EXECUTIVE INSIGHTS

Customer Data Diligence Is Becoming Table Stakes for Consumer M&A

After the COVID-19 pandemic accelerated the trend of direct customer engagement, direct-to-consumer (DTC) and digitally native businesses became hot commodities. Corporations are now looking to buy them to widen their consumer audience, deepen their customer relationships, inorganically expand their DTC/ecommerce presence or simply to acquire DTC capabilities. Financial investors, meanwhile, have noted the incredible growth trajectory of certain DTC/digitally native businesses, as they've generated excellent returns both on the private and the public market, by way of numerous initial public offerings (IPOs).

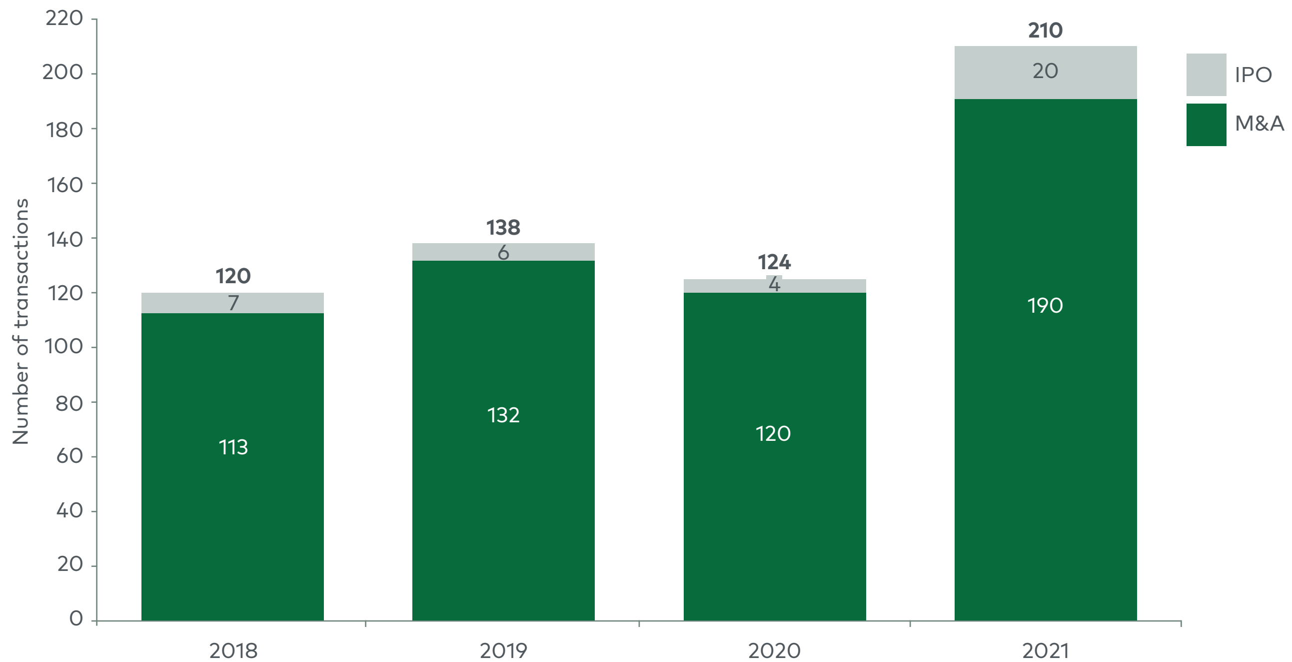
But not all DTC businesses are created equal. Many struggle with profitability. And so as costs — notably customer acquisition cost (CAC) — continue to rise, assessing each business's ability to increase the value of its existing customer base is imperative. Thankfully, they have customer data — a lot of customer data — which is a veritable gold mine of information. In this *Executive Insights*, we examine how leveraging that data is now a core step in the diligence process for anyone looking to make a successful acquisition in this space.

A surge of DTC deals

The number of M&A transactions and IPOs of DTC businesses has been climbing in recent years. In 2021, there were 190 M&A transactions of DTC companies and brands with material online sales, the highest level since 2018. Meanwhile, the number of public debuts in the space has skyrocketed, climbing to 20 in 2021 alone (see Figure 1).

Figure 1

IPOs and M&A transactions over time, DTC and brands with material ecommerce or DTC sales (2018-2021)



Source: S&P Capital IQ; L.E.K. interviews, research and analysis

DTC ecommerce sales are surging as well, rising 15.9% in 2021, reaching $129.3 billion, and are forecast to reach $174.9 billion in 2023 according to eMarketer.[1] And that number is expected to grow steadily over the next few years as more ecommerce brands adopt the DTC model.

