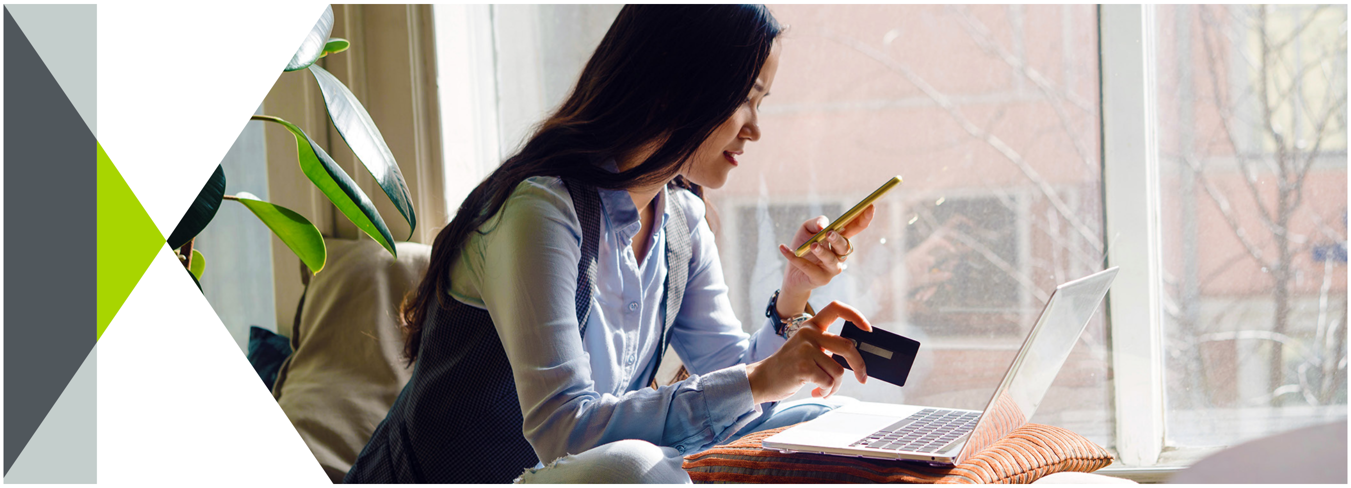


EXECUTIVE INSIGHTS

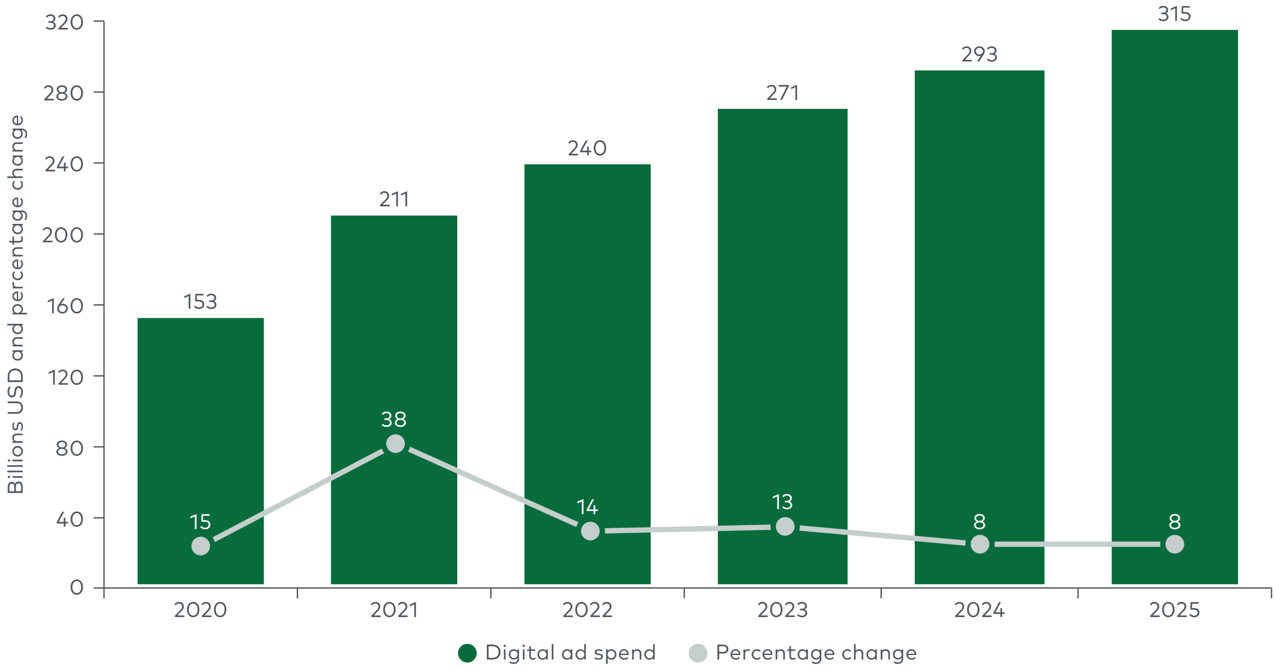
Fighting Rising Direct-to-Consumer Customer Acquisition Costs

