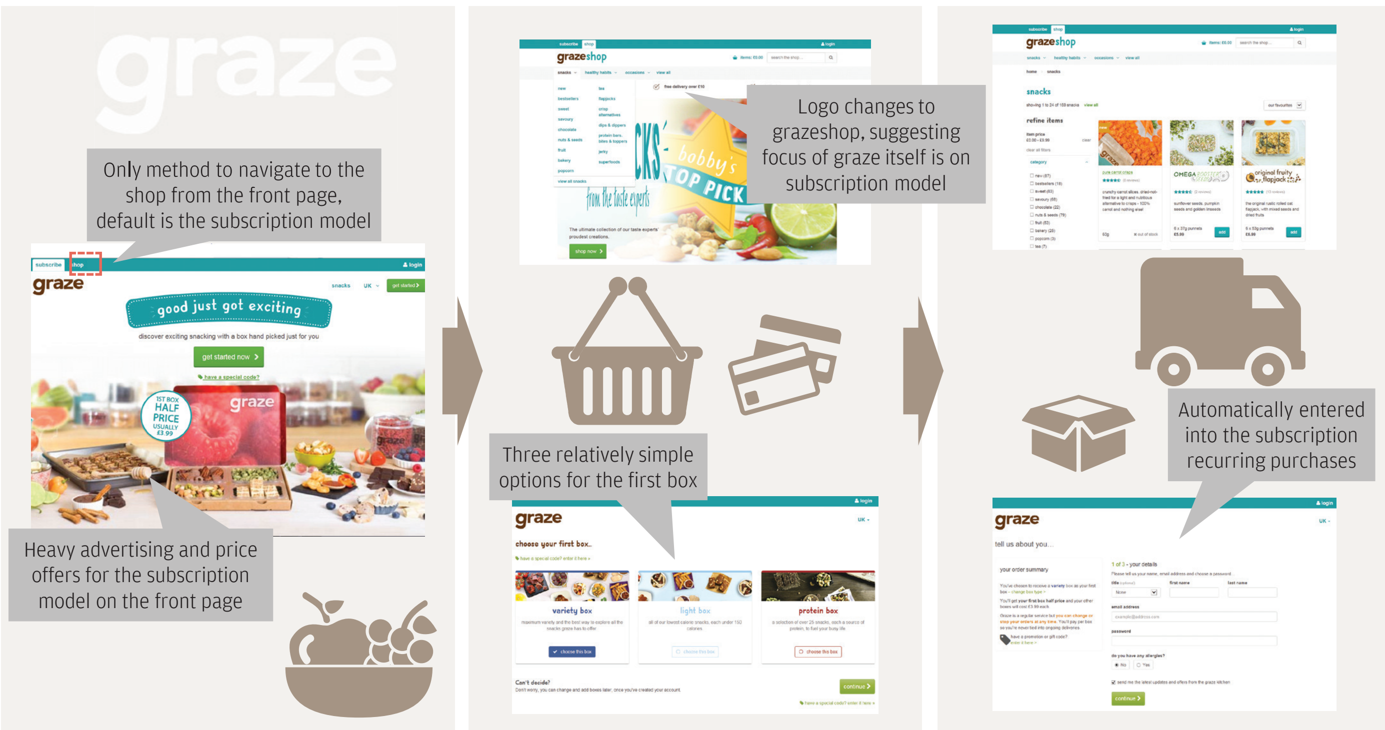
Direct to Consumer (D2C) businesses have been launching across consumer categories in recent years – from apparel to beauty – fuelled by VC funding and a business model promising higher margins and a direct relationship with the consumer.

The emergence of these businesses has raised a number of questions across the market:

- How can the potential for these businesses be assessed?
- What are the right metrics to assess performance?
- Given the large amounts of capital deployed, what can an investor expect from a D2C business?
- What are the implications for competitors with more traditional business models?



# WHAT IS D2C?

Propositions in the sector are continually evolving and the lines are blurring between D2C and more traditional retail as existing businesses adapt and acquire. In order to understand the evolution and the implications, it is important to begin with a more narrow definition of digital D2C. The easiest way to do that is to think in terms of 'what' these businesses are selling and 'how' they are selling to the consumer.