But just because a business uses the DTC model doesn't mean it's a great investment. Some DTC businesses, particularly early-stage businesses, manage for growth over profit, which may not be aligned with an investor's objectives — think Allbirds, hims & hers and Stitch Fix, which continue to favor topline growth at the expense of worsening profitability. But corporate or private equity investors are ultimately looking for accretive profit in addition to growth, and there is always a very real risk that a DTC brand may not ever become profitable. For a corporate investor whose strategic growth investment becomes increasingly margin dilutive or, worse, a distraction from the growth of the core business, such an investment can be a disaster. A financial investor is equally unlikely to continue to fund unprofitable growth.

The culprit driving poor profitability is typically CAC. The increasing cost of digital marketing via social media combined with the ever-growing loss of customer data transparency (e.g., with iOS 14/15) means it is becoming harder to find DTC businesses that can turn the profitability corner, and buying new customers as a way to scale is becoming price prohibitive (see Figure 2).

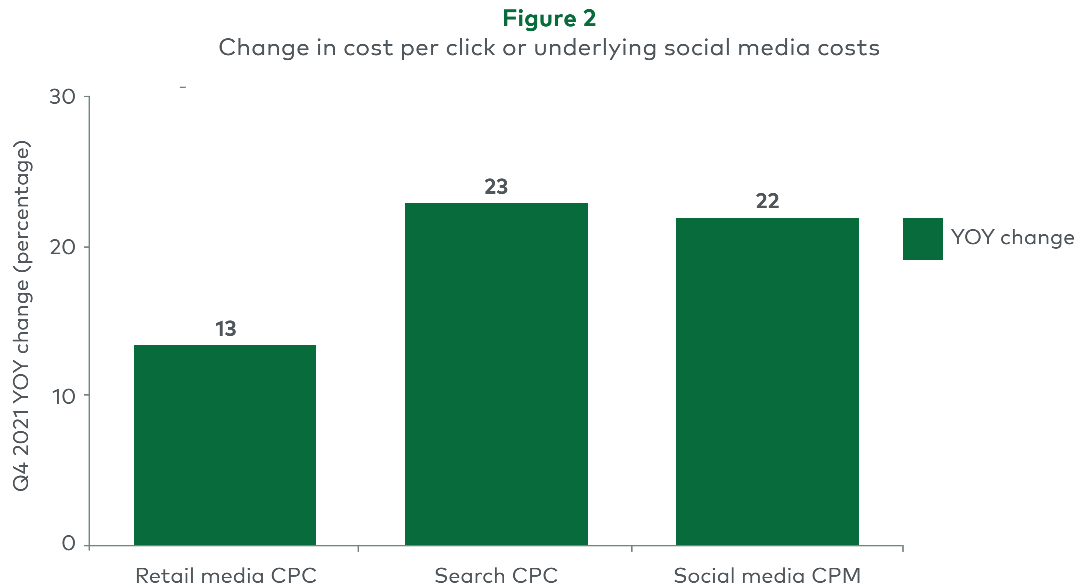


Figure 2
Change in cost per click or underlying social media costs

Source: SKAI

"As the world has moved online and as commerce has had its second renaissance, the side effect is that customer acquisition costs have risen to enormous levels," notes Carl Rivera, VP of Shop at Shopify.[2] "The clear solution for brands is to increase their repeat rates and increase customer lifetime value." They must focus, in other words, on driving longer-term customer value to offset the higher acquisition costs and grow profitably.

The illuminating power of customer data

Assessing a business's ability to increase the value of its customer base is imperative. Thankfully, DTC companies have a proliferation of customer data. By conducting a detailed assessment of a DTC business's customer base along with its economics and dynamics, investors are able to accurately assess whether it has a solid proposition that consumers buy into and will remain loyal to and that can continue to attract new customers, which are as valuable — if not more — than prior cohorts. Such assessments can also shed light on growth opportunities that will improve average customer value (e.g., customer segmentation by value, which highlights the more valuable customer types the business should be targeting, changing the mix away from those that are less valuable).

Customer analytics during the diligence process is becoming more common not only for DTC companies but also for general subscription businesses, businesses with loyalty data, B2B businesses with a large volume of customers and even traditional wholesale-focused businesses that have been expanding into DTC in a material way. Sellers are increasingly either offering up access to full transaction files unprompted or in response to buyers (or their advisors) requesting access to them.

