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Are You Doing Direct-to-Consumer All Wrong?

Here's How to Fix It

RaboResearch
Food & Agribusiness
far.rabobank.com

Bourcard Nesin
Analyst – Beverages
+1 207 290 0835

Contents

Summary

Beverage companies are changing how they approach their online direct-to-consumer business (DTC). In the past, most multinationals invested in DTC hoping to unlock a scalable, high-margin sales channel but instead found failure and frustration.

Despite their struggles in the past, brands have to rethink and reinvest in the DTC channel. Instead of trying to build a large, margin-accretive DTC business, large food and beverage companies should use the channel to build a robust ecosystem for gathering consumer insights and testing new ideas that can be used to improve efficiency and spur innovation across their organization.

With the potential to revolutionize the brand development pipeline, improve customer segmentation, and drive the efficiency and efficacy of marketing campaigns, a DTC program optimized for insights offers more benefits and far less risk of a billion-dollar mistake than the past approach to the channel as a scalable sales channel.

Why (Almost) Everyone Failed the First Time

In the past, many large beverage companies – and CPG companies more generally – invested in the DTC channel, with scalability and profitability as the primary goals. Last year, Procter & Gamble CEO, David Taylor, who has seen the company acquire multiple DTC brands during his tenure, told the Wall Street Journal, "There are many, many launches that grow fast, and people call them successes because they grow fast. We're in the world of having to create value, not just grow. A business model that makes money is a higher challenge." Here is why that was likely the wrong approach.

"CPG and FMCG companies are traditionally optimized for brand-building, product innovation, and large-scale wholesaler/retailer sales and distribution. DTC is a completely different kind of business, requiring significant upfront investment, new types of talent, resources, and technology."

- Wayne Blum, Director, US E-Commerce Strategy, Diageo

Scalability is the core challenge large food and beverage companies face when trying to develop a digital DTC business.[1] First, e-commerce penetration is very low for food and beverage products in general, so this immediately and dramatically narrows the total addressable market of the offering. Even the most tech-savvy consumers, however, can't really be bothered to shop on a company website offering only a few widely distributed brands. They don't want to buy ordinary potato chips, dish soap, soda, and beer from separate websites, each requiring separate accounts, checkouts, shipping charges, and deliveries. Consumers would much rather just go to the supermarket. Thus, companies that want to scale their DTC business have to spend loads of cash on advertising and incentives to attract consumers to their platform. The population of easy-to-convert consumers that respond to such incentives tend to be more opportunistic than brand loyal, leading to a dramatic drop in active users once those margin-busting incentives (30-day trial, etc.) disappear. These customer-acquisition costs (CAC) – combined with fulfillment costs and low barriers to entry that lead to fierce, unrelenting competition – ensure that, regardless of scale, purely digital DTC businesses will struggle to make a profit.

Some Tactics Work Better Than Others, Even if the Strategy Is Flawed

Obviously, some products and offerings have performed better than others in the DTC channel.[2] Premium products and bulk packaging can improve unit economics and unique offerings (i.e. exclusive access to early launches or brands with limited retail distribution) and generate more demand (and thus have a lower CAC) than widely distributed brands. While an exclusive launch is a great way to generate excitement and buzz around a brand, it is not, by design, a scalable sales channel.

That said, beverage companies don't have to reinvent the wheel in order to launch a successful, modern DTC program.[3] Most of the challenges they face won't be fixed with a more powerful AI engine or a high-tech e-commerce platform. In the end, the problem isn't the DTC platform itself (or its offerings) but how companies use the platform and their expectations for growth, scale, and profitability.

A Total Mindset Shift: Approaching DTC as an Insights Platform, Not a Scalable Sales Channel

If DTC sales are neither particularly profitable nor scalable, why are some companies doubling down on their DTC investments? It comes down to a mindset shift. Rather than approach it as a stand-alone business, food and beverage companies need to build DTC platforms that are optimized for testing new-to-world innovation and collecting first-party data that can be utilized in their much more scalable (and ultimately more profitable) traditional routes to market.