It's a tough time for direct-to-consumer (DTC) businesses. Companies are experiencing spiraling customer acquisition costs (CACs) amid broader economic challenges, including inflation, higher supply chain costs and widespread fulfillment disruptions. Simply throwing money at digital marketing to quickly expand the customer base — regardless of profitability — has become prohibitively expensive. Instead, DTC businesses are looking for better ways to manage their CACs. In this first of our two-part series, we look at the challenges facing DTC businesses and how they can overcome them.

CACs are on an upward trajectory for two main reasons. First, as DTC businesses compete for consumer eyeballs, demand for online advertising has grown, driving up the cost. By Q4 2021, social media cost per thousand advertisement impressions (CPMs) and search cost per click (CPC) rose 22% and 23% respectively year on year, according to data from SKAI,[1] although prices had tempered slightly going into Q2 2022. Digital ad spend is expected to continue its growth trajectory for at least the next several years (see Figure 1).

The second contributor to higher CACs is new privacy restrictions, largely prompted by the European General Data Protection Regulation (GDPR). For example, Apple launched Apple App Tracking Transparency (ATT) in April 2021 as part of its iOS 14.5 update, and consumers must now actively opt in to allow apps to track them across apps and websites owned by other companies. With 57% of all U.S. mobiles using Apple iOS systems, the impact of this change cannot be underestimated. According to Adjust, only about 25% of consumers are opting in to allowing apps to track their wider activity.

Figure 1
US digital ad spending, 2020-2025



Source: eMarketer

The effect on the digital marketing industry has been massive. Advertisers in apps such as Facebook are no longer able to track consumers' digital pixels to see where else they have been browsing, limiting their ability to serve consumers targeted advertising. Click-through conversion rates have plummeted as a result. Things are only going to get worse with the looming Google "cookiepocalypse" — Google's sunsetting of third-party cookies. While this move was originally scheduled for 2022, Google has pushed out implementation until 2024 and is undertaking measures to work with marketers to manage the transition via its Privacy Sandbox.

Given all these developments, what can DTC businesses do to acquire new customers at a reasonable cost? To be sure, you will want to keep up with all the changes occurring across various channels and also work with agencies to enable better benchmarking and sharing of best practices. But don't wait passively for changes to take effect — focus on things you can control.

While there is no silver bullet, L.E.K. Consulting has worked with a large number of DTC companies to tackle rising CACs in different ways. We have summarized these approaches in an overarching framework (see Figure 2). While these are all things that DTC companies should be doing anyway, the rising cost environment makes them more critical than ever.

