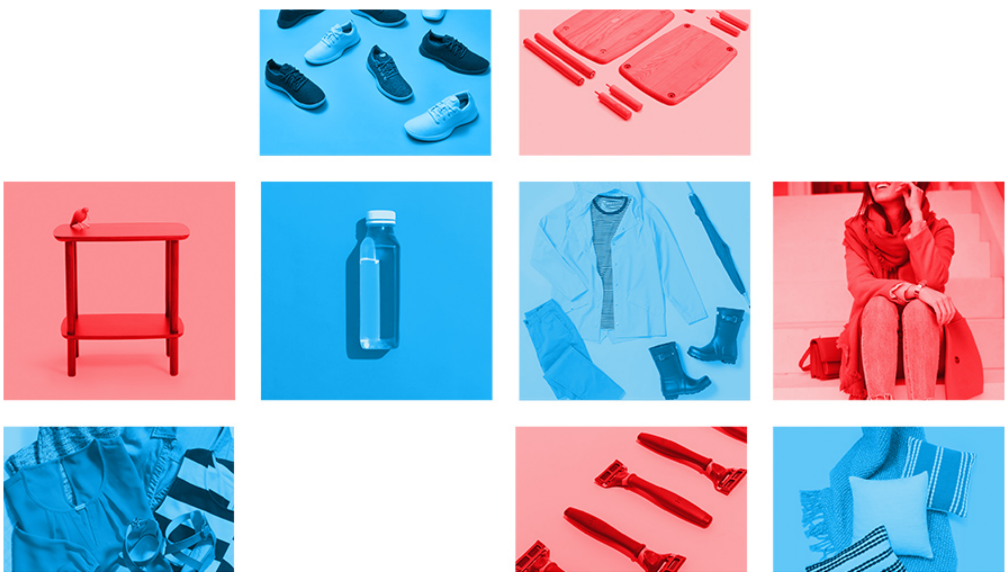
ADWEEK

Challenger Brands

For the Next Wave of DTC Brands, the Path to Success Looks More Complicated Than Ever

How they will need to evolve in order to be profitable

By Ann-Marie Alcántara | 17 hours ago



Investments in ecommerce companies and related businesses declined 8% to $19.7 billion in 2019.

Credit: ChefBoyRG

Ten years ago, when the internet still held infinite possibilities, a new breed of brand built on the web began to pop up, promising to cut out the middleman and bring consumers cheaper, better products.

This newfangled category was given the very official-sounding name "direct to consumer" (DTC). And then, because one buzzword is never enough, Andy Dunn, co-founder of Bonobos, coined https://medium.com/@dunn/digitally-native-vertical-brands-b26a26f2cf83) "digitally native vertical brand"

(DNVB) in 2016 as an alternative—and pretty soon rookie brands like Bonobos, Dollar Shave Club, Everlane and Glossier became synonymous with the segment. Women's shoe brand Rothy's, for example, is emblematic of DTC brands' early success. Founded in 2012 and fully launched in 2016, and known for its professional, washable and sustainably made flat, the company is now valued at $700 million, has raised $42 million in three rounds of funding and has been profitable since day one.

Each promised to use the powers of the internet for good while taking away market share from the entrenched incumbent conglomerates like Unilever and retailers like Gap, which were largely creating siloed ecommerce strategies from brick-and-mortar shops, with a much less direct relationship with consumers.

Shoppers, and investors, responded enthusiastically.

