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Enlighten Fashion Brands' Routes to the DTC Model

Building eight pillars to enable DTC transformation for continued growth

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Contents

Foreword

The way people socialize and work has been reshaped due to the epidemic and other uncertainties, leading to dramatic shrinkage of population flow and offline shopping. It brings negative effect to bricks-and-mortar retail industries in terms of consumer flow dropped, offline shopping flumped, and social activities decreased. Thus, unprecedented challenges are presented to fashion brands for business growth, especially in the footwear, apparel, and cosmetics sectors.

Meanwhile, given that China has a vast market and complex distribution systems, traditional players of fashion consumer goods often connect to terminal retailers or final consumers via regional distributors. In the past, this could reduce inventory and capital pressure, as well as the complexity and investment needed for expanding the sales network and managing sales in different regional markets. However, alongside a backdrop of upgraded demand among the main customer segments, intensified industry competition, and digital transformation of the value chain, the drawbacks of relying solely on distributors to reach the market are constantly exposing. Typical challenges include lagging response to market competition and changes in consumption, long process to launch new products, brand damage by hunting short-term yield, inflated terminal prices and imbalance in consumer value perception.

The pandemic has made those worse, but consumers' demands still need to be met, so the click-and-mortar retail model, whereby offline stores serve as warehouses and delivery centres and online ones take orders, has become more popular. Benefiting from this model, some brands are embracing the Direct to Consumer (DTC) model. Strategy& subscribes to the view that, unlike traditional direct retail, DTC connects the brand and consumers directly. By delivering personalized products, services, experiences, communication and value transfer via digital insights on customers, DTC highly facilitates consumers' acquisition and retention, as well as market expansion.

It should be noted that Covid-19 is just one of the factors that make DTC model under heated discussion. Many of China's leading fashion companies had plans for DTC transformation before the pandemic. By analyzing the performance in the past three years (2019-2021) of 19 major DTC fashion brands (including DTC-oriented ones) in China and North America, we spotted an increasing number of Chinese brands achieving high net profit margins while maintaining high revenue growth.

In summary, many fashion companies have encountered unprecedented challenges under the post-pandemic era. Therefore, it is of high significance to dig into the early adopters of the DTC model that have sustained healthy growth. This white paper aims to analyze the key success factors for fashion brands who adopt the DTC model, as well as the five challenges for growth-seeking players. Finally, it proposes eight pillars for DTC transformation to unleash growth potential.

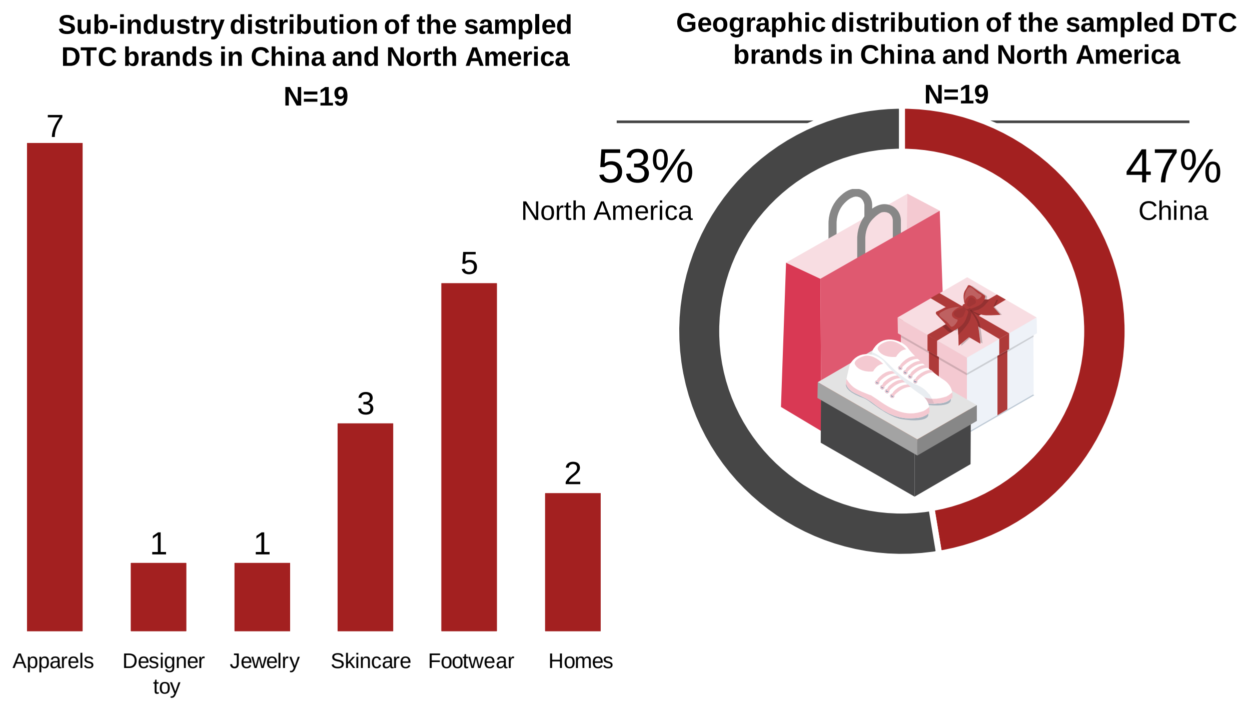
DTC revenue over

60%

> DTC model has developed for a long time in Europe and America fashion industries, while several new DTC brands sprung up recently. Some traditional worldwide brands have announced transformation strategies, striving to boost their DTC revenue to half, or even 60% of the total revenue in the next 3 to 5 years.

Against the backdrop of the pandemic, it is meaningful to analyze how typical DTC brands (including companies for which DTC accounts for the majority of revenue, hereinafter referred to as DTC brands) at home and abroad have performed in the past three years, and summarize the useful experience of outstanding players. This white paper singles out 19 fashion DTC brands, of which 9 are in China and 10 in North America, covering 6 sub-industries, including apparels, footwear, skincare, jewellery and designer toys (see Figure 1).

