New Frontiers in Retailing: Magic and Logic

NAVIGATING AN EVOLVING DTC LANDSCAPE

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EXECUTIVE SUMMARY

In today’s evolving retail landscape, DTC strategies are paramount for brand growth. With consumer behaviors shifting towards online shopping, DTC channels offer a direct avenue to engage with customers and build lasting relationships. To succeed in this environment, brands must prioritize agility and innovation. Rapidly changing consumer preferences require flexible approaches to product development, marketing, and distribution. DTC brands have the advantage of gathering real-time data and feedback, allowing for quick adjustments to meet evolving demands. This is much harder to do with brands that rely on retailers, as they are limited to the information they can receive about their customers and preferences.

Consumers are now more discerning and socially conscious than ever, preferring brands that align with their values. DTC brands have the opportunity to tell their story directly to consumers, fostering trust and loyalty. Incorporating digital technology is also essential. From personalized online experiences to seamless purchasing journeys, DTC brands can leverage technology to enhance customer engagement and satisfaction. Embracing emerging trends such as augmented reality (AR) for virtual try-on experiences or artificial intelligence (AI) for personalized recommendations can further differentiate brands.

DTC strategies are crucial in today's market. They enable brands to establish direct relationships with consumers, gather valuable data, and personalize experiences. DTC also offers greater control over the customer journey, fostering agility and innovation. They also diversify revenue streams, increase profit margins, and reduce dependence of third-party retailers. DTC has become essential for brands of all sizes to stay competitive and relevant in the rapidly evolving market landscape.

Key Findings:
Impact of COVID-19 on DTC: The COVID-19 pandemic significantly accelerated the growth of DTC brands, driven by the e-commerce rush during the pandemic. However, post-pandemic, DTC brands faced challenges in retaining their customer base as in-person activities resumed.

Challenges Facing DTC Brands: Digitally native brands are grappling with increasing CAC, which have spiked over the past year due to heightened competition in the digital advertising space. As CAC rises, brands need to find more efficient ways to acquire and retain customers to sustain growth.

Expanding Beyond DTC: To overcome the limitations of relying solely on DTC distribution, brands should consider expanding into hybrid or omnichannel retail strategies. Partnering with the right retailers or marketplaces can help decrease CAC and extend the customer lifetime value . This approach allows brands to reach customers where they are while maintaining control over the brand experience.

Recommendations:
Digitally native brands should prioritize building connections with customers beyond online channels to ensure long-term growth.

Established brands should invest in DTC channels to engage with customers directly and create personalized experiences.

Brands should consider a balanced approach to distribution, incorporating both DTC and traditional retail channels to reach a broader audience.

I. THE POST-COVID CONSUMER LANDSCAPE

Brief overview of the pre-COVID DTC landscape

In the pre-COVID Direct-to-Consumer (DTC) landscape, brands embraced innovative strategies to carve out a niche in the market and establish a direct connection with consumers. A prevailing winning formula among these brands was to revitalize slow categories while simultaneously investing in social media advertising. This dual approach allowed digitally native brands to disrupt traditional markets, capture consumer attention, and drive sales growth. Revitalizing a slow category involved identifying stagnant or overlooked product segments and injecting new life into them through innovative products, marketing campaigns, and consumer engagement strategies. By targeting these slow categories, these brands could differentiate themselves in crowded markets and capitalize on untapped opportunities for growth.

Additionally, digitally native brands recognized the strategic importance of social media advertising in reaching and engaging with their target audience. Platforms such as Facebook, Instagram, and Twitter offered unprecedented opportunities for brands to connect with consumers on a personal level, share their brand story, and showcase their products. Through targeted advertising campaigns, influencer partnerships, and engaging content, brands could amplify their brand visibility, drive traffic to their online stores, and ultimately increase sales.

Furthermore, selling online emerged as a faster and more accessible alternative to opening traditional retail stores. Unlike brick-and-mortar establishments, online stores required minimal upfront investment and overhead costs. There were no fixed expenses such as rent, utilities, or employee salaries to contend with, allowing digitally native brands to allocate more resources towards product development, marketing, and customer acquisition. This flexibility and cost-effectiveness made online selling an attractive option for emerging brands looking to establish a presence in the market without the financial burden associated with physical storefronts.