But the DTC fervor is dying down. Investments in ecommerce companies and related businesses declined 8% to $19.7 billion in 2019, down from $21.5 billion the year before, according to research firm CB Insights. And the past few weeks have brought a parade of punishing headlines: The luggage company Away had a leadership meltdown after the CEO's Slack messages were leaked to the press. Athletic-apparel company Outdoor Voices' CEO stepped down after poor financial results. Brandless, which offered everyday household items in minimalistic packages at low prices, abruptly halted operations because the "fiercely competitive direct-to-consumer market has proven unsustainable for our current business model." And Edgewell abandoned https://www.adweek.com/retail/after-months-of-turbulence-brandless-is-shutting-down/) its $1.37 billion acquisition of Harry's razor company https://www.adweek.com/retail/direct-to-consumer-brands-had-a-bad-week-but-its-not-all-doom-and-gloom-for-the-industry/) after the FTC sued https://www.adweek.com/retail/ftc-blocks-edgewells-acquisition-of-dtc-shaving-brand-harrys/) on grounds that the deal was bad for consumers.

Tempting as it may be, don't call it a bubble. Insiders we spoke to—from vps at DTC brands to venture capitalists on the front lines—instead said a correction is upon us. To navigate DTC 3.0, the next wave of brands will have to go beyond simply being digital, mastering values like community and sustainability. And their investors will have to adopt more realistic financial expectations, with acquisitions looking less like Unilever's $1 billion purchase of Dollar Shave Club and more like Casper's IPO https://www.adweek.com/retail/caspers-ipo-leaves-the-dtc-industry-with-more-questions-than-answers/), which recently valued the company at about $468 million instead of the $1.1 billion projected a year earlier.

A new era in the industry is here, with insiders calling on the category to combine the flexibility and customer-centricity of DTC with the core strengths of traditional retail.

Identity crisis

Derris, a public relations and marketing consultancy, is often credited with helping DTC darlings like Everlane, Glossier, Harry's and Warby Parker grow. In the early days, DTC brands were known for a customer-centric mindset and an emphasis on storytelling, and it was possible to advertise on digital channels for cents because customer-acquisition costs (CAC) were low and social media channels weren't saturated with DTC messaging.

But now, says founder and CEO Jesse Derris, the moniker has come to represent brands whose "primary consideration was the customer experience," with a strong ability to tell a story about a product—as opposed to solely delivering products on a one-on-one basis to customers. He points out that DTC brands sprouted because of a digital arbitrage—and that investors pumping money into them misunderstood the margin structure of a consumer business, mistakenly assuming that a DTC operation functions just like a tech company.

And when these digital arbitrages—like low CAC on platforms such as Facebook, Google and Instagram—increased in price, DTC businesses became a less attractive investment opportunity.

"Once search happened on a social network, you're on your way to paid advertising, and once paid advertising becomes ubiquitous, everyone has the same access to it [and it] becomes democratic—there's no arbitrage," Derris explains.

Like Derris, Emily Heyward, co-founder and chief brand officer of Red Antler, the agency behind the aesthetic of challenger brands https://www.adweek.com/brand-marketing/meet-the-surprisingly-small-group-of-branding-shops-behind-todays-top-challenger-brands/) like Casper, also takes issue with the term DTC. She recently told Adobe 99U https://99u.adobe.com/articles/61579/michael-ventura-self-observation-is-the-skill-of-the-future) one of her New Year's resolutions is to remove the acronym from her vocabulary entirely. She notes that the label defines a company that only operates digitally—a model that many new brands are moving away from.

Companies like shoemaker Allbirds (launched in 2014) and furniture firm Burrow (2017), for example, opened physical stores to complement their online presence, adopting a bricks-and-clicks strategy.

Rothy's approach is to own the supply chain and let customers vote for favorite old styles—which in turn lets Rothy's only produce silhouettes it knows will sell. It can also pull new shoe styles https://www.adweek.com/brand-marketing/rothys-decision-to-pull-its-latest-silhouette-was-prudent-experts-say/) when they don't meet its standards, as it did with its "Slide" silhouette in May 2019.

"We can build this process as we go, which is definitely something that people are going to try and reverse engineer," says Elie Donahue, svp, marketing at Rothy's.

Rothy's will "continue to have thoughtful growth," she says, such as testing new styles, as it did with a sneaker in 2018 and with a wool shoe in fall 2019. A growing retail footprint is also in the works for the brand, with three stores currently open and a wholesale relationship with Neighborhood Goods' two stores.