Figure 1: Sub-Industry and geographic distribution of the sampled DTC fashion brands



Source: Strategy& analysis

The sampled companies have managed to re-construct their relations to consumers as direct connections through digital technology and data insight applications, enabling them to capture users' needs and meet them perfectly, to deliver differentiated consumer experiences. Figure 2 shows the differences between the traditional retail model and DTC models in terms of consumer insights, business model, marketing, and distribution channels.

Figure 2: Traditional model versus emerging DTC model

Traditional Model	Emerging DTC Model
Consumer Insights Ad-hoc research (focus groups, panels, surveys) dominated by third-party agencies	**Consumer Insights** Data-driven, real-time insights about individual consumers through digital technologies
Business model Product, price and promotion determined at a general customer level	**Business model** Product, price and promotion determined at an individual customer level (or micro-segments)
Marketing Online advertisement driven. 'Spray and Pray' model* with no clear approach for customer acquisition, conversion	**Marketing** Marketing across multiple digital media, but increasingly targeted at individual consumers based on insight and preferences
Channels Reliance on retailers to sell products to the consumer. Limited direct interaction with consumers	**Channels** Increasing use of several direct channels – Owned e-commerce, owned physical retail, 1-to-1 social selling, in-store shops

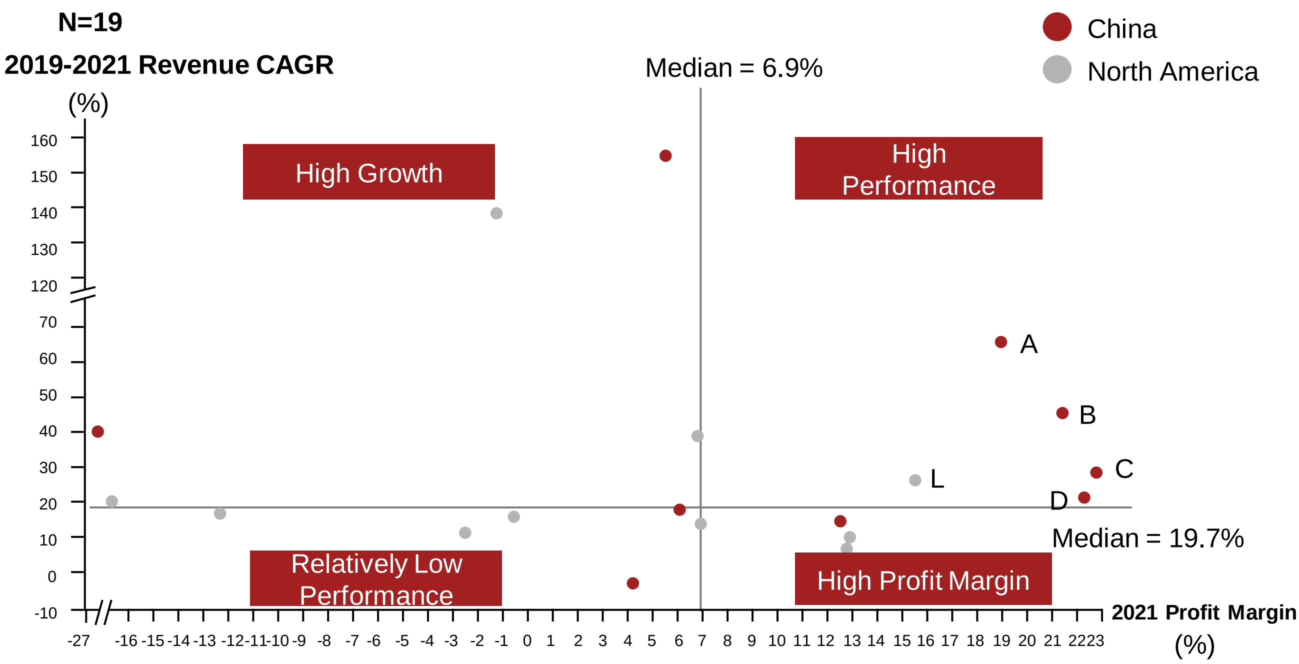
*Note: Spray and Pray here means to randomly send out a large amount of marketing information, praying to get orders.
Source: Strategy& analysis

I. Key success factors for DTC fashion brands to achieve profitable growth

To identify high-performance DTC fashion brands, Strategy& tracked these 19 sampled companies in China and North America in the past three years. We constructed a two-dimension performance matrix with two core indicators, i.e., the Compound Annual Growth Rate of Revenue (CAGR) and the net profit margin (using 2021 figures as a baseline), between 2019 and 2021. Based on the median of the two indicators, the matrix was divided into four quadrants, i.e., high-performance quadrant, high-growth quadrant, high-profit margin quadrant, and relatively low-performance quadrant. As shown in Figure 3, about two-thirds of the samples have sustained both high revenue and positive profitability.

More importantly, within the high-performance quadrant, i.e., the range with revenue growth and profit margin both above the median, China has more companies than North America does (red dots represent Chinese brands, and grey dots represent North American brands). It indicates that during the pandemic in recent years, China has more DTC brands with higher revenue growth and higher profit margin. Now the question is why they stand out.

Figure 3: Revenue growth and profit margin in recent 3 years of the sampled DTC fashion brands* in China and North America



Note: Brands in the above diagram are 19 sampled DTC-oriented brands, which are desensitized as A, B, C, D, L, etc.