Impact of COVID-19 on consumer behavior and shopping habits

The onset of COVID-19 precipitated a rapid surge in e-commerce adoption, profoundly altering consumer behavior and shopping patterns. Digitally native brands experienced significant growth during this period, buoyed by the e-commerce rush driven by the pandemic. Platforms like Etsy saw a remarkable threefold increase in revenue, underscoring the pivotal role of online shopping in meeting consumers' needs for convenience, safety, and accessibility amidst social distancing measures.

This shift towards e-commerce has not only empowered digitally native brands with increased visibility and reach but has also reshaped consumer expectations. Convenience and digital experiences have become paramount, prompting traditional retailers to swiftly adapt to the new landscape. As consumers continue to prioritize online shopping post-pandemic, DTC brands are poised to thrive, leveraging their agility and customer-centric approach to meet evolving market demands and drive sustained growth.

II. IMPORTANCE OF DTC TODAY

Adopting a DTC model unlocks valuable insights and benefits in customer experience, impacting discovery, engagement, purchase and post-purchase service that cannot be replicated in-store. Prior to rolling out at scale, firms launching a DTC model note a 2:1 CLV to CAC ratio (McKinsey, 2020). Benefits of DTC strategies include:

- **Own the entire customer experience**
  L'Oréal, for example, generated a "lock-in" effect through their online loyalty program Worth It Rewards: the more information subscribers offer, the more rewards they receive in return. Through constant input, product recommendations adapt to become more targeted, incentivizing subscribers to buy more, satisfying the customer with a personalized offering while additionally feeding L'Oréal's insights in a virtuous cycle (McKinsey, 2020).

- **Build direct relationships with consumers**
  Advances in technology and AI have established a new way of approaching consumers – dubbed conversational commerce. We see firms leverage digital touchpoints as potential "gateways to points of sale" or enriched platforms for engagement outside of the customer journey (BCG, 2023), especially as the DTC barriers to entry decrease, and the marketplace becomes saturated with entrants.

- **Increase access to customer data**
  Developing an online DTC channel creates competitive advantage in harnessing a deep knowledge of their customer base and extensive control over customer profiles. Unlike traditional retail distribution channels through intermediaries, DTC brands have rich data sources to draw insights from, such as exactly who their customers are, how they first interacted with the brand, and product recommendations (McKinsey, 2021). Building a reliable data pool can influence future go-to-market strategies in new product innovation, new sales channels, and new geographic regions.

- **Rapidly test product performance**
  Outside of a retailer's restrictions, digitally native and direct-to-consumer brands are poised to quickly pivot direction and assortment based on rapid customer feedback, including product assortment, promotional pricing, shipping costs, bundling /online kitting and marketing to retain their customer base (McKinsey, 2021). Adjusting marketing tools in micro-shifts allow brands to adapt the value proposition in direct response to the customer, testing insights in demand forecasting and churn before a broader rollout. PepsiCo and Kraft Heinz test value size or bundled items online to assess if bulk purchasing would increase a customer's WTP in shipping cost (McKinsey, 2020). By controlling the assortment, low margin brands can expand reach online while limiting to products that balance revenue potential, operational feasibility and value add to the end user.

Challenges facing digitally native brands today
Post-pandemic, as in-person activities resumed, digitally native brands that retailed almost exclusively online started to face challenges concerning their growth. Consumers were no longer bound to online shopping and were making new product discoveries in brick-and-mortar stores, leaving digitally native brands to struggle with growing and retaining their customer base.

Etsy, a global e-commerce marketplace focused on unique handmade products and vintage items, was an example that experienced softening business as shoppers returned to physical retail. The business grew significantly during the pandemic with 89.4 million active buyers today, almost double that of 2019. However, in 2022, the value of items sold on Etsy was down 1.3% from the prior year. It's stock was down -40% (MarketBeat, 2022) and was also downgraded, citing that the business suffered "too much shopper turnover" (Fortune, 2023). The company has since increased their platform sales commission from 5% to 6.5%, and is investing in marketing campaigns to re-target shoppers.