What investors should be looking at

As ever with diligence, assessing the health of the underlying business — including keeping an eye out for any red flags — while also looking for growth opportunities is key. To accomplish both, investors should be digging into the data and asking questions about the following key metrics of customer value:

Retention:

- What is the level of customer retention, and has it been increasing or decreasing over time?
- How many one-and-done customers does the business have, and is there a risk that it will work through its entire target audience in the near term?
- How big a loyalist base is the business building?
- Have any changes to the business (e.g., new product launches) had an impact — be it positive or negative — on customer retention?

Average order value (AOV):

- Has the business maintained or increased AOV?
- Has it been successfully increasing its basket size and cross-selling new products?
- What is the potential for it to increase AOV through new product launches and additional cross-selling?

Order volume:

- Has the customer base been increasing its number of orders per year?
- How might (or has) a subscription model or new product launch increase(d) order volume and in the process, improve(d) retention?

However, while assessing these metrics over time will provide a picture of a business's overall health, to make that picture even more complete, investors should also be applying them to the following areas:

Business segments. Different parts of the business, such as different brands or geographies, may have different stories attached to them, which can help make clear which parts to prioritize — or deprioritize — for growth.

Cohorts. Analyzing these metrics across cohorts (e.g., the number of new customers in each subsequent year) can cast light on the changing quality of newly acquired customers. For example, it can make clear whether the customers acquired during COVID-19 were of low quality given how much more time consumers were spending shopping from home and seeing ads on social media, or whether the business's current target pool is running out of high-quality consumers.

Customer segments. It is frequently possible to segment a business's customer base to isolate the more valuable customer segments, which can then be translated into a more targeted customer acquisition strategy. It may also bring to light any customer satisfaction issues related to certain products (e.g., products targeting consumers with certain types of skin or hair needs).

Analyzing these metrics will enable investors to better evaluate whether management's revenue projections make sense by applying forward modeling to the trends seen in the data. Doing so often reveals that revenue will in fact fall far short of those projections unless the business can acquire and retain a significantly higher number of new customers than management's current model lays out.

Assessing the cost of acquiring new customers

Understanding how the value of a business's existing customers is trending is imperative, but more information is needed, as increasing the value of a business's customers may not be enough to offset what it will cost that business to acquire new customers. That's why it's equally important to understand the ratio of customer value to customer acquisition cost and how that metric has been trending.

This is where the biggest red flags will often appear, such as CAC that is spiraling out of control due to the startup pumping money into increasingly expensive social media campaigns in an effort to "blitzscale," despite having little to no understanding of its audience. Moreover, understanding why a startup's CAC is growing can shine a light on value creation drivers, among them improving website design to increase conversion rates, changing the digital marketing mix and implementing organic targeting campaigns to increase the number of lower-cost-to-acquire referrals/organic customers.

What good looks like

Benchmarks in this space can be misleading. Retention can be impacted by subscription models or initial promotions such as "first month free." AOV depends on the average ticket size and portfolio of products available, whereas order volume depends on usage — people buy mattresses much less frequently than they do food, for example. And CAC depends not only on a business's ability to acquire customers organically instead of paying for them but also on where in its life stage that business is.

So while looking at benchmarks is important, investors should do so cautiously. The only real indicator of a business's future success is the improvements it's making and its ability to cover rising CAC with improving lifetime value.

The data doesn't lie

DTC/digitally native businesses have an abundance of first-party customer data at their fingertips. Investors need to make analyzing it a core step in their diligence process — or risk jeopardizing their returns down the road.

They should start by recognizing whether the investment they're considering has a fragmented customer/consumer base and captures that data — especially if it is a material part of the business. If so, they should request the transaction file during the diligence process. Once they have the data, they should look for any red flags by examining the trends that are creating customer value, as well as any that are impacting the cost of acquiring those customers in the first place. But investors should also keep in mind that most DTC businesses typically expand into other channels (e.g., brick-and-mortar wholesale, stand-alone stores, Amazon/third-party marketplaces) in order to increase brand awareness, reduce CAC and grow profitably, so looking at the performance across a business's channel mix holistically is still important.

The adoption and expansion of DTC channels are exciting growth drivers for many businesses today; however, such channels come with inherent risks and uncertainties. Investors should never be afraid to walk away from a deal that won't meet their profitability targets. Fortunately, such businesses also have an inherent asset that can help investors assess the true potential of these opportunities: their data.

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

Endnotes

[1]eMarketer.com, "What you can learn from disruptive D2C brands."
https://www.emarketer.com/content/what-you-learn-disruptive-d2c-brands

[2]Shopify.com, "Your roadmap to the future of commerce."
https://www.shopify.com/research/future-of-commerce

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