Case Study: PepsiCo's DTC Data Play

PepsiCo's recent launch of Snacks.com and PantryShop.com offers a great, real-world example of this mindset shift. The company's new DTC offerings are basically online stores populated with a few familiar brands sold in bulk or in curated bundles. This rather mundane offering will never attract a huge audience, but then again, it was never meant to. "Retail is obviously our primary way in which consumers will experience our brands and purchase our brands, and we don't expect that to change at all," PepsiCo's then head of e-commerce told Adweek after the launch in May 2020. The goal is insights, so even 100,000 customers and a few million in revenue go a long way.

PepsiCo leadership clearly states their DTC program is optimized for insights, not scale. This is also reflected in how they set up the platforms. On Snacks.com, the consumer's path to purchase feels more like a survey than a traditional e-commerce shopping experience. For example, in order to find a product on Snacks.com, consumers must choose to shop by "brand," "snack type," "flavor," or "occasion." This is a transparent attempt to better understand the dimensions along which consumers make their purchasing decisions. The learnings have obvious implications for the messaging PepsiCo uses in marketing and on their packaging, as well as the keywords they use for optimizing search results on a third-party website.

"The direct-to-consumer models [sic]…is more of an attempt for us to stay closer to the consumer, read them, understand [their] reaction to early innovation and then obviously take it [that innovation] mainstream."

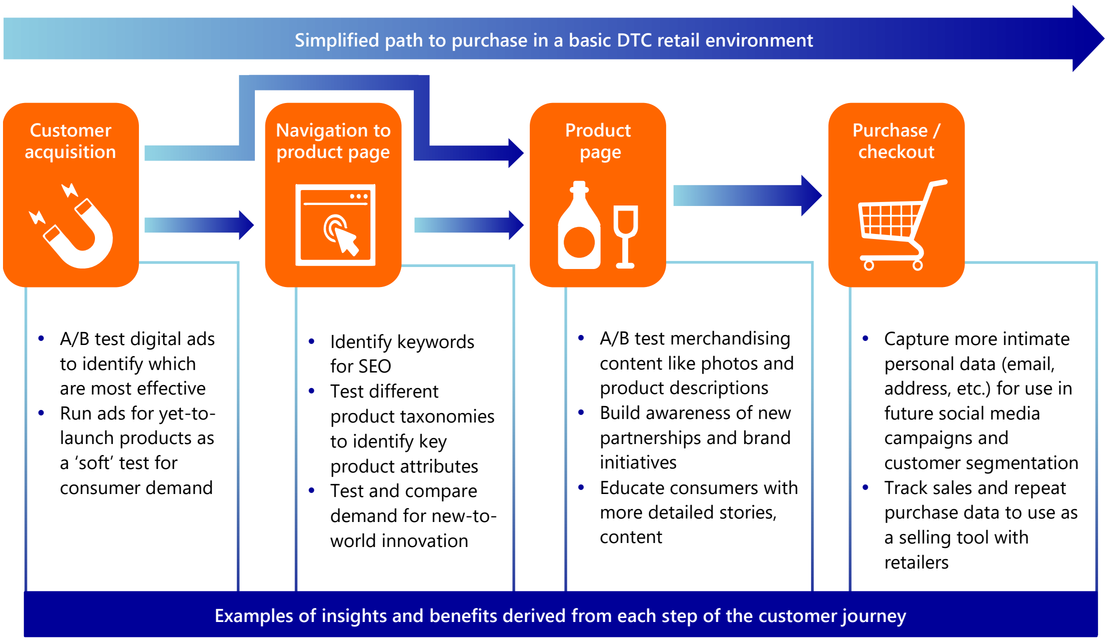
- Ramon Laguarta, PepsiCo CEO

The current form of PepsiCo's DTC offerings is likely still in the pilot stage – I doubt even they would consider a 'bundle' containing 16 bags of apple chips and 40 bags of smart food "early innovation." Their offering will evolve as they bring *real* new-to-world innovations on the platform. One good candidate for the DTC channel is Driftwell, PepsiCo's new functional beverage that focuses on helping consumers "relax and unwind." It is one of their most anticipated new launches in years, and Driftwell represents the CPG giant's first push into a pioneering new category. An early launch into the DTC channel offers an opportunity to hone messaging and marketing and to collect data that will improve the likelihood of success when they launch the product in traditional retail channels.