Increasing CAC is another key challenge faced with 65% of DTC brands claiming that their CAC has spiked over the last year (Gitnux Market Data Report, 2024). While established brands with big marketing budgets were able to spend up to $150,000 to produce and broadcast a 30-second TV commercial (Harvard Business School Online, 2024), digitally native brands focused on reaching customers through a more focused online marketing strategy. However, the surge in popularity of digital ad usage drove costs up significantly, especially on platforms such as Facebook and Google. It was reported that CAC had increased by 222% between 2013 to 2022, increasing by as much as 60% within the last 5 years (Business Wire, 2022).

III. DTC Strategy Recommendations

Expanding Beyond DTC for Digitally Native Brands

Once digitally native brands have achieved a certain level of brand awareness and are past the stage of “gaining traction” (Figure 1), they would need to secure new sources of growth. Introducing promotions to induce repeat purchases and expanding product assortments to increase average order value are some tactics that digitally native brands have adopted. However, there is only so much these strategies can do to drive top-line revenues, and brands must look for other ways to acquire new customers in order to scale.

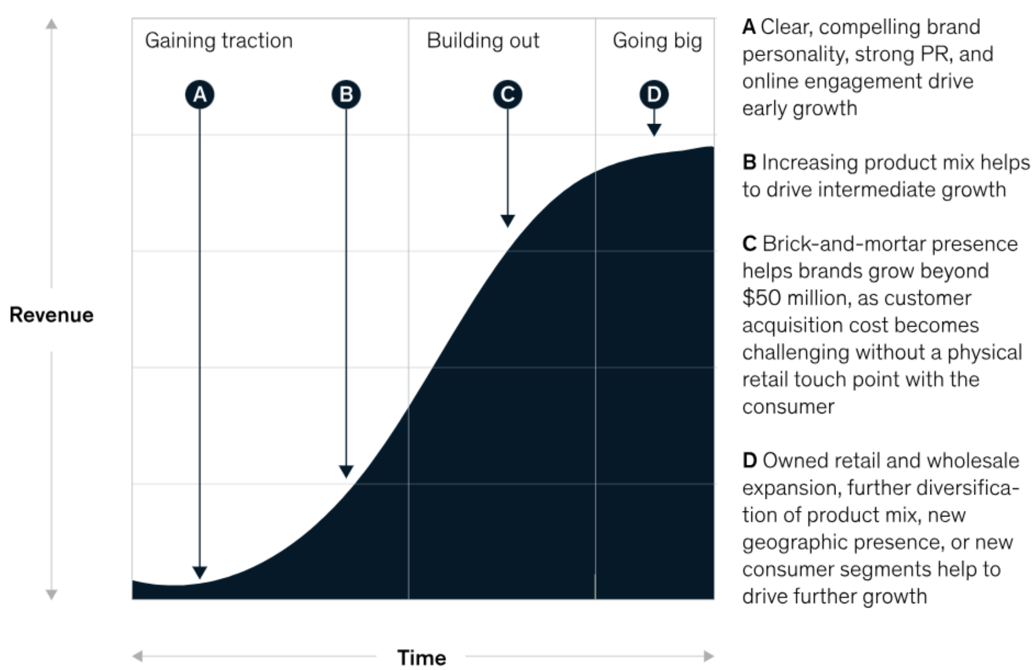


Figure 1, Growth milestones for digitally native brands (McKinsey & Co., 2021)

Partnering with the right retailer or marketplace should ultimately help to decrease CAC and extend a customer’s Life Time Value (LTV). DTC brands that have had some physical presence report lower return rates and higher repeat purchases. Considering consumer shopping habits today, solely relying on DTC distribution can be a bottleneck to growth (Harvard Business Review, 2020), making it necessary for digitally native brands to embrace hybrid or omnichannel retail. Arguably, brands should look to incorporate these other distribution channels even in their early stages of growth, before “maxing out” on DTC; **more importantly, there needs to be a strategy in place that will provide a balance between owning the brand experience and reaching customers where they are at**.