Figure 2

Six areas to drive improvement in CAC

Optimize and measure "paid for" clicks			Generate organic leads		Bring it home
1 Diversify data sources and leverage first-party data	**2 Diversify marketing channels**	**3 Take a holistic approach to marketing analytics**	**4 Diversify sales channels — move to omnichannel**	**5 Increase organic traffic**	**6 Improve on-site conversion**
• Collect a range of first-party data points: - Collect emails in initial clicks for retargeting and collate with 3P data - Collect other identifiers to drive personalization - Leverage existing customer 1P data (e.g., geotargeting, lookalikes) • Explore other data sources/ solutions (e.g., clickstream data) • Invest in a CDP	• Explore and grow other channels (e.g., TikTok, YouTube influencers, CTV, email, SMS, affiliates) • Consider top of funnel marketing (e.g., Pinterest, OOH) • Consider bottom of funnel marketing (e.g., marketplaces/ Amazon) if omnichannel	• Restructure marketing team to move away from siloed channel management • Define consistent metrics to measure ad-spend ROI across platforms • Improve CDP capabilities to track and measure across all platforms to give 360° view • Constant A/B testing of content and platforms	• Assess expansion into new channels (e.g., retail partnerships, brick and mortar, marketplaces/ Amazon) to drive scale and brand awareness	• Focus on customer referral programs • Invest in brand advertising and engagement content and consistent brand experience across platforms	• Analyze key drop-off points • Offer table-stakes options (e.g., immediate shipping options, buy now pay later) • Optimize experience (e.g., clicks to purchase, reviews/ testimonials)

Note: 1P=first-party; 3P=third-party; CTV=connected TV; SMS=short message service; OOH=out of home; CDP=customer data platform; ROI=return on investment

1. Diversify data sources and leverage first-party data

With the gradual demise of third-party cookies and tracking, first-party data has never been so valuable. Most businesses don't even collect the data they are able to, and those that do often fail to use it to their best advantage. The ability to collect at least one identifier — preferably an email or phone number — can allow you to retarget visitors via email or text. You can also buy information about that customer so you can better target ads to them. Sign-up incentives are a sure way to do this, and many DTC businesses (e.g., Blue Apron, Goop, Everlane, Allbirds) employ this tactic.

Other businesses gather even more data via sign-up surveys. For example, Curology and Function of Beauty ask consumers detailed questions about their skin and hair respectively to personalize solutions based on their responses. Survey data allows you to build models that can help you understand which consumers are most likely to be upsold which products, which are likely to churn fastest and have lower lifetime value (LTV), and which tactics work best to retain them. Loyalty programs are also an excellent and low-cost way to gather data, track customer activity and target reactivations.

Once you have a deep understanding of your customers through both first- and third-party data, you can craft detailed customer segmentations or buyer personas based on behavioral and psychographic data. This allows you to optimize targeting (e.g., content types, offers, channels), increase engagement, and keep customers around longer, ultimately lowering CACs and increasing LTV.