**WHAT?** D2C businesses are businesses that are typically selling own brand products. The proposition commonly involves a subscription model or 'club' element in order to increase consumer engagement – something more than just selling third party products. Dollar Shave Club is an excellent example where consumers are subscribing to a service that sells Dollar Shave Club branded razors and replenishes the razor blades on a monthly basis. The business has a high level of engagement with consumers through brand messaging, content – 'bathroom notes' – and an experience appealing to an 'everyman' demographic. There are many other examples of branded products across categories including Graze in food, Glossier in beauty and Everlane in apparel.

**HOW?** D2C businesses typically sell via a branded online platform to deliver a differentiated consumer experience. For Dollar Shave Club, this means that the website is the way to purchase and to update your subscription over time. They do not sell the product in stores and remain the only channel through which a consumer can purchase the products.

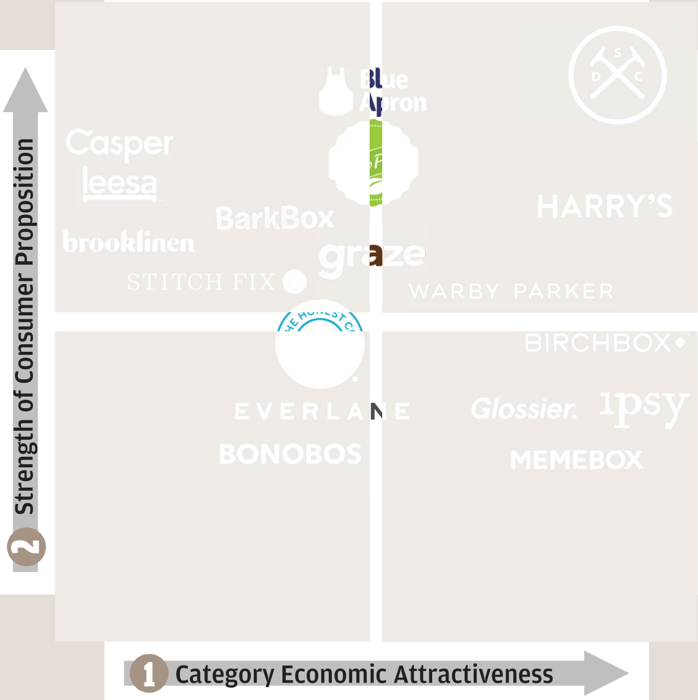
Of course, hybrids do exist where offerings can include third party products and an offline presence – either through their own retail or through other retailers. Graze and The Honest Company are both examples of these hybrid models where they are selling through major retailers in addition to their website. Many of these are important, evolutionary business models that we will discuss in more detail later.

## So, how can we determine whether it is a good D2C business? We have identified several key factors to assess the potential success of a D2C business across two key dimensions:

### D2C LANDSCAPE

**Strong Consumer Proposition Operating with Unattractive Category Economics**
A strong consumer proposition operating in a category that is economically not attractive for D2C may see high growth but long-term viability may prove challenging

**Strong D2C Offering**
A strong consumer proposition supported by favourable category economics present best opportunities for growth and profitability




**Challenged D2C Offering**
Challenging category economics and a weak consumer proposition suggest overall difficulty building a D2C business that can achieve growth and profitability

**Weak Consumer Proposition Operating with Attractive Category Economics**
A weak consumer proposition for D2C but the category economics are attractive may struggle to win and retain consumers in a D2C model

## 1 SUITABILITY OF CATEGORY ECONOMICS

Attractiveness varies significantly across categories where some are far more suited to D2C businesses. Generally, those that are suited have some combination of the following characteristics:

- Habitual usage: Core offering of habitual use products (ideally with expandable consumption) which enables D2C businesses to create an annuity revenue stream and increases the customer lifetime value
- Dense, high value product: Challenging shipping economics for D2C businesses can be made more efficient with smaller, expensive product. Distribution costs are typically driven by a combination of size and weight – the larger the product, the more specialist, and expensive the distribution
- Attractive product margins: Higher margins allow D2C businesses to mitigate the additional costs such as supply chain complexities and customer acquisition costs. It also allows D2C businesses the oxygen to invest in consumer packaging
- Optional: hardware lock-in: Encourages repeat usage by consumers who require the 'refill' or similar consumable product

This doesn't mean that is it impossible for large, infrequently purchased items to be successful via D2C – it does mean the hurdle rate for individual order economics is significantly higher.

Returning to our Dollar Shave Club example, it is clear that the category economics are attractive for a few key reasons. First, men who shave require regular replenishment of razor blades – meeting both the criteria for habitual usage and for the hardware lock-in. Also, razor blades are small and relatively inexpensive to ship via the post which means that shipping costs are fairly low. Finally, the razor market has historically been a high margin market which supports coverage of key costs associated with going direct. The market is characterised by highly consolidated large scale efficient manufacturers that get high consumer price points – leading to high margins. This greater margin oxygen enabled D2C to flourish.

