Brick-and-Mortar Retail Resurrected

By Anye Wanki

As e-commerce and brick-and-mortar worlds intersect, companies that invest in seamlessly integrating the online and in-store customer experience will come out ahead.

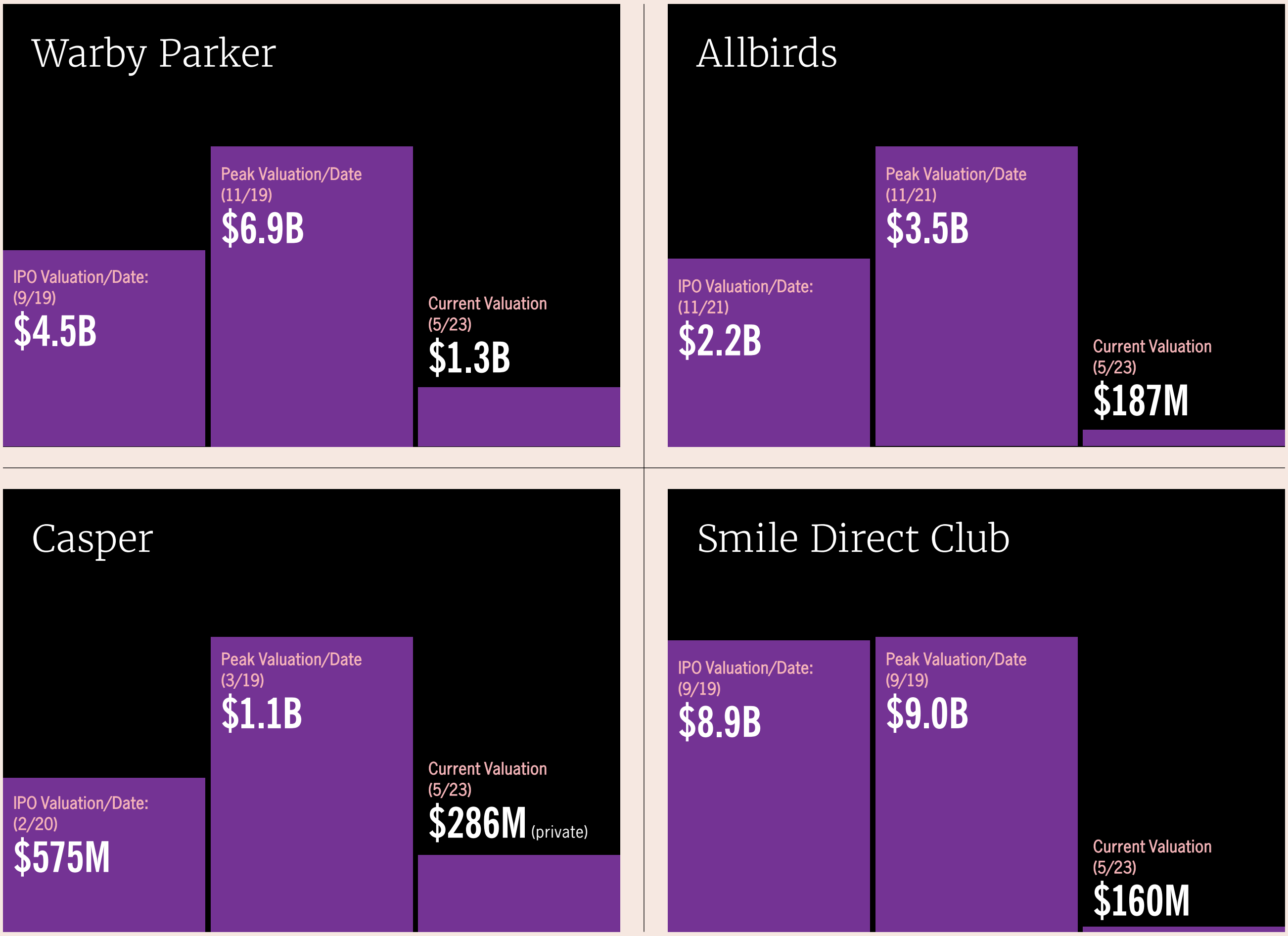
In 2012, Michael Dubin filmed a low-budget commercial promising to ship high-quality razors directly to customers for only one dollar a month. Featuring the now-famous tagline, "Our Blades Are F**cking Great," the humorous 90-second spot caught consumers' attention and helped usher in the era of a popular and innovative new business model: direct-to-consumer (DTC) retail. With DTC, upstart companies promised customers more affordable products and better customer experience by skipping the retailers and controlling the entire value chain from manufacturing to delivery to post-delivery services.