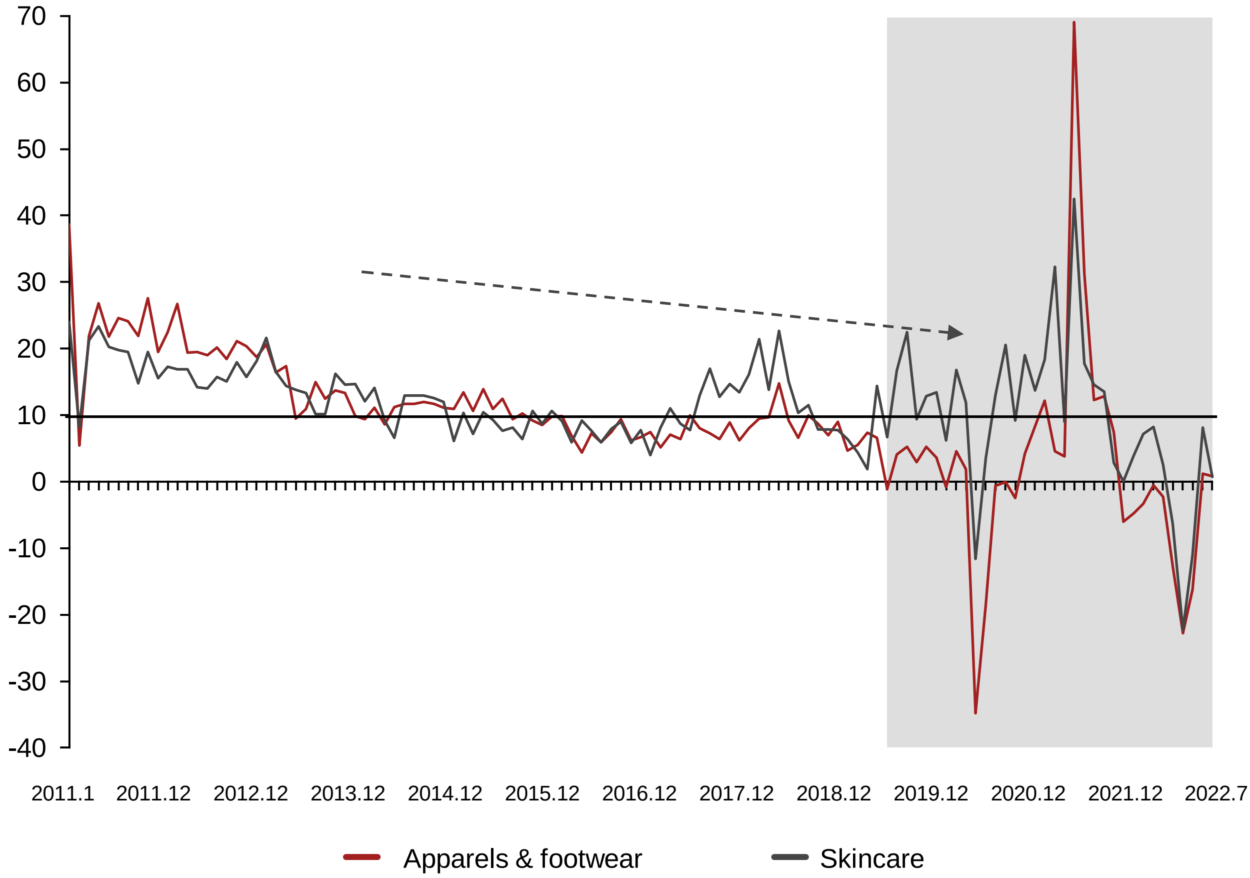
Sources: Annual Reports, Strategy& analysis

It was not easy for the top performers to make achievements in the past three years, as the overall business environment in China was experiencing uncertainties and weak growth. Here, take apparel & footwear sub-industry and the skincare sub-industry as two examples. Since the end of 2019, the two segments had dropped to the bottom of the MoM growth rate at least twice, in January 2020 and February 2022 respectively. But January 2021, the MoM growth rate witnessed a high peak in nearly a decade, quickly rebounding from the first trough with a booster of the recovery of the pandemic. Putting these extremes aside, the two sub-industries endured lower growth during the pandemic, compared with the pre-covid levels (see Figure 4).

Figure 4: Month-to-month sales growth rate of apparels & footwear and skincare in China

2011.1 - 2022.7

MoM Growth Rate (%)



Note: Jan to Feb data for 2012 and subsequent years are not disclosed by the National Bureau of Statistics, thus not included in this figure.

Source: National Bureau of Statistics

In this context, it is even more valuable to further analyse and identify how these outperformers sustained growth. Analyzing the four Chinese DTC brands with excellent performance, and eliminating covid-related factors (such as business disruptions due to social isolation policies, non-habitual buying in e-commence due to blocked shopping in stores and etc.), we summarize three key factors for their success:

01 Offline brand-owned stores guide potential customers to online stores

- Even negatively impacted by COVID-19, both online and offline stores of outperforming DTC players have experienced double-digit growth, whereas online stores have achieved much higher growth.
- Those channels in the DTC model do not operate independently. Offline stores function as experience centers and provide excellent experience, which encourages consumers to share posts on social media for word-of-mouth communication. Then, these user-generated contents (UGC) will guide potential customers to online stores.

02 Repurchase contributes more to the sales growth

- Consumers of outperforming DTC brands are more willing to repurchase.
- High consumer retention rate is not only driven by the superior experience and customer satisfaction from both online and offline brand-owned stores, but also by membership systems and operation targeting existing customers.

03 Product portfolio driven by real-time market insights contributes to balanced sales growth

- High-performance DTC brands have balanced product portfolio, which provides a more obvious long-tail effect in sales.
- Assisted with direct consumer connection, DTC brands can dynamically perceive consumers‘ preferences and feedback, to respond to consumers’ needs, iterate new products, and upgrade existing products at a faster pace.

This white paper will dig deeper into the above three key factors from the perspective of data insights.

1. Offline brand-owned stores guide potential customers to online stores

As shown in Figure 3, four of the nine DTC fashion brands in China are within the high-performance quadrant, and the rest are distributed across the other quadrants. These four companies will be referred to as the “outperformers” (desensitized as A, B, C and D) and the rest as “other companies” (X1, X2, X3, X4 and X5) respectively. In comparison, we track the changes in their revenue CAGR in the recent three years of the DTC channels, including brand-owned stores online and offline. Our analysis shows that, for the four outperformers, both online and offline stores have sustained revenue growth (except for company B, a late adopter of DTC, whose offline stores were under self-adjustment), and online stores have maintained a rate much higher than offline stores does. For the other companies, the revenue growth rate of online and offline stores is different. For example, the offline stores of company X1 record a much higher growth rate than its online stores does.