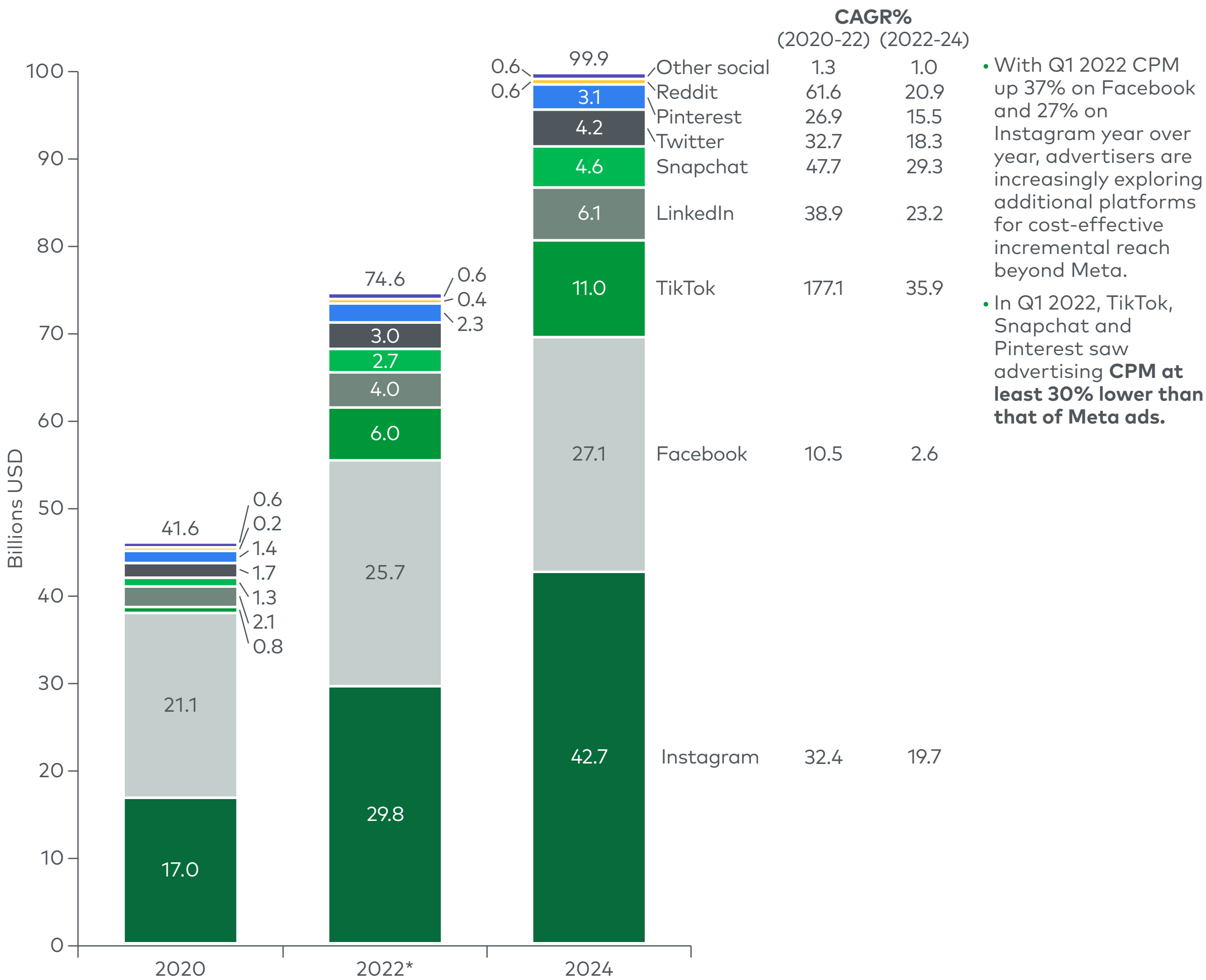
Customer data platforms (CDPs) have an increasingly important role to play as well. CDPs aggregate data across sources and inputs — both first-party and third-party — to build a 360-degree profile of each customer. These unique customer profiles are shared across other tools, such as the CRM and marketing automation platforms, to enhance the personalization and delivery of marketing messages. With each engagement, interactions can be mapped back to the unique customer profile, enriching it further and allowing even more targeted (and retargeted) communications, which ultimately increases conversion and retention.

2. Diversify marketing channels

Ad-channel diversification is one of the primary strategies DTC companies have been using to address CAC inflation. Brands across the board are shifting spend mix away from Meta platforms — probably the player that has been hardest hit by privacy restrictions, given its mobile focus — and trying newer sources with lower CPMs. Some are focusing on more top-of-funnel advertising such as out-of-home (OOH) ads (for example, Away's investment in billboards) and Pinterest. Most are moving to different social channels such as TikTok and YouTube. Indeed, TikTok is expected to benefit the most, and the platform is quickly increasing its ability to support third-party ads in response to demand. eMarketer expects TikTok's ad revenues to grow at 36% p.a. from 2022 to 2024 while Facebook shrinks to just 2.6% p.a. growth (see Figure 3).