In relatively low-innovation, low-involvement retail markets such as toiletries, office supplies, and beverages, big brands have remained impregnable for decades thanks to their scale, ability to achieve top-of-mind awareness, and constant availability for repurchase. Not surprisingly, the top brands in the most fast-moving consumer goods (FMCG) categories in 1980 look remarkably similar to those that dominate today.[1] Unilever, Procter & Gamble, Colgate, PepsiCo, and Coca-Cola have been mainstays for decades.

In the new DTC era, however, startups claimed to provide better quality and lower costs than their multibillion-dollar brand competitors. Gone were the days when huge traditional ad spends on television and billboards fueled brand awareness and significant sales force investments drove retail partnerships. Gone were the days when big-brand budgets overflowed with cash and new upstarts were buried and outspent. The DTC saviors didn't need to start with a big advertising budget to get the attention of consumers. They didn't need a manufacturing plant. They didn't need to spend millions of dollars on research and development. They didn't need a retailer to carry the product. All they needed was a manufacturing partner and a super cool advertising campaign targeted at millennial digital natives. In hindsight, this was too good to be true.

The value proposition for both the brand and consumer was obvious: sell the product to consumers at a price above traditional wholesale, but lower than retail. Then, use the premium earned over the wholesale price (along with the savings from store rents and promotion costs) for marketing — specifically, targeted advertisements aimed at replacing the attention that brick-and-mortar retail stores traditionally grabbed. In the end, the consumer pays less but the producer makes the same profit. Meanwhile, the company also builds a direct relationship with the customer that enables it to create feedback loops and better utilize customer data for product improvement and expansion. Everyone wins!

The success of the DTC strategy seemed to be corroborated in 2016 when Dollar Shave Club reached the critically acclaimed "Unicorn" status and was acquired by Unilever for $1 billion. Other DTC unicorns followed. Smile Direct Club went public at a valuation of $8.9 billion in September 2019. Casper peaked at a valuation of $1.1 billion in March 2019 and IPO'd with a $575 million valuation in February 2020. Warby Parker joined the New York Stock Exchange in 2021 at a valuation of $4.5 billion, and Allbirds hit the NASDAQ in 2021 valued at $2.16 billion. Since going public, however, the valuations of all five of these DTC flag bearers have declined precipitously and were, as of earlier this year, less than half of their peak value.



RISE IN SHORT-TERM OPERATIONAL COSTS

What seemed too good to be true was indeed too good to be true. Profitable retail is extremely difficult, and none of the unicorn DTC retail companies have become profitable. With all the hype that DTC brands generated from winning top-line market share, many ignored (or at least neglected to report on) the huge costs that DTC brands incur to skip the middleman's retail stores: marketing, fulfillment, order support, customer service, pick and pack, and returns. Many of these costs increased precipitously over the past two years, leaving DTC companies with glim hopes of a path to profitability. Specifically, there are two categories of short-term operating costs that had the biggest negative impact on a DTC company's potential profits.

CUSTOMER ACQUISITION COSTS

1. Facebook Ad Prices. The cost of Facebook ads has skyrocketed due to rising demand — and in some cases, contracting supply — leaving DTC companies in a bind. In the U.S., the cost to reach 1,000 people on Facebook jumped from $6 to as much as $18[2] from 2020 to 2022. In the first half of 2022, Warby Parker spent about 17 percent of its revenue on marketing. Nike, on the other hand, spent only about 8 percent of its revenue on advertising and promotions in 2022.

2. Apple's iOS Privacy Changes. As advertising prices increased, privacy changes from Apple have added yet another obstacle, harming the ability of DTC companies to measure whether their social media ads are working. The internal metrics and mechanisms that Meta uses for attribution are off by anywhere from 30 to 50 percent[2], leaving companies blind when trying to optimize their advertising. "A men's underwear brand that previously would have earned one customer for each $5 ad targeting 1,000 men now has to show it to 2,000 people because they don't know who is a man and who is a woman,"[3] *Forbes* reported. "And you still only have five dollars for those 2,000 impressions. So, the acquisition costs doubled, and the lost yield is 50 percent."