So, are there synergies between the revenue growth of online and offline brand-owned stores of the outperformers? From the perspective of the customer journey, more and more fashion goods consumers, especially the younger generation, won’t buy a product without being deeply attracted to it at first. Frankly speaking, if there are no effective touchpoints for a fashion brand or new product to establish consumer recognition, consumers are likely not to purchase. We also notice that the brand-owned stores of outperformers have both merchandising and experience functions, and there are many posts related to their experience centers on social media.

Based on the number of posts in a leading lifestyle social media platform, outperformers have on average more than twice of posts as the other companies. Besides, not all of these posts are released by the brand's official account, instead, most are created by users after they visited experience stores, i.e., user-generated contents (UGC). Even though such stores are usually located in a few first- and second-tier cities and a large number of consumers in other cities cannot be covered, these online contents are able to attract online customers and drive potential customers to make purchases online. This business loop is creating greater opportunities for brands to improve user conversion on e-commerce platforms. Similarly, considering the popularity of short videos, we also look into the "user traces" of a well-known short-video platform and find out a similar result. The offline experience centers ignite numerous UGC short videos, and these contents attract more potential consumers to watch and give a like. We count the number of likes, and find out that outperformers receive more than four times of positive reviews than the other companies.

Therefore, it can be seen that the outperformers' online and offline channels do not operate separately; bricks-and-mortar stores are no longer solely for sales, but also double up as key touchpoints that offer interaction, experience, service value extension, digital perception and application to consumers. Meanwhile, to make the stores popular on social media to attract more users, outperformers often design interactions, activities and integrated experience to target users' demands and using scenarios. In addition, they produce banners, slogans or visual hammers to resonate with users based on their value proposition. In this way, they could acquire new customers or purchases through users' recommendations. In conclusion, outperformers achieve growth in both offline and online stores, while the former provides leverage value for the latter.

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Case study: A fashion brand opened a strong experience store to boost e-commerce sales

A fashion clothing brand leverages its offline stores to direct traffic to its online. In 2021, the brand opened the first experience store that integrated "coffee + customization + clothing retail" in a popular business district in Beijing. Combining clothing products with coffee, the store allowed consumers to taste special coffee and desserts while shopping, creating a fashionable lifestyle.

The newly opened store quickly attracted a large number of potential customers. Within a month, more than 300 posts have been posted on a leading lifestyle social platform, and received more than 10,000 likes, favorites and comments in total. A large number of non-Beijingers asked how to buy the products via comments, and the bloggers replied to them, telling them that the items could be bought in the brand's online flagship store.

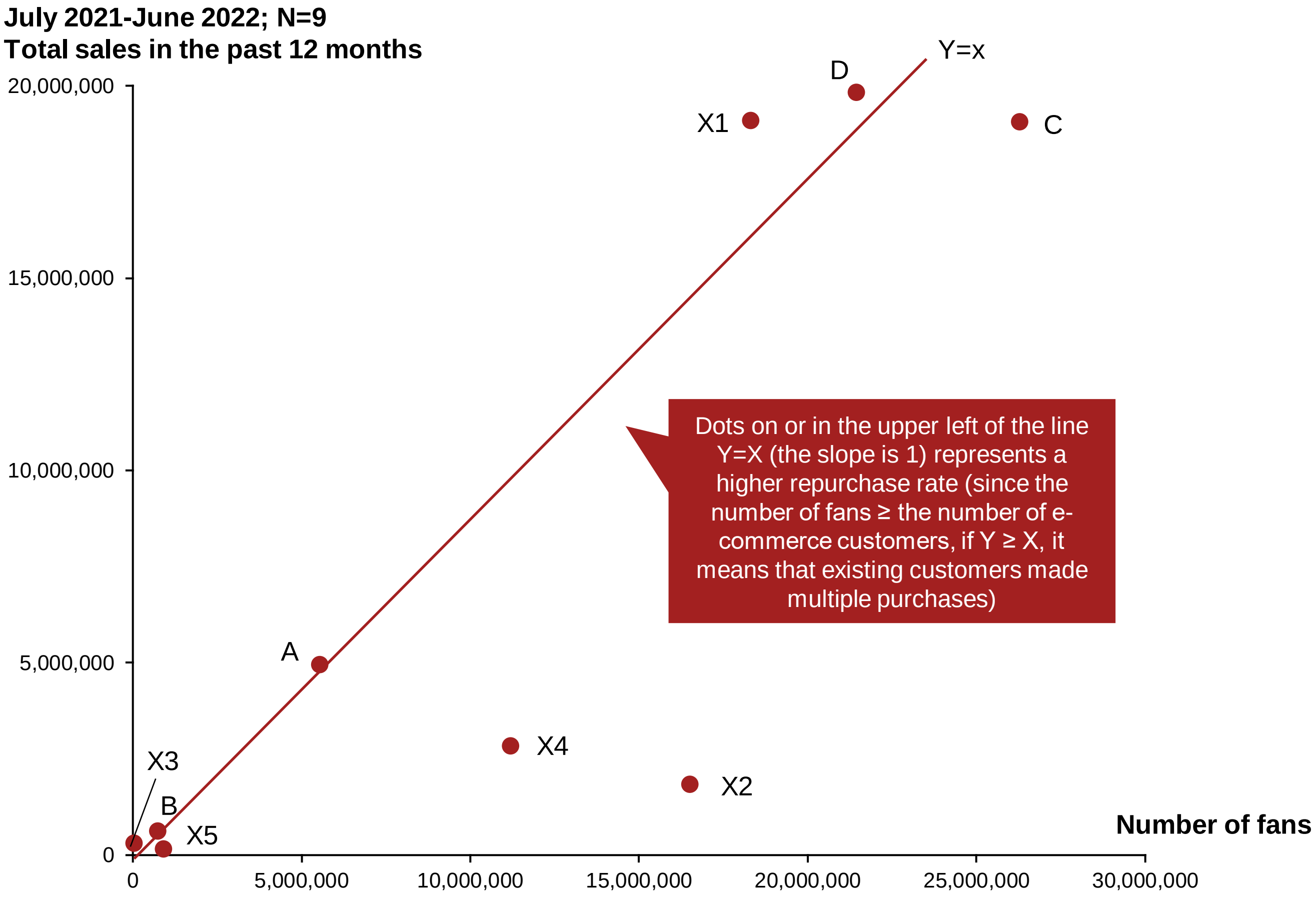
According to sales data, in the first month when the store opened, the online flagship store reported a double-digit growth in sales compared with the previous month, and saw sustained growth of this scale in the following months. It demonstrates how offline store is valuable in the surrounding area, as well as how offline store boosts online exposure and e-commerce conversion as the young generation has a preference for online shopping.