"This is just the beginning," says Donahue. "We see this woman everywhere. We have developed this product that she just loves, and now is the time and the moment to deliver and give her what she needs."

The ways forward

Paul Munford, founder of Lean Luxe, an ecommerce newsletter and investor in DTC brands like cookware startup Great Jones and Gen Z underwear company Parade, says the DTC category is still in the process of maturing and evolving. But even if it's experiencing growing pains, its impact is undeniable.

"No one company is going to take over P&G," he says, "but what [DTC brands] have been able to do [is] reshape the conversation and make the marketplace more about the consumer than the conglomerates themselves."

"We saw a lot of exuberance around commerce and DTC brands, and there are certain categories and companies [where we'll see] very large outcomes," says Laura Chau, principal at Canaan Partners. "We haven't seen that many exits, and that's part of where this whole equation needs to be tested."

From the venture side, Andrea Hippeau, principal at Lerer Hippeau, a venture fund whose portfolio includes Casper and Glossier, says the newest crop of DTC brands, like the piercing shop Studs, is focusing on sustainability and community building. First- and second-wave DTC brands focused on hero products or owning the supply chain. But to become successful in today's landscape, it's not enough—and even legacy companies are expanding beyond these initial brand storytelling moments.

Allbirds, for example, hands out unique pins in each of its stores as a gift to customers and encourages them to share their shoe style with the hashtag #weareallbirds. Universal Standard lets customers book its showroom for meetings and parties, free of charge. Burrow has teamed up with pet brand Wild One and CBD drink Recess https://www.adweek.com/retail/these-5-dtc-pet-brands-threw-a-puppy-party-to-connect-with-each-others-customers/) to stage events at its SoHo store in New York.

Alex Kubo, Burrow's vp, ecommerce and digital marketing, says these initiatives let participants tap into each other's audiences and offer a competitive advantage at a time when companies are moving away from performance marketing because of high CAC.

Meanwhile, Everlane, founded in 2010, has doubled down on sustainability, pledging to stop using all virgin plastic in its products by 2021.

"Brands that are mastering [sustainability and community building], at least for 2020, are the ones that will stand out," Hippeau says. "Building a really customer-centric brand—that is going to be sustainable in the long run."

Notes Brent Vartan, managing partner at Bullish, an investment firm and creative agency, DTC 3.0 is about "consultative commerce," an era in which brands customize and anticipate consumer needs.

Procter & Gamble acquired Native in 2017 for $100 million.
Native

Matt Kaden, managing director at MMG Advisors, says in the new era of DTC, challenger brands will work in tandem with legacy brands, whether through wholesale, factory direct or retail, in order to be successful.

Brands will also reconsider what qualifies as success. Reaching a billion-dollar valuation may not be the only way. "It's OK to have a business that runs beautifully and operates with excellence," with more realistic valuations and growth strategies, says Kaden.

Native, an aluminum-free deodorant founded in 2015 by Moiz Ali, is one example. Procter & Gamble acquired Native in 2017 for $100 million. He says that at the time, Native was growing revenue at 500% year over year.

"If you can build a $10 million business with 20% margin, there's a lot of opportunity," says Ali, who left his position as CEO of Native at the end of January.

The challenges ahead

Two acquisitions in 2019, Wacoal Industries' purchase of Lively https://www.adweek.com/retail/wacoal-acquires-lingerie-brand-lively-for-85-million-to-expand-business-beyond-japan/) for $85 million and S.C. Johnson buying Oars + Alps https://www.adweek.com/retail/yet-another-dtc-brand-debuted-in-target-stores-earlier-this-month/) for a reported $20 million https://www.bizjournals.com/milwaukee/news/2019/09/12/s-c-johnson-buys-chicagomens-skincare-startup-oars.html)—which followed Movado acquiring MVMT watches for $200 million in 2018—suggest that the DTC category still has strong potential.