3. Supply Chain Costs. As the pandemic progressed, the cost to import containers from China exploded, in some cases by a factor of 102. This added yet another expense to the DTC balance sheet. Furthermore, DTC companies, which prided themselves on customer service, did not have the scale or clout to negotiate better deals with suppliers to increase the speed of delivery.

LONG-TERM STRUCTURAL CHALLENGES

To successfully disrupt established players, new realm businesses need both successful short-term operational execution and long-term structural tailwinds. However, DTC companies face not only short-term operational cost pressures but also long-term structural headwinds that exacerbate the challenge of reaching profitability.

1. Competing on price. The value proposition of lower prices from DTC companies can be easily eroded, especially by larger competitors. Larger and more diversified competitors with bigger balance sheets can afford to trade prices for market share. Furthermore, larger companies can negotiate better supplier and logistics rates due to economies of scale.

2. Customer Retention. Many DTC companies face a customer retention problem, especially ones that sell low-turnover items, e.g., mattresses or suitcases. In other words, their customer lifetime value (LTV) < customer acquisition cost (CAC). They must consistently remarket to new customers and can't drive down their marketing spend after acquiring customers, making it difficult to increase profitability.

3. Market Saturation. There is an oversaturation of DTC companies in the market, leading to customer fatigue. A customer must care enough about the product to buy specifically from a brand instead of buying everything from a retailer. Customers feel the inefficiency of shopping in multiple places for materials.

4. Subscription Fatigue. For commodity brands that offer subscriptions, there is subscription fatigue. Customers do not see the need to subscribe for commodities when Amazon and Walmart can deliver them within hours.

BACK TO BRICK-AND-MORTAR

With the struggles of e-commerce DTC exposed, companies are now finding that an omnichannel strategy makes the porridge taste just right. DTC companies have been forced to do what they tried best to avoid — open brick-and-mortar stores or collaborate with retailers in search of profitability. And it's paid off. Since 2019, Warby Parker has registered more sales from their 223 brick-and-mortar stores in 169 cities than from e-commerce.

Warby Parker

	2019	2020	2021	2022
Retail Revenue	65%	40%	53%	61%
E-commerce Revenue	35%	60%	47%	39%

Similarly, Allbirds grew its retail sales by about 70 percent from 2020 to 2021 and about 50 percent from 2021 to 2022. Currently, they have 58 stores in the United States, up from 35 at the end of 2021.

Allbirds

	2019	2020	2021	2022
Retail Revenue	17%	11%	19%	28%
E-commerce Revenue	83%	89%	81%	72%

"Having a true omnichannel experience is crucial for customer retention," says Allbirds CEO Joey Zwillinger. "In 2021, omnichannel repeat customers spent one and a half times more than single-channel repeat customers at Allbirds." Furthermore, in-store sales are simply more profitable due to the lack of shipping and fulfillment costs, and a lower return rate.

It's true that at the beginning phase of market entry, DTC companies can experience fast growth with relatively low customer acquisition costs due to the willingness of early adopters and innovators to try something different. However, no digitally native brand has reached a billion dollars in annual revenue without an actual store.[4] Stores serve as a cost-effective customer acquisition channel — especially, as customer acquisition costs increase.

That said, DTC companies do have an advantage when it comes to opening brick-and-mortar stores. By entering through an online channel initially, DTC companies avoid large, recurring real estate costs while they test the market and use customer data to improve and expand their products. From there, these companies can leverage the data gained from initial online sales to better inform where to locate new stores and how to optimize their layouts.

As DTC companies expand into the brick-and-mortar space in search of profitability, ironically, incumbents are doing the opposite — looking toward DTC e-commerce in search of growth and higher margins. And when both worlds intersect, companies that invest in seamlessly integrating the online and in-store customer experience will come out ahead.

Anye Wanki
anye.wanki@jabian.com

Sources:

1 *Ritson, Mark. "The Threat of Direct-to-Consumer Disruption is Seriously Overblown." Marketing Week, 6 Nov. 2018*
2 *Kantrowitz, Alex. "The Direct-to-Consumer Craze is Slamming into Reality." CNBC, 14 Mar. 2022*
3 *Rosenfield, Brad. "How Marketers are Fighting Rising Ad Costs." Forbes, 14 Nov. 2022*
4 *Thomas, Lauren. "Why digital retail darlings Warby Parker and Allbirds are betting big on stores to grow ahead of public debuts." CNBC. 17 Sep. 2019*