2. Repurchase contributes more to the sales growth

By tracking the performance of the 9 Chinese DTC companies' self-owned flagship stores on an important e-commerce platform in China, we identified two noteworthy dimensions of data: one is the total sales in the past 12 months, and the other is the number of the store's existing fans. We tried to illustrate the retention rate through the linear relations between these two dimensions. It should be noted that flagship stores' fans are usually more than actual customers, which means that it is almost impossible to have each fan purchase at least once. As shown in Figure 5, axis X notifies the "number of fans" and axis Y refers to the "total sales in the past 12 months". If Y≥X, i.e., the intersection of X and Y is on, or in the upper left of, the line Y=X (the slope = 1), it means a fan-converted customer makes multiple purchases on average.

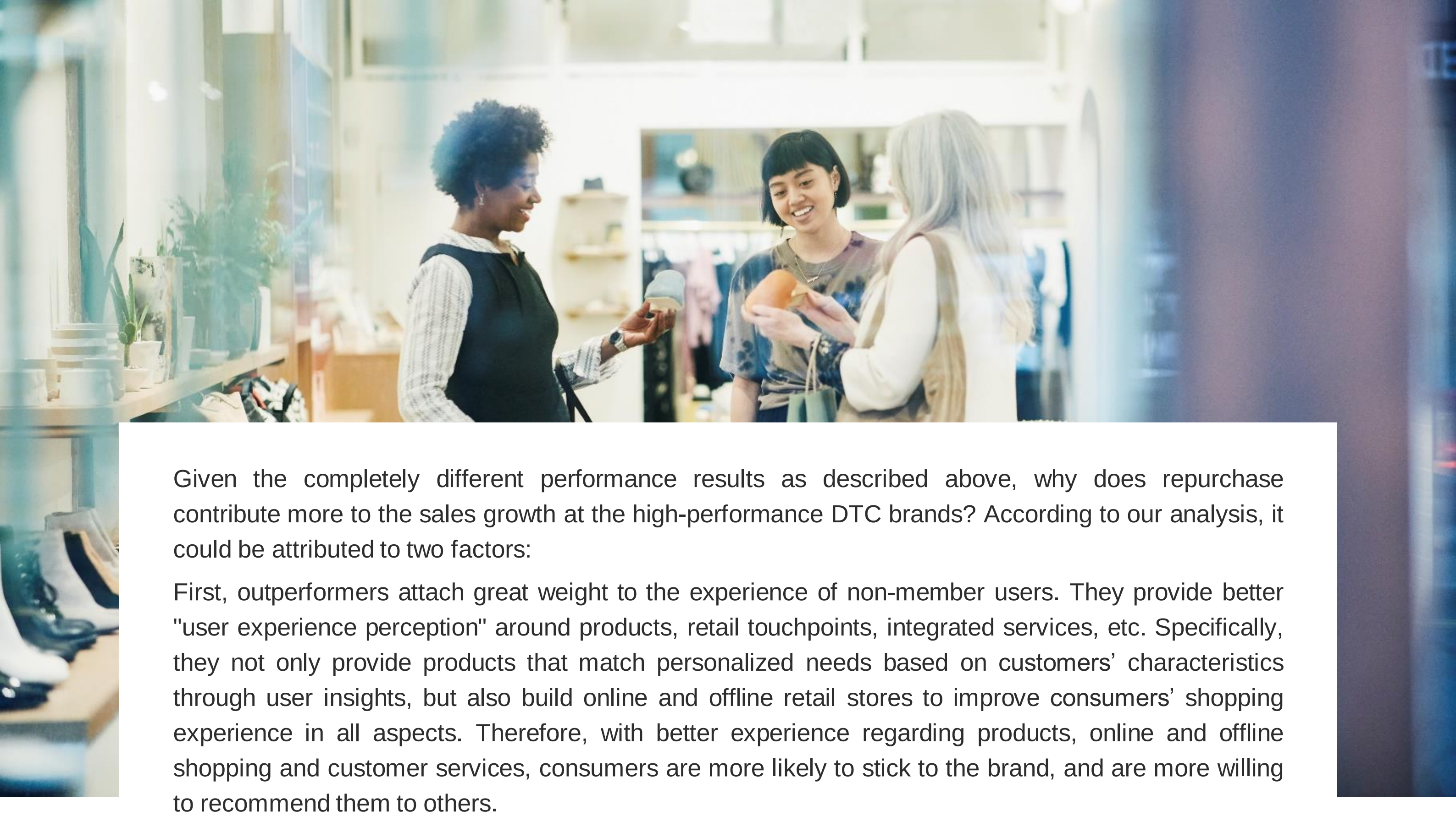
It is worth noting that three of the outperformers (A, B, D) fall on or in the upper left of the line Y=X, while most of the other companies (X2, X4, X5) fall in the lower right of the line. It indicates that the outperformers attracted more repurchasers (defined as those who made two or more purchases in the past 12 months), reflecting a higher rate of customer retention.