When deciding between establishing owned stores, retailing through a marketplace, partnering with a retailer, or some combination of these, some considerations to note are:

- **The dynamics of the category and product**
  Is the product of replenishable nature?
  Is loyalty easily established, or are impulse purchases more common?

- **Where target customers are shopping**
  What is the product discovery process and where is it taking place?
  How does interacting with the product physically enhance the buying experience?

- **What level of control needs to be maintained**
  How much of the brand's storytelling will hold outside of DTC?
  What balance of customer data can be foregone?

These considerations should also guide the overall distribution strategy, which would then determine the assortment mix and other promotional tactics available to each channel.

Using Amazon as an example; the platform itself holds 74% user share (Statista, 2024), making it the most used online shop in the US today. The company used to be known as "the everything store" and has now evolved into an "everyday store", evident from its growing assortment mix and expansion into consumer staples such as the Beauty & Personal Care category. Amazon established its Beauty store in 2004, starting with Mass Beauty, but has since expanded into Premium, Professional, and Indie beauty storefronts. Their acceleration in beauty has put pressure on other industry players, as evidenced when Ulta and Sally Beauty's stock dipped by 2.7% and 17% respectively, when Amazon announced that it was entering the Professional Beauty segment (CNBC, 2019). Amazon's Beauty & Personal Care category is forecasted to grow at 26% year over year in 2024, with search volumes for the category up by 38.6% (Momentum Commerce, 2024).

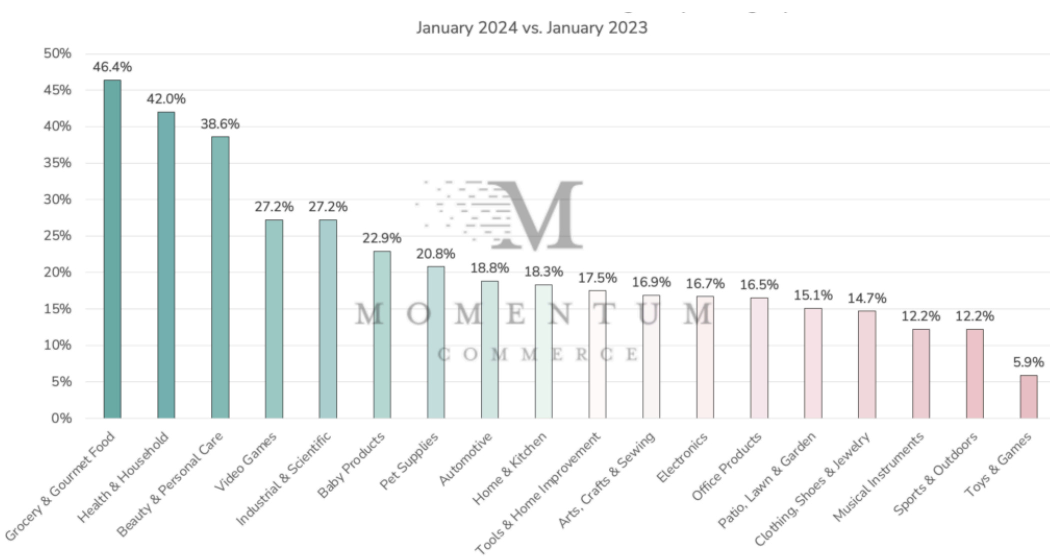
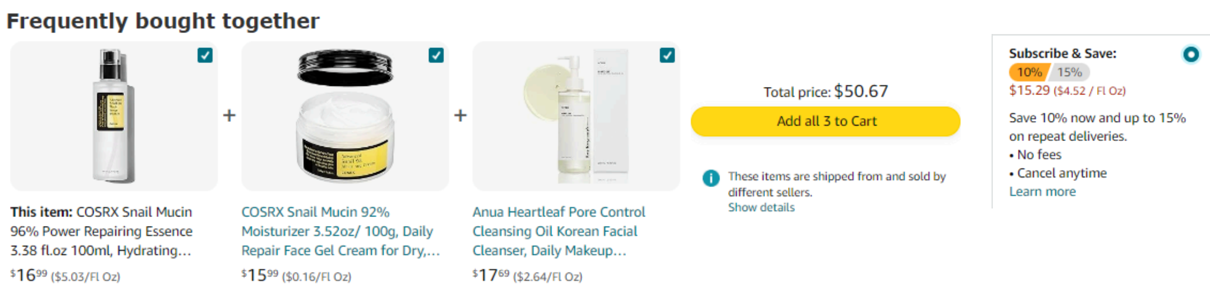