While diversifying campaigns across channels and adding new channels to the mix broaden marketers' reach, they also add complexity to campaign design and execution. Marketing automation platforms can help streamline the underlying tasks and workflows that create this complexity. You can also identify, track and engage individual buyers; prioritize leads based on purchase intent; automatically execute multichannel outreach; and measure revenue contribution from each campaign. This allows you to scale your campaigns, reach customers more effectively and improve ROI.

Figure 3
US ad revenues of select social media platforms



*2022 forecast as of March, 2022
Note: CPM=cost per thousand impressions; CAGR=compound annual growth rate
Source: eMarketer

3. Take a holistic approach to marketing analytics

Marketing teams often live in silos, focused on their individual campaigns and budget allocations, but it is imperative for the broader organization to have a complete understanding of the effectiveness of their marketing channels and the acquisition costs across each channel relied upon. Increasingly, more mature DTC businesses are moving their teams away from siloed channel management and managing their digital marketing channels (and team structure) holistically.

Tracking relative performance across digital marketing platforms is notoriously difficult given the different data sets and metrics reported by each. Consequently, more and more DTC businesses are investing in tools to help monitor ROI across platforms in order to better judge where to direct spending. CDPs are also becoming more important for managing disparate data and channels. This also allows the team to react with flexible budget allocations versus preallocating the budget to individual channels.

4. Diversify sales channels — move to omnichannel

Very few brands are still pure-play DTC, and moving into omnichannel can be an extremely attractive way of increasing brand awareness and quickly ramping up sales, albeit at the expense of direct customer relationships and first-party data collection. Countless DTC brands — Soylent, Aloha, Belgium Boys, Ministry of Supply and more — have moved onto Amazon. Others, such as Fly by Jing, are fast-forwarding their in-store grocery rollouts. Big box retail has also been a way to propel a brand's growth — a strategy adopted by several DTC businesses in the beauty space (Dr. Squatch in Walmart and Function of Beauty in Target to name just two).

5. Increase organic traffic

Maximizing the share of consumers through "free" or lower-cost channels such as referrals or affiliate links can have significant impact on a company's blended CAC. While this isn't easy, there are many examples of brands that have done it successfully using a handful of strategies:

- **Referrals:** Native is a natural deodorant brand that has had considerable success with a referral program in which both the referrer and referee receive a free mini deodorant. Their testing showed that free product samples were more effective at generating referrals (and impacted profitability less) than "give $xm get $x" offers. But others have reported success with this monetary incentive scheme, and many brands, such as LOLA, Dr. Squatch and others, follow this tactic.
- **Influencers:** While this is a well-trodden path, finding an authentic influencer can lead to a significant uplift in sales. Curology launched a YouTube video with Emma Chamberlain in May 2018 that generated over 2 million views, mainly due to the fact that she was a genuine user and the campaign was authentic. Creator management platforms can help identify relevant influencers for a brand, engage them on campaigns, track the performance and manage the workflows to build credibility among the target audiences.
- **Focusing on content:** Consumers are overloaded with social media, so having content that stands out is crucial. When your content goes viral, it's an added bonus; to increase your

chances, make sure you have an angle — whether it's humor, authenticity or simply standing out. Leaders like Dollar Shave Club and growth brands such as Truff and others have continued to invest in unique, funny and compelling content on their own social platform pages to create brand recognition and word of mouth.

- **Finding the right partnerships:** Partnerships are also a means of generating brand awareness. For example, Bombas socks teamed with Sesame Street for exclusive product releases. As a B Corp, Aloha partnered with Conscious Alliance and worked with Chicago schools. Many food brands partner with celebrity chefs. The key here is making sure the partners you select are a good fit for your brand message.

Other tactics include affiliate links/PR links (e.g., Vogue published an article about Away's initial product when it first came out in 2017), online blogs, and pop-up events and samples (e.g., Dollar Shave Club created a retail pop-up inside Neighborhood Goods).

6. Improve on-site conversion

A lot of traffic can drop by the wayside if your website does not offer a great shopping experience. Areas for improvement can be identified by analyzing drop rates at each point of the exploration and purchase journey. Making those improvements can yield dramatic results: One DTC business in the protein bar space saw an eightfold increase in conversion when they revamped their website.