Figure 5: Linear relationship between the number of fans of self-owned flagship stores and the total sales in the past 12 months of DTC fashion brands in China



Note: The total sales in the past 12 months refer to those of the Tmall flagship store of respective brands between July 2021 and June 2022; and the number of fans is based on the data of the Tmall flagship store of respective brands in early July 2022

Source: Tracker of e-commerce flagship stores, Strategy& analysis



Given the completely different performance results as described above, why does repurchase contribute more to the sales growth at the high-performance DTC brands? According to our analysis, it could be attributed to two factors:

First, outperformers attach great weight to the experience of non-member users. They provide better "user experience perception" around products, retail touchpoints, integrated services, etc. Specifically, they not only provide products that match personalized needs based on customers' characteristics through user insights, but also build online and offline retail stores to improve consumers' shopping experience in all aspects. Therefore, with better experience regarding products, online and offline shopping and customer services, consumers are more likely to stick to the brand, and are more willing to recommend them to others.

Second, they emphasize membership systems and operation strategies targeting existing customers. Traditional fashion brands usually use membership point systems to motivate engagement and spending (i.e., brands allow consumers to redeem points for gifts, thereby encouraging them to make repurchases and continue to earn points). Compared with them, outperformers know how to better retain high-value users in a differentiated way. Instead of offering extra benefits like discount coupons or special discounts for members, outperformers forge an emotional connection with consumers through "interest circles" and "lifestyle circles", and provide exclusive experiences throughout the consumer journey, thus creating a sense of belonging and value identity among members. Therefore, consumers can interact with the brand, connect with other members, and attract more potential customers, which in turn drives repurchases and sales growth.

Case study: A designer toy brand re-designed its membership system to drive repurchases

A designer toy brand has transformed its membership system under the DTC model in recent years. In 2017, it had only about 300,000 members. The poorly designed membership system failed to attract and engage members, and membership-based operation created little value. In 2020, the brand decided to upgrade the existing membership system, with the aim of improving customer retention and value contribution through "circles of interest". The company started with WeChat official account, mini program, storefront and social media to pursue exposure and establish online communities, and set up a community operation department in 2021. With more than 800 online groups, it gathered more than 100,000 like-minded designer toy lovers, forming a foundation for customer acquisition and retention. Therefore, the brand's number of members has increased by tens of millions since 2020; and, by 2021, members contributed 92% of its total sales, with a repurchase rate of 56%.

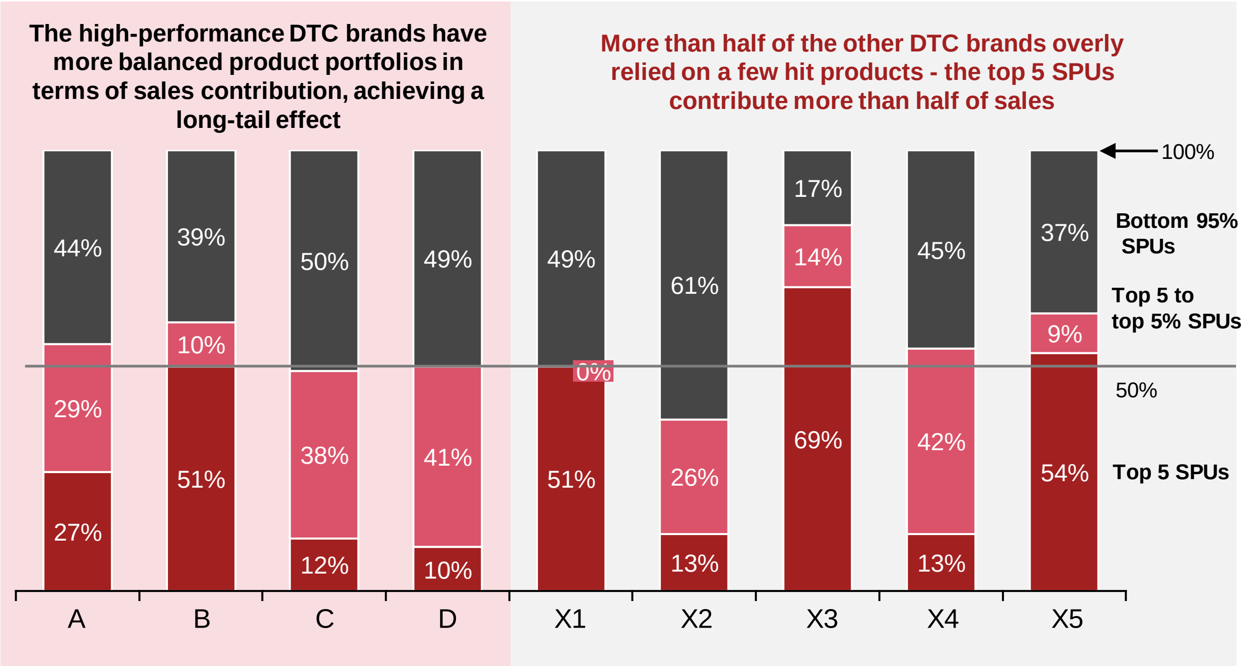
3. Product portfolio driven by real-time market insights contributes to balanced sales growth

We tracked the sales of the above-mentioned 9 DTC companies' Standard Product Units (SPUs) from their self-owned online flagship stores, trying to identify how the sales contribution of SPUs differs from outperformers and other companies under the DTC model. We divided the SPUs of flagship stores into three groups based on their sales: the top 5 SPUs, the top 5 to the top 5% SPUs, and the bottom 95% SPUs. According to statistics (see Figure 6), more than half of the other companies rely heavily on a few of hot selling products that their top 5 SPUs account for more than 50% of the total sales; while outperformers are with obvious long-tail effect, that their non-top 5 SPUs contribute a large share of sales. Here outperformers C and D are taken as examples. Each of them has more than 2,000 SKUs. Among these SKUs, their top 100 SKUs contribute 50% and 51% of total sales respectively, and the top 500 SKUs contribute 83% and 85% respectively. Compared with the other companies, the outperformers are better at creating popular products. Instead of relying on a few hit products, they usually scale up the sales with various product portfolios to balance SPUs' sales contribution.

Abundant SKUs are required for a brand to scale up. But if they are not recognized by the market, the stock of long-tail SKUs will pile up, resulting in a waste of resources and costs. Therefore, companies need to make more popular products, to achieve sales synergy and drive revenue growth.