Figure 2, Amazon US Search Volume Changes by Category (Momentum Commerce, 2024)

For beauty & personal care consumers, Amazon can provide an enhanced shopping experience. For instance, their “Frequently bought together” recommendations allow customers to know what other consumers use to complete their regiment, providing brands with the opportunity to cross-sell across brands.



With the growth in demand for the category, Amazon has also started curating online beauty events for the summer and holiday seasons. Another key feature on its platform that works well with the category dynamics is Subscribe & Save. By providing a small discount on a subscription, brands could expect to see increased revenue with higher customer loyalty and accelerated reorder rates.

Amazon has also introduced Virtual Try-On functions on its iOS shopping app. In addition to its application for color cosmetics, this feature also extends itself to other consumer categories, such as apparel, footwear, and even furniture.

Additionally, established retail channels have built out accelerator programs to help emerging DTC Brands scale their business to then feed into their portfolio. Through co-creation of a firm’s value proposition, product assortment and economies of scale, DTC brands are primed to expand their reach exponentially. Amazon’s Small Business Accelerator Program aids participating brands with less than one million in revenue to recoup benefits such as profit sharing through their Appstore – lowering the barrier to entry to new entrants.

DTC Strategies for Established Retail Brands
While the economics of a DTC business are daunting for digitally native brands, we view this channel as a key growth driver for established brands. Indeed, these brands recognize it too: Nike has grown their DTC sales from ~38% of total revenue in 2021 to ~44% in 2023, Crocs now makes more than 50% of their sales from their DTC channel, and Mondelez is aiming for DTC to make up 20% of their sales (Nike 2023 10-K; Crocs 2023 10-K; Pilot44, 2023). Additionally, established brands made up 76% of DTC e-commerce sales in 2022 (Pilot44, 2023). We will summarize the upsides and risks associated with the two main ways established brands can build their DTC channel: (1) branded stores and (2) e-commerce.

Looking forward, established brands can further engage with their customer base in ways they never could before by opening branded-stores, giving them creative control to create shopping experiences that reflect the brand. For example, Levi’s sees their branded stores as a key part of their DTC strategy, allowing them to “showcase the fullest expression of [their] brands and drive category diversification while also enhancing connections with the consumer” (Levi’s 2023 10-K). **This strategy is a more viable one for established brands over digitally native brands because they have already reached scale.** In fact, BMO analysts note “scale is…crucial for DTC profitability” (RetailDive, 2021). Brands that historically have relied heavily on wholesalers have the capital and baseline brand recognition to pursue this approach whereas digitally native brands have many competing capital needs. It is worth noting that while branded-stores have higher gross margins, they also bring higher SG&A costs (from hiring retail staff), increased rental expense, and the added operational complexity of actually running a store. However, for established brands, these added costs might be worth it to **create further differentiation** and turn their stores into a branding vehicle. Figure 3 plots the annual branded-store count for Nike and Levi's, demonstrating established brand focus on this channel. It is also worth noting that Nike has grown comparable store sales at ~14% CAGR 2021-2023 and Levi's a CAGR of ~4% (Nike 2023 10-K; Levi's 2023 10-K).