"The Death of the Focus Group": A Digital Testing Ground

By establishing a direct connection with consumers, CPG companies can essentially create a focus group on steroids, giving brands a place to build their digital muscles and collect personal data from real consumers in real time and at a much larger scale than is possible with a focus group.

Figure 1: A robust DTC program allows brands to collect insights from each step of the customer journey



Source: Rabobank 2020

All these insights can lead to some serious savings. Here is a list (which is by no means exhaustive) of ways brands can improve their core business on the backs of their DTC programs:

- As the Snacks.com example demonstrated, companies can optimize the DTC shopping experience for identifying the hierarchy of attributes that drive demand (i.e. do consumers buy a particular brand of kombucha because it advertises probiotics, because it is low-calorie, or because it has convenient packaging to take on-the-go).
- Brands can use A/B testing on social media to identify which ads drive conversion on their DTC platform before deploying them at scale to drive traffic to traditional and much larger e-commerce outlets.
- The personal data they collect can be linked back to social media (via email) and geography (via delivery address), helping create more accurate and thus more efficient target consumer groups, as well as improve merchandising and activation on a local level.
- Brands can observe how consumers shop on their DTC platform and use those learnings to improve digital merchandising programs, thereby improving conversion across all e-commerce channels.
- Covid-19 has disrupted the traditional model of sampling and trial in the on-premise, something critically important to beverages and beverage alcohol in particular. A DTC program can help build muscles for driving sampling and trial in a digital environment.
- The sales data can be a powerful sales tool with retailers, especially if you can show that there is latent demand from consumers buying that product in their geography or show that the individuals buying the product on the DTC platform are also an important target/block for retail and distribution partners.

The most exciting opportunity, however, is how some DTC models can help revolutionize the product innovation pipeline. Whereas consumers in a focus group express their preferences by checking a box, consumers in the DTC environment express their preference by checking out. *Revealed preference* (i.e. actual purchasing behavior, not *stated preference*) is the best way to measure what consumers actually want and are willing to pay for.

"What is different about this is we're getting data on what people are doing versus what they say they will do. People are voting with their wallet, so we know exactly what resonates."

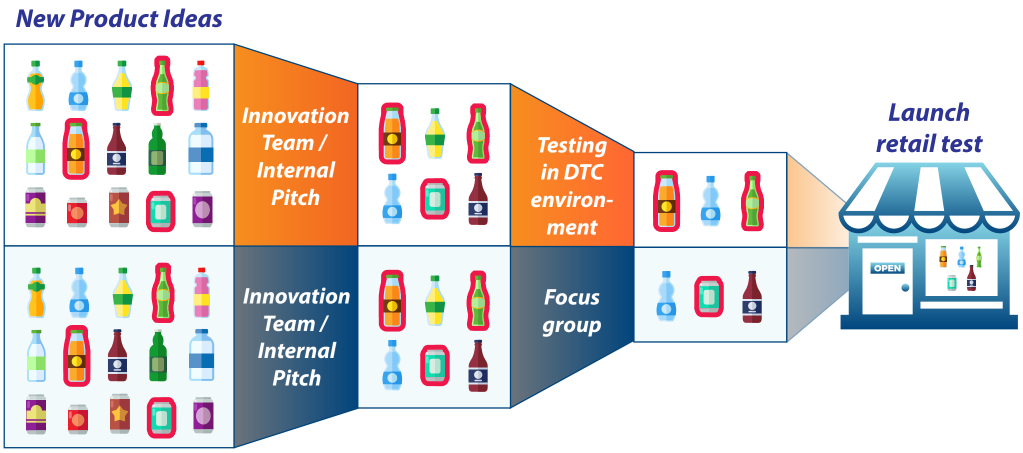
- Gibu Thomas, former Head of E-Commerce, PepsiCo[4]