Figure 6: The outperformers versus the other companies - Sales contribution of SPUs at online flagship stores

June 2022; N=9



Source: Tracker of e-commerce flagship stores, Strategy& analysis

As mentioned above, an important lever for companies to create a more balanced product portfolio is to better understand and respond to changes in market trends and demands, so that products can be converted to revenue rather than become useless stock. Then, how to realize that? We find that outperformers attach more weight to their capability of grasping market trends, and try to improve their products' marketability from the perspective of users (outside-in) rather than the designer (inside-out). More specifically, the DTC outperformers are better at perceiving changes in market trends and consumer demands using big data, the Internet of Things and other digital technology. They can understand the market performance and consumer feedback of their new products more efficiently. Accordingly, they can improve product portfolios, adjust clothes design and materials, and optimize customer experience, thus, driving sales synergy via product portfolios. These explain why outperformers can maintain strong competitiveness despite their variety of SPUs and the complexity of the business.

Case study: A women's apparel brand used market insights to improve marketability

Let's look into the women's apparel industry. By tracking the popular trends of silhouette dresses in the spring and summer of 2022, we find that X-shaped and A-shaped dresses account for a relatively large share of sales, while S-shaped, T-shaped and O-shaped dresses' sales also grow rapidly at a rate of 30% ~ 50%. It indicates that these types are more popular in the market. Outperformers tend to perceive the latest trends in time. For example, a women's wear brand launched a variety of silhouette dresses in this year's product portfolio, especially A-shaped, S-shaped and T-shaped dresses, each of which accounted for about 30% of the total number of SPUs. This move was largely consistent with market trends. In contrast, its competitors relied more on the designer's experience and value proposition when designing products. Their portfolio was mainly concentrated on A-shaped and H-shaped dresses, whose SPUs accounted for 80% and 20% respectively. Unsurprisingly, due to the difference in their ability to perceive changes in market demand, their sales were very different - the women's wear brand's top 1 SPU at the flagship store sold nearly 10,000 pieces per month, and other SPUs also achieved good sales results. In comparison, the top 1 SPU of its rivals only sold 200 pieces in the same period, let alone other SPUs' sales.

II. Five constraints to growth during DTC transformation

To realize DTC transformation, fashion companies not only need to possess the three success factors of outperformers mentioned above, but also overcome the challenges caused by differences in business and operation models, managerial and digital capabilities, etc. There are five typical challenges: lack of synergy, poor experience, homogeneous user operation, single data source, and an unresponsive supply chain (see Figure 7).

Figure 7: Five typical factors challenging fashion companies' DTC transformation

Key success factors of the high-performance DTC brands

01 Offline brand-owned stores guide potential customers to online stores

02 Repurchase contributes more to the sales growth

03 Product portfolio driven by real-time market insights contributes to balanced sales growth

Five typical factors challenging fashion companies' DTC transformation

1. Lack of synergy: Online and offline channels compete with each other and compromise profits
2. Poor experience: Separated design and management of online and offline experience
3. Homogeneous user operations: Undifferentiated management of existing customers/membership
4. Single data source: Focusing on internal data only and ignoring exterior data analysis
5. Unresponsive supply chains: Failure to coordinate design, procurement, manufacturing and distribution

Source: Strategy& analysis

1. Lack of synergy: Online and offline channels compete with each other and compromise profits

Companies often face conflicts when distributing product portfolios both online and offline. Some may adopt a very simple business logic—move offline best-selling products online in the hope of maximizing sales. As online stores often have to reduce prices under the pressure of e-commerce platforms for promotion, a product may sell for different prices on online and offline channels, leading to competition between the two channels and limited profits.

Here a women's shoe brand is taken as an example. The overlapped SPUs between its online and offline are up to 72%; half of the best-selling SPUs online can be found in offline stores; among the overlapped SPUs, nearly 70% also sell well offline. Furthermore, as the brand's self-own e-commerce channel adopts the low-pricing strategy to attract potential customers, the average difference between online and offline prices is up to 42%. In this case, rational consumers prefer to "kick the tires offline and purchase online", which has caused huge profit losses to companies. In other words, the more the brand sells online, the greater the overall profit loss will be. Therefore, the lack of synergies between online and offline channels and the "same product with different prices" strategy is obviously bad for companies. In the long term, it would be difficult for them to maintain market competitiveness.

Will a company be competitive if it adopts the "same product with same price" strategy? If a product sells for the same price everywhere, price-sensitive customers may choose where to buy more randomly. For example, they may buy a product in offline stores because of the chances to try it out, or go online considering the efficiency of delivery. However, it is worth noting that China's online and offline consumers have fundamentally different profiles, preferences and needs. For online buyers, women, especially those women aged under 30, make up a large share. Online buyers are more likely to make their own judgments and decisions based on product reviews given by other consumers or even strangers, while offline buyers are more willing to talk with shop assistants and accept their recommendations. Therefore, adopting the "same product with same price" strategy alone is unlikely to improve the attractiveness and drive synergistic growth between online and offline channels.

Here the scene of buying cosmetics is taken as an example. There is a significant demographic difference between people who like shopping offline and those who prefer shopping online. Users in different channels may have fundamentally different preferences and needs in terms of brands, categories, packaging, and product combinations when purchasing cosmetics.

2. Poor experience: Separated design and management of online and offline experience

Different from the "first-hand experience" provided by brick-and-mortar stores, only second-hand experience such as fine-tuned pictures or videos is available for online shoppers. As a result, how to improve potential customers' awareness of the brand before they make a purchase decision is particularly important for companies, especially for fashion categories such as clothing & shoes, and home furnishing. However, many companies do not have effective means of managing user experience and online and offline coordination.

With the example of underwear products, when shopping online, consumers may wonder whether the size is suitable or whether there are differences in size between different brands even if the brands adopt the standard size measurement. Bad experiences such as size issues and mismatches cause a large proportion of underwear return orders, which is one of the core pain points for online sales in this industry. Some brands have solved this problem to a certain extent by opening offline experience stores, allowing users to try on them and find the most suitable size. But not all online users will visit offline stores for this purpose.