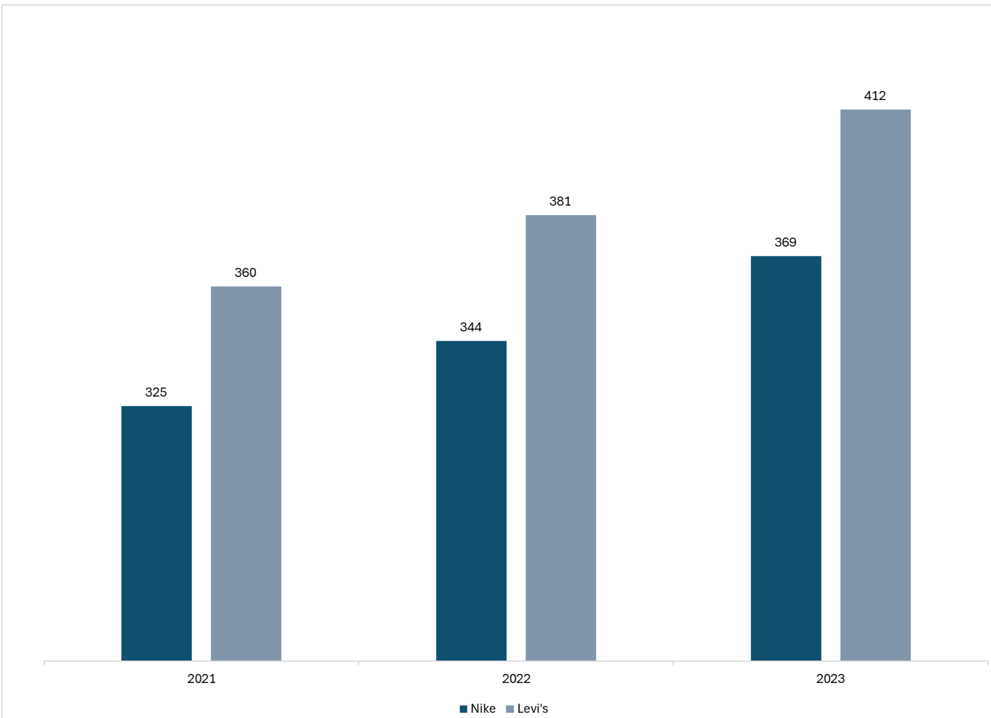


Figure 3, Annual branded store-count for Nike and Levi's

In addition to branded stores, established brands can pursue e-commerce. While this is far from a novel idea, we feel that this approach is best used to allow for customer-centric shopping by creating bespoke experiences. For example, Nike has done this for years with their Nike By You offering, but we are seeing this approach reach even food & beverage: Mondelez has created OreoiD where customers can create customized cookies (Pilot44, 2023). Not only does this create more customizability with products, but **we feel focusing on this approach will break down the stigma that massive retail brands/conglomerates are too large and out-of-touch to cater to the individual.** The key risks here, however, are that building out this channel not only requires technological investment, but the fulfillment speeds must compete with the Amazon's of the world. To be specific, a PwC paper notes that around 80% of American consumers view "speed" as a crucial element to their experience and, for international established brands, consumers outside the US are even more speed sensitive (PwC). With that being said, in an increasingly digital world, we feel investing in e-commerce is essential for success for established brands and this channel will allow them to continue to grow as brick-and-mortar retail becomes less prevalent.

IV. CONCLUSION & TAKEAWAYS

In the current evolving retail landscape, the future of DTC appears promising yet challenging. While the pandemic accelerated the shift towards online shopping and highlighted the importance of direct consumer relationships, it also intensified competition and raised customer expectations.

To succeed, DTC brands must focus on differentiation through personalized experiences, authenticity, and sustainability. They should leverage digital innovation to enhance customer engagement and streamline operations, while also prioritizing transparency and ethical practices.

Additionally, partnerships and omnichannel strategies can help DTC brands reach a wider audience and mitigate risks associated with reliance on a single distribution channel.
Overall, while the retail landscape presents both opportunities and challenges for DTC brands, those that adapt to changing consumer behaviors and market dynamics are poised for success in the years ahead.

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