How DTC Could Revolutionize Brand Development

After developing a new brand or line extension (often via a focus group), brands typically test the product in a limited retail setting, often a regional grocery chain like Harris Teeter. There are a couple of major drawbacks to this process. First, the retailer is only willing to accept two or three brands per year. Second, brands get data on product sales (i.e. velocity), but the data on who is actually buying the product is incredibly expensive and often patchy at best.[5]

This process is slow, forcing companies to commit significant resources to a product that has no proven track record. No doubt this is one reason large companies are famously bad at 'failing small and failing fast.' A failed new brand launch can be very expensive, not to mention embarrassing.

Figure 2: Stages and gates in the brand development pipeline: DTC vs. the old-fashioned way



Products outlined in **red** represent new products that would have commercial success if brought to market at scale.

Source: Rabobank 2020

A DTC platform – especially those focused on sampling and discovery – would conceivably allow brands to launch two or three new products every month, with high visibility into who purchases them and which products keep consumers coming back for more. Testing brands side by side in the DTC environment acts as a filter, similar to a 'stage' in a stage-gate system, that helps companies identify which brands show the most potential and thus should get tested in a traditional retail environment and, hopefully, achieve scale in those traditional channels. We highlight two businesses that have successfully transitioned digital brands into traditional retail below.

The goal is not to guarantee success but dramatically lower the likelihood of failure. If manufacturers only have a few opportunities to test new products in retail every year, isn't it better for real consumers to decide what those new products should be? As one source told Rabobank, "It's basically a sandbox and, done right, is a better R&D lab than what 50 people said in a focus group, and therefore, reduces the probability of expensive failures."

Case Study: How Two Digitally-Native DTC Brands Use Data to Identify Which Products to Launch in Traditional Retail Channels.

NatureBox and Winc are digitally-native DTC companies that primarily run monthly subscription services focused on trying new things. Both companies have developed new products online that were later successfully launched into traditional retail channels.

NatureBox sells curated bundles of organic products to their monthly subscribers, but also allows consumers to buy those same products individually from the website. The monthly bundle allows consumers to sample and discover new products but offers little in the way of data on consumer preferences. If they like a particular product, however, the consumer is likely to buy it separately from the website, which is a super strong indicator of preference.

When someone subscribes to Winc, on the other hand, they buy USD 60 of 'credits' that can be redeemed for four bottles of wine every month. Similar to NatureBox, Winc also allows consumers to buy additional bottles of wine whenever they like.

We highlight both companies to show that slightly different models can deliver similar results. The key is that both platforms have a mechanism for eliciting consumers' revealed preferences alongside an offering centered on fast-cycle, new-to-world innovation (i.e. lots of new products developed really quickly). These two things allow Winc and NatureBox to identify consumer trends and product attributes that determine which products should get thrown in the trash and which products are most likely to outperform in retail distribution.

To quote the CEO and founder of NatureBox on this process: “We really thought about how do we use the online part of our business to generate data and insights about the consumer, and create products … that are proven winners? So we knew from day one that eventually we'd be serving brick-and-mortar stores”

A DTC program with these brand development capabilities that could plug into the retail and distribution power of a large CPG company would be formidable.

Smaller Channel, Smaller Conflict

Even if we resolve the problems of scalability and profitability, there remains one major problem that is bound to arise with a DTC investment: channel conflict.

Companies with enough scale to invest in an e-commerce-focused DTC business are wary of potential conflicts with retailers, bottlers, and, in the case of beverage alcohol, wholesalers. This concern is perfectly valid if brands are developing the DTC channel in order to take margin from other actors in the value chain, but everyone benefits if manufacturers are bringing more innovative products to market and sharing novel insights up and down the value chain.