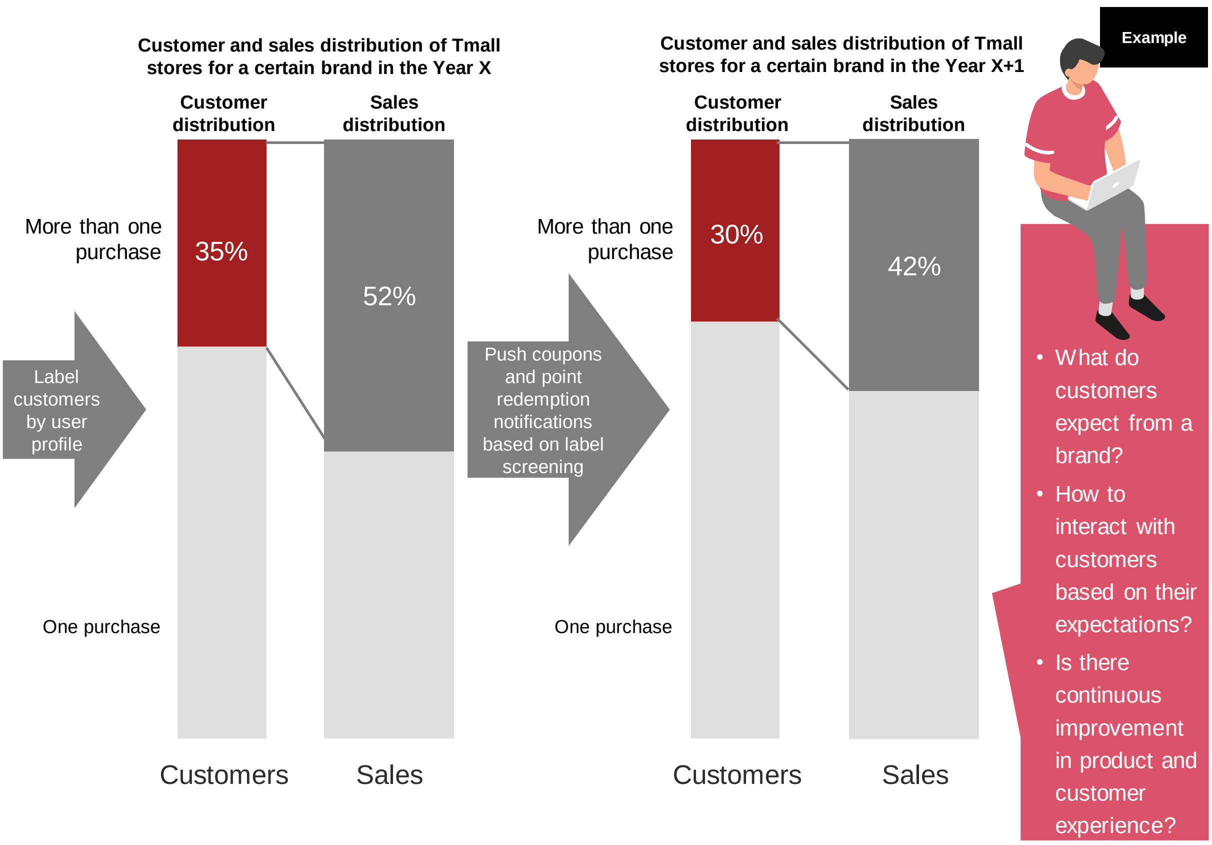
Apart from product selection, a big gap also exists between traditional brands and DTC brands in consumer experience management. A typical example is the unboxing experience. Before receiving the delivery, the user's awareness of the brand and product is virtual (often gained through pictures, videos, etc.). The moment when the user opens the package is the first time consumers establish physical perception, so the experience is very important. However, this point is ignored by many brands, which dents the user's value perception and satisfaction. Therefore, users will be less willing to post pictures of the product and recommend the brand to others. Some might even give a negative review.

Moreover, the consumer journey is becoming more and more randomized. In the past, consumers often had a clear idea of what to buy, such as a pair of shoes and a piece of clothing. They often asked friends for recommendations or searched for related information in forums, and then bought the products in department stores, shopping malls or other offline channels. However, as Gen Z and millennials have become the main consumer group, they can be very random when choosing where to buy, online or offline. Besides, they won't buy a product without being deeply attracted to it at first. If fashion companies can not manage these user touchpoints well, they will be unable to provide differentiated experiences for consumers, and, as a result, likely to lose potential customers.

3. Homogeneous user operation: Undifferentiated management of existing customers/membership

Although many fashion brands have increasingly valued customer repurchases and introduced membership programs, they often fall into a homogeneous competition. Many brands set up point accumulation and redemption rules with basic membership levels and benefits. These membership systems are roughly similar and are often separate for online and offline stores, which fails to attract customers.
In the absence of a differentiated loyalty program, the customer retention rate and the share of repurchase sales decline (see Figure 8). If a brand simply labels its customers based on basic user profiles, and pushes coupons and point redemption notifications accordingly, it barely boosts the increase in customer repurchase.

Figure 8: Number of repurchase consumers and repurchase sales contribution of brands without differentiated user operation



Source: Strategy& analysis

4. Single data source: Focusing on internal data only and ignoring exterior data analysis

As most fashion companies relied on distributors for sales in the past, who only recorded point-of-sale (POS) data, details such as customer purchase behavior, customer profile and customer preference were often unavailable. Meanwhile, since brand-owned channels are new to most brands, they are still unable to systematically acquire, integrate and utilize the data from these channels, resulting in insufficient understanding of final consumers. Quite a number of brands collect the POS data and product category data from major e-commerce platforms, and use them to analyze owned businesses and competitors. However, due to requirements on data asset protection and data desensitization, the brands cannot obtain detailed basic user data.

Therefore, even if the brands have comprehensive data analysis teams and tools, they can hardly perceive in-depth consumer insights and accurate demand forecasting due to the limited data shared by the distributors or e-commerce platforms. In other words, knowing what customers have purchased and how often they purchase is not enough for the brands to engage