EXECUTIVE INSIGHTS

Eyeing the Acquisition of a Direct-to-Consumer Business? Here's What You Need To Know

Corporate buyers (corporates) are stepping up acquisitions of direct-to-consumer (DTC) businesses, whose sales are forecast to grow a healthy 16%-18% per year[1] for the next several years. The trend reflects corporates' ambitions to expand their product offerings and cross-market to a new customer base. It also marks a shift in how consumer businesses are adapting to changing consumer preferences by blurring the lines between online and in-person experiences in order to meet consumers where they like to shop.

Corporates have always invested in small brands to further their growth. But DTC businesses are especially attractive because the absence of a middleman often means higher margins. They also tend to have a strong customer orientation, including a deep set of consumer data and a well-developed, wholly owned digital commerce experience — attributes that corporates often struggle to acquire organically.

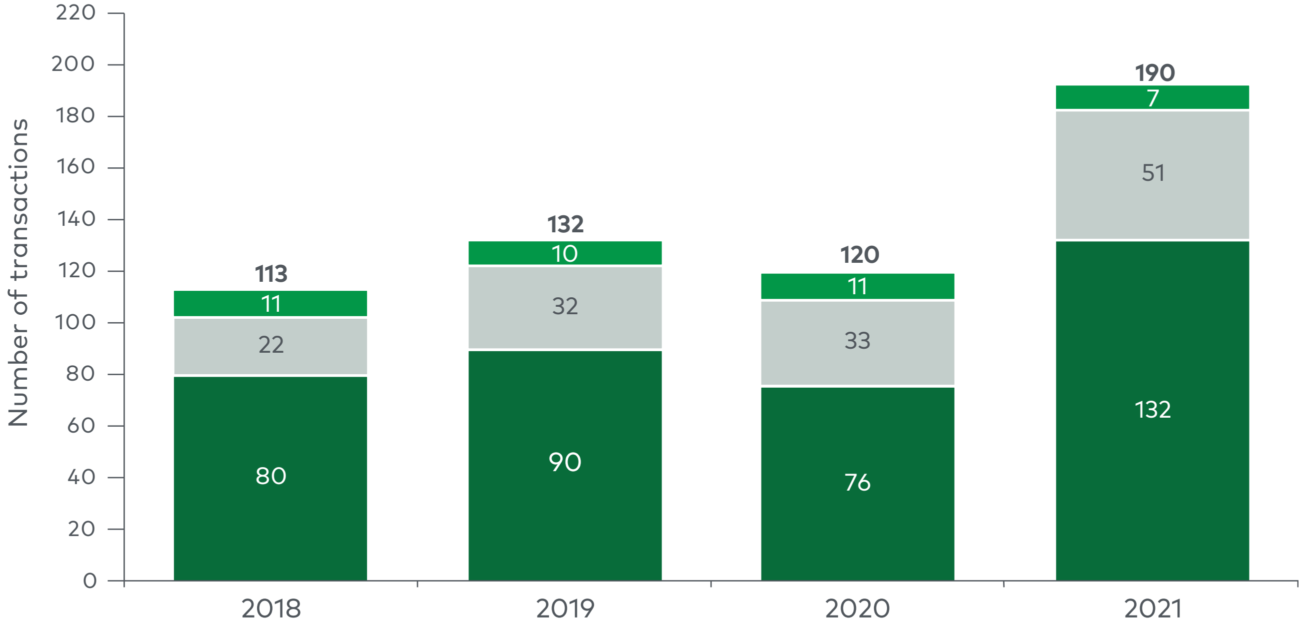
At the same time, the acquisition trend has yielded several high-profile deals that fell short of expectations. It turns out that many DTC businesses have hidden pitfalls that can trip up even the most experienced of corporates.

In this *Executive Insights*, we'll look at where deal activity for DTC businesses has been going and what the attractions are for both buyer and seller. Then we'll outline some concrete steps you can take to know what you're buying and increase the odds of a successful transaction.

A robust environment for acquisitions

A growing number of DTC businesses have been hitting the M&A market in recent years. Most have been snapped up by corporates (see Figure 1).