In the example of Graze, the attractiveness of the category economics is less clear. While it is a consumable product that actually does support habitual use, the product margins are less attractive and the product itself is not particularly dense or high value. So, while consumers may be happy to have a subscription which will increase the consumer lifetime, the order economics appear less compelling.

## 2 STRENGTH OF THE PROPOSITION

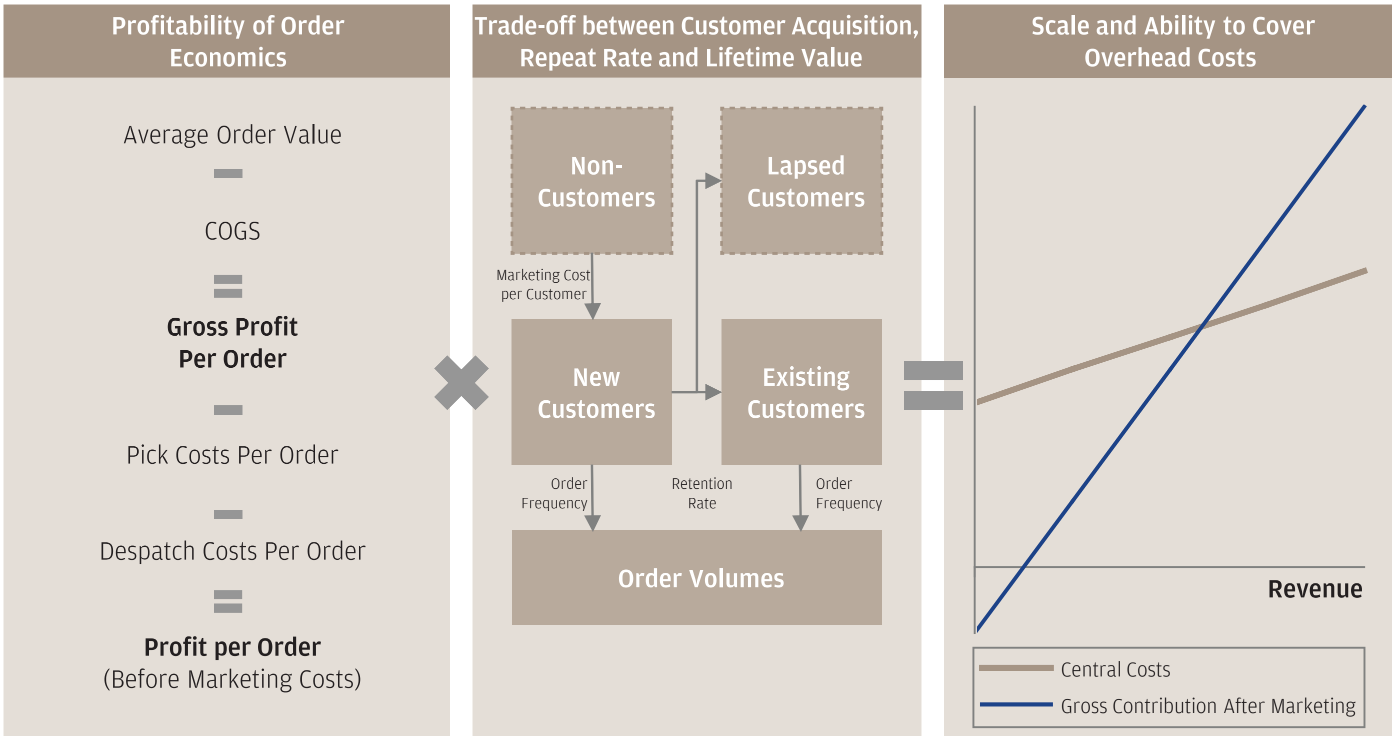
D2C businesses have to break the mould and convince a consumer to change their established buying behaviour. We are all, to varying extents, creatures of habit, so the proposition has to be sufficiently distinctive to drive the necessary consumer disruptions. There are a few important components to drive this disruption – successful D2C businesses have to incorporate at least 2 of these in their propositions although the relative importance differs markedly by category.