Even so, brands should not underestimate the power of retailers. As once source told us, “as DTC becomes bigger, bigger conflict!” In the short term, brand manufacturers will have to tread lightly and communicate to retailers and distributors that their DTC business is not a threat, but a support system. As more brands buy into the DTC channel as an insights and brand development engine and as the benefits from the channel start trickling down to other segments of the value chain, we expect everyone will get on board… or at least grow a bit more tolerant.

Moving Your DTC Business to the Next Level and Beyond

The problems of scale and profitability have long dogged large companies’ attempts to develop the DTC channel. These and many other problems are vastly diminished if companies instead approach the DTC business as a platform for insights and innovation. Hopefully, this mindset shift will help companies be open to experimentation. After all, the risk of making a billion-dollar mistake is vastly diminished if the goal was never to create a billion-dollar sales channel.

A robust DTC program has positive externalities, and financially minded leaders must take this into account as they evaluate their investments in the channel. The data collected in the DTC channel is critical to creating more efficient marketing and improving the innovation pipeline. It has value, even if it does not show up directly on the balance sheet.

Ultimately, many companies will have to turn to M&A to develop and execute an effective DTC strategy. Having worked with many of the largest companies in the world on their e-commerce strategy, we feel most companies do not have the internal skills, tools, and focus to do it on their own. An acquisition would offer:

- A ready-built digital audience
- Portfolio of brands, some with potential for scaling through traditional sales channels
- Marketing professionals highly skilled in executing bottom-funnel digital campaigns
- A team that has the technical knowledge and skills needed to operate a business optimized for testing and gathering first-party data, and is able to extract insights from the data they produce.

These are skillsets that all but a few of the largest manufacturers need dearly. The team alone would be transformative.

As a final note, we are not suggesting that companies give up on building scalable and profitable alternative routes to market. New, hybrid models that preserve the close communication with consumers that define the DTC channel but make more full use of a brand's existing distribution and retail infrastructure are very promising. Rabobank analyst, Sudip Sinha, explores one such model in his latest report, "Community Commerce: A New Model for Beverages." It really is a must read.

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[1] DTC sales are not necessarily digital. In fact, a farmers market counts as direct-to-consumer. Nike's store on 5th avenue in New York, NY counts as direct-to-consumer as well. In this report, however, we focus on direct-to-consumer e-commerce. So when we refer to a DTC business, the reader can assume we are referring to a company-run website.

[2] There are, of course, some large brands, like Nespresso and SodaStream, that have managed to build a large and profitable DTC program. And while the strategy and structures that enabled their success are fascinating, they are not always generalizable to other brands and categories. For example, one way many of these brands immediately differ from your typical beverage product is their business model's dependence on equipment and specialized packaging. We will explore what made them successful in a future publication.

[3] In some highly regulated segments, like beer and spirits, brands may need to look toward a hybrid model wherein the brand controls the consumer experience (and collects the data), but fulfillment is executed through established channels. (We discussed how Molson Coors is using Drizly for this purpose in our report, "The 2020 Alcohol E-Commerce Playbook"). This approach limits the channel's usefulness for new brand development (these models rely on product already sitting on retailers' shelves), but can definitely still support the other functions we described above. It is a particularly interesting model for luxury brands looking to leverage exclusivity or limited-edition product drops in the image of Nike and their SNKRS app. This is the model used by LVMH's Clos19, for example. At the very least, it allows brands to monetize traffic to their website.

[4] Quote reported by Adweek.

[5] Loyalty programs offer some insights, but many brand manufacturers complain that retailers are either unwilling to share raw shopper data or charge so much that even the largest companies balk at paying for it.

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RaboResearch
Food & Agribusiness
far.rabobank.com

Bourcard Nesin	Analyst – Beverages	Bourcard.Nesin@rabobank.com +1 207 290 0835