Figure 1
DTC M&A transactions by acquirer type (2018-2021)*



Percentage acquired by corporates	71%	68%	63%	69%

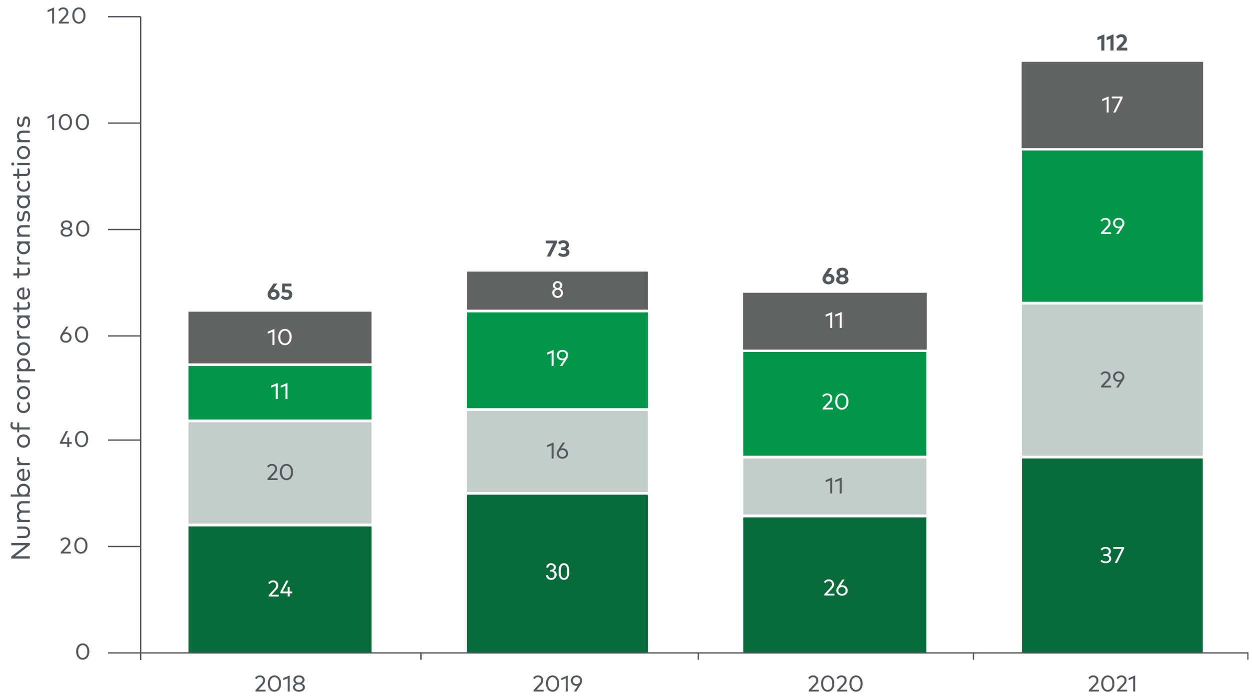
*Includes DTC and brands with material ecommerce or DTC sales
Source: S&P Capital IQ; L.E.K. interviews, research and analysis

In 2021, about 85% of these corporate DTC acquisitions were consumer businesses. Food and beverage was the most popular category, but meaningful deal activity took place across the consumer spectrum (see Figure 2).

DTC businesses are an attractive takeover target because they can help corporates achieve their strategic intentions. These include:

Expand consumer reach. The consumer populations of DTC businesses are often younger and quicker to adopt emerging trends. Access to that group was a key driver of Movado Group's 2017 acquisition of upstart brand MVMT, which sells affordable watches and accessories with help from a significant presence on social media.[2] Serta Simmons followed a similar pattern when it purchased DTC mattress company Tuft & Needle in 2018. The tie-up offered the chance for Serta Simmons to expand beyond its traditional brick-and-mortar channels to reach generally younger bed-in-a-box consumers.

Figure 2
Corporate consumer DTC M&A transactions by category (2018-2021)*



Percentage of consumer transactions relative to total corporate transactions	**81%**	**81%**	**89%**	**85%**

*Includes DTC and brands with material ecommerce or DTC sales
Source: S&P Capital IQ; L.E.K. interviews, research and analysis

Home
Soft goods
Beauty/personal care
Food and beverage

Deepen customer relationships. DTC businesses have direct customer interactions that let them gather consumer data in ways that traditional wholesale brands can't. With Lululemon's 2020 acquisition of Mirror, a subscription-based home fitness startup, the company gained more data on consumer fitness preferences that it could use to expand its offerings and consumer touchpoints across fitness occasions. In 2021, women's beauty and health startup FemTec Health acquired Birchbox, Mira Beauty and Liquid Grid — all data-rich businesses — in an apparent bid to further its artificial intelligence-driven personalized health offerings. This deeper understanding of the consumer allows for more targeted product development and marketing, ultimately improving the consumer experience and deepening customer relationships.

Acquire capabilities. DTC businesses come with digital capabilities that the acquirer can plug into its own business. In this respect, sometimes the brand or product is of less interest than the people and know-how. MVMT came with an experienced management team that could advance Movado's Digital Center of Excellence initiative. At Serta Simmons, Tuft & Needle's co-founders have been helping to shake up product lines, ramp up direct channels and change the company's approach to marketing.