- Convenience: enabling easy access to a potentially challenging product / service – 'makes life easier' for the consumer
- Value: Less expensive than comparable available products – offering consumers value for money
- Differentiated product offering: Differentiated product or experience creates a unique offering and increases levels of consumer engagement

Dollar Shave Club scores relatively high across two of the key metrics with a strong convenience offering and compelling value versus existing market players. A key part of the proposition is offering convenience to men so that they do not have to think about buying new blades, but rather the blades are delivered to them at the appropriate time for replacement. In addition, prices versus existing offerings such as Gillette are significantly lower.
For Graze, the proposition scores highly on convenience and differentiated product offering, but offers no additional value versus offline alternatives. Snack boxes are delivered monthly with an assortment that can be custom selected by the consumer making it both convenient and differentiated from a product perspective. Given prices are comparable, the argument for additional value for money is weak.

# ATTRACTIVENESS OF UNDERLYING ECONOMICS

## D2C economics are fundamentally different. In particular it is not possible to diagnose business health from traditional 'in year' P&L metrics. You need to consider the lifetime economics of different customer cohorts (from the longest standing, to the newest recruits) to form a clearer picture. There are 4 key metrics that need to be considered for each of these cohorts of customers...




**Cost per acquisition (CPA):**

- Total marketing spend required to recruit each additional consumer, ie marketing spend / # of recruits
- Cost of acquiring a new customer is fundamental to managing customer lifetime contribution and profitability
- Key question is how fast is this rising and where will it settle? Typically these business have a high digital marketing element to the mix - SEO, banners, video and social media. The costs of each of these is structurally inflating as competition becomes more fierce (a factor amplified if there are multiple D2C businesses in the same category)

**Average order value (AOV):**

- Average order value impacts the economics of each order particularly given the important of shipping costs
- Key question is whether the business is managing to premiumise or upsell existing consumers? Strong D2C businesses look to convince consumers to trade-up and participate in new products / adjacent categories to grow the individual order size

**Average order frequency (AOF):**

- Frequency of orders is a factor in the economics calculation particularly when considering subscription models
- Primary question is whether the business is maintaining the frequency of purchase as it expands beyond its initial consumer set

**Retention:**

- Retention and customer lifetime value more generally are key to customer profitability particularly where CPA is high or increasing
- Key question is whether the new recruits proving more or less sticky than the original customers. Two key considerations for retention as D2C businesses expand: appeal of the underlying proposition to newly recruited consumers and effectiveness of the proposition execution including CRM to maintain and recruit lapsed customers

In practice, these metrics indicate the relative health of the business and performance trajectory.

# STAGES OF D2C EVOLUTION

## D2C businesses will likely be loss-making for years, but a sustainable one will move towards profitability once scale is achieved.


Three phases of growth:

1. **Start-up:** Invest to grow – significant capital required to support this phase of growth particularly where first mover is an advantage
2. **Accelerate growth:** Continued investment where losses accelerate in pursuit of scale
3. **Move towards profitability:** Topline growth continues supported by a strong (and sustainable) proposition enabling the business to move towards profitability

Non-sustainable standalone businesses broadly have two options:

- Seek an economic unlock via an exit enabling transformation of cost structure and preferential access to larger consumer base
- Pursue channel diversification to survive but must consider the impact of channel conflict on the existing proposition

For these challenged D2C businesses, other channels are often pursued to support growth but channel conflict can create complications. Pursuing an omnichannel strategy appears seductive, and can be successful, but comes with a severe health warning. If migration is not handled successfully you can end up with the worst of both worlds - a relatively undifferentiated store business that has further eroded the economics of the direct consumers. In cases where the channels cater to different shopping needs and ideally where underlying single consumer consumption can be increased through accessibility, omnichannel can potentially be sustainable and can provide a timely boost to the overall business economics. As always with products sold through multiple channels understanding the role of each and managing the proposition accordingly is the key to success.

# WHAT'S IN IT FOR ME?

### FOR THOSE ON THE SIDELINES...

- **How will D2C impact your consumers and categories – can you afford to ignore it?**
- **Does it present an opportunity to access 'locked out' adjacent categories in which you have a right and desire to play?**
- **What can you do to make your core business more robust to this new competition?**

### SHOULD YOU BUY, BUILD OR IGNORE?

### FOR THOSE ALREADY PRESENT...

- **What is the end game in terms of customers, products and channels?**
- **Are the economics of that position sustainable?**
- **Who is fighting over that end game position and how defensible are you today?**

### WHAT DO YOU NEED TO DO TO MAKE YOUR POSITION MORE ROBUST?

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