But it's also clear there's no silver bullet for success.

Micky Onvural, CEO of Bonobos—which first opened a store in 2011 and now has 68 locations—says the menswear company focuses on innovation and customer experience as a means to grow and stay relevant with its consumer, a strategy she calls "relationship commerce." In other words, it would seem to be doing everything right, as evidenced by its 2017 acquisition by Walmart for $310 million.

But as Bonobos underwent layoffs in October 2019 https://www.vox.com/recode/2019/10/7/20903400/bonobos-layoffs-walmart-andy-dunn-marc-lore) and Dunn left Walmart in early January, doubts about its viability began to emerge. A report from Recode https://www.vox.com/recode/2019/7/3/18716431/walmart-jet-marc-lore-modcloth-amazon-ecommerce-losses-online-sales) pointed to additional troubles the brand is facing, including a potential sale.

"There are sobering moments, but there's never been more money out there and the public markets are taking any kind of IPO," Vartan says. "We might see some sobering moments from irresponsible valuation creation, but it's way too early to say whether consumer investments are failures. We're in the early stages of what's going to be a massive transformation of how a brand comes to market."

The answer might be found in the past—in the old-fashioned approach to building a brand with staying power: reasonable expectations and patience.

Richie Siegel, founder and lead analyst at Loose Threads, believes we'll see more DTC brands developing successful businesses at $5 million, $10 million, $20 million a year and growing at a steadier pace.

"Consumer behavior changed structurally," he says, "but what a good business is and how to build a good one didn't change."

Legacy Brands Shift Their Perspective on DTC Challengers

On July 20, 2016, CPG giant Unilever announced it was acquiring direct-to-consumer startup Dollar Shave Club https://www.adweek.com/brand-marketing/dollar-shave-club-acquired-unilever-reported-1-billion-deal-172589/). The deal propelled other legacy brands to start buying up DTC brands as well. P&G bought natural deodorant brand Native in 2017 and in 2018 Walker & Company https://www.adweek.com/retail/pg-acquires-walker-company-maker-of-beauty-and-grooming-products-for-people-of-color/), a personal care and beauty brand for people of color. To amp up its products and compete with Amazon, Walmart also acquired a variety of brands—Bonobos and ModCloth in 2017 and Flipkart https://www.adweek.com/retail/amazons-bid-to-buy-a-majority-stake-in-flipkart-signals-its-ready-to-grow-even-more-in-india/), Eloquii https://www.adweek.com/digital/walmart-buys-the-limiteds-former-plus-size-line/) and

Bare Necessities https://www.adweek.com/retail/walmart-acquires-20-year-old-intimates-brand-bare-necessities/) in 2018.

As big brands saw it, with these moves they were buying the best talent—rather than incubating and trying to build new brands in-house—and gaining new opportunities to connect with millennial and Gen Z shoppers. But their outlook on DTC companies has since shifted: Walmart sold ModCloth https://www.theverge.com/2019/10/4/20899540/walmart-sells-modcloth-acquisition-compete-amazon) two years after buying it, and Dollar Shave Club isn't selling as many razors https://www.adweek.com/retail/direct-to-consumer-brands-had-a-bad-week-but-its-not-all-doom-and-gloom-for-the-industry/) as DTC rivals like Harry's.

"There's still a notion that those DTC companies are a significant irritant because they do capture some market share, sometimes meaningful and sometimes not so much," says Jason Goldberg, chief commerce strategy officer at Publicis. And, in fact, the acquisitions haven't come to a complete halt: P&G bought Billie, a women's shaving brand, in January. But incumbents are discovering that "the answer is not to become them," says Goldberg. Challenger brands "are just another market force we have to compete with."

Older brands actually have an advantage over challengers because they already know how to deal with tariffs, recessions and other obstacles that arise in running a business, argues Moiz Ali, founder and former CEO of Native.

"They've just been around the block longer," he says. "All the newcomers—[you] don't know anything until you run into a brick wall."

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