On the other side of the transaction, acquisitions often appeal to DTC brands as a way to tap into the well-developed logistics, marketing and human resources operations of an acquiring company. In addition, a corporate owner can likely help with wider brand marketing and provide access to new channels, which drives brand awareness and creates avenues for reaching a new set of consumers. Since its 2018 sale to Kroger, Home Chef has brought its meal kits into the supermarket company's stores even as it maintains its ecommerce business. Meanwhile, Tuft & Needle mattresses are now available at Lowe's and Crate & Barrel along with brick-and-mortar locations under its own brand. Serta Simmons' capital and expertise fueled much of this expansion.

Best practices for DTC due diligence

But DTC businesses face growing headwinds. Digital marketing costs are rapidly on the rise. Privacy changes are impacting effective consumer targeting and acquisition attribution. Supply chain snarls are taking a toll. For many, profitable customer acquisition has stalled.

Challenges like these can create a cash black hole and become a painful distraction from the business of the acquiring company. After its 2016 acquisition of Dollar Shave Club, Unilever struggled to expand the brand and overcome its high customer acquisition costs. And even the customers that DTC brands already have aren't guaranteed to stay. ModCloth was supposed to bring younger demographics to Walmart, but the deal turned off customers[3] who liked ModCloth's unique, independent positioning. Walmart sold the company in 2019, just two years after purchasing it.

So, if you're in the market for a high-growth DTC business, how can you improve your chances of picking a winner? Here are six considerations for your due diligence:

1. **Align your investment criteria to your goals.** Before doing too much work, align on what the strategic goals are for the potential acquisition, whether it's to reach a new consumer base, access data, jump-start your digital capabilities or something else. With this in mind, be clear on what you're willing to accept from a profitability perspective (current and future) and how much you're willing to pay to achieve your aims. Depending on your goals,

consider how a DTC acquisition compares with an organic pathway and other alternatives, like acquiring a pure-play technology company that has the capabilities you're looking for.

2. **Evaluate the target company's profitability and the quality of its customer base.** By analyzing the expansive data set[4] a DTC business has on its customers, you can find out where its margins are headed. Many DTC businesses aren't in the black yet, and that may be OK. But customer acquisition costs, retention and order volumes are critical to profitability in the long term. Any negative trends in these metrics could signal an issue with the business proposition and long-term sustainability.

3. **Understand brand value.** Does the brand have authenticity? Is the product a good one that consumers want to buy? Does it stand out from similar DTC and established brands? Are there any reputational risks? You'll want a brand that stands the test of time while avoiding any consumer backlash associated with a corporate acquisition.

4. **Model synergies into your offer.** Synergies between businesses will likely be your advantage over financial investors competing for the same deal. Many synergies will be revenue based, using the new customer audience (and the data you have on them) to cross-sell and expand share of wallet. This may be especially true when you're looking to deepen customer relationships with your existing customers through an acquisition or acquiring a new customer base. There may be some cost synergies too, especially for DTC brands relying on contract manufacturers for small-run orders. And shared services could help any acquired DTC reduce its costs. Take these into account to develop a competitive offer but be sure to risk-weight synergies, as they aren't guaranteed.

5. **Assess how operating models align.** DTCs are often more nimble, innovative, willing to take risks and focused on growth versus the bottom line. These cultural dynamics will influence the people they hire, the processes they have and how they structure their organization. Understanding which of these elements are key to success for the target company should play into your acquisition decision, including whether to fully integrate them or let them operate independently.

6. **Consider team retention lock-ins.** Certain people may be critical for the continued growth and culture of the DTC business. If that turns out to be the case — or if you're buying the business for its talent — find out their intentions and what it would take to keep them on board once the deal has closed.

Set your deal-making up for success

M&A transactions involving DTC companies and brands with material online sales hit a four-year high in 2021. Corporates are leading the way, having recognized the value of these businesses as a way to evolve alongside changing consumer behavior.

But success isn't guaranteed, and DTC businesses have a particular set of challenges that can make it hard for them to become or remain profitable. By making sure you are clear-eyed on the goals of the acquisition and carefully considering the pitfalls, you can increase your chances of a value-creating acquisition.

For more information, please contact strategy@lek.com.

Endnotes

[1]Insider Intelligence Inc. 2022, "How Established Brands and DNVBs Achieve Sustainable Growth with Direct Sales Strategies." https://www.emarketer.com/content/d2c-brands-2022

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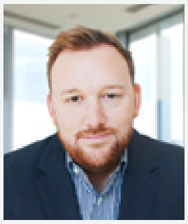

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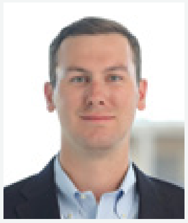

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