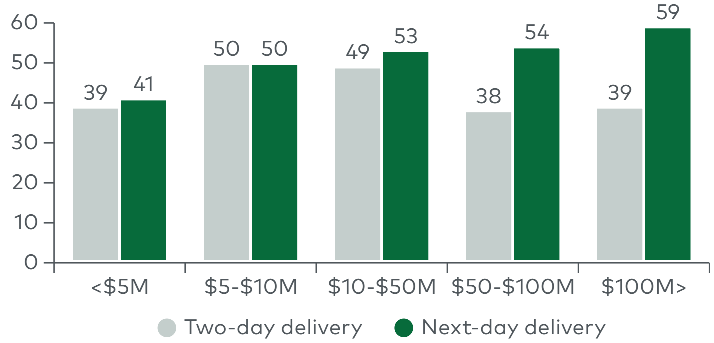
Following the consumer through the purchase journey can also contribute to conversion. Enabling landing pages specific to the ads they clicked through helps maintain a consistent customer experience and also gives you more tracking data. You can go a step further by incorporating personalized digital experiences using a digital experience platform (DXP) — typically a suite of complementary modules that help marketers create, manage and deliver targeted content at scale to optimize the entire digital experience. A DXP will also allow you to experiment with personalized content and use the resulting data insights to improve the customer experience.

Another factor that boosts conversion is the availability of fast or free shipping, something that has increasingly become table stakes in the DTC world, despite the cost (see Figure 4). Consumers often expect free shipping and can be turned off without it, even for high-ticket purchases. Offering free shipping with a spend threshold can help increase average order value (AOV) and product trial, which can in turn raise customer lifetime value.

Figure 4
Factors affecting on-site conversion

Examples of factors impacting website conversion rates

Penetration of shipping speeds by size of business
Percentage of businesses with shipping offers within each annual GMV* range



- Eighty percent of U.S. consumers give etailers that offer free shipping a clear advantage over competitors.
- For smaller DTCs (i.e., <$5M GMV), 41% now offer next-day delivery, up from 26% in 2019.

*GMV=gross merchandise value on the DTC brands' own websites
Source: PipeCandy, "The State of the Direct-to-Consumer Industry 2022." Econsultancy shipping times are not mutually exclusive.

Beyond CAC: Maximizing lifetime customer value

Managing CAC is clearly essential to DTC businesses, particularly in today's challenging economic climate. But it's not the whole story. An even more effective route to profitability is optimizing lifetime customer value: finding ways to retain customers once you've acquired them and getting them to spend more on products and services. Companies can improve retention through personalization, subscriptions, feedback emails, samples or reactivation strategies. They can increase AOV through product expansion, bundling offers, shipping minimums, pricing optimization, limited-release products or other strategies. Many of these approaches rely on gathering and optimizing first-party data through customer segmentation. In our next article, we'll focus on tactics for minimizing customer churn and successful upselling.

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

Endnote

[1]SKAI, "Digital Marketing Quarterly Trends Report Q2 2022." https://skai.io/wp-content/uploads/2022/08/2022-Q2-Skai-QTR-Summary-Report.pdf

About the Authors

Claire Davies
Claire Davies is a Managing Director in L.E.K. Consulting's Los Angeles office, in the Retail and Consumer practice. Claire has deep expertise in leading corporate and business unit growth strategy and commercial due diligence projects for private equity investors, retailers and consumer brands. She has experience across many retail and consumer sectors, including ecommerce, direct-to-consumer, subscription businesses and more.

Stephen Matthews
Stephen Matthews is a Managing Director in L.E.K. Consulting's Los Angeles office and a member of the Technology, Media and Entertainment (TMT) practice. Stephen advises clients on a range of issues related to strategy development, customer segmentation, diversification, pricing, go-to-market approaches and M&A. Stephen has substantial experience assessing and evaluating addressable markets, generating growth forecasts and strategies, and providing sales expertise for clients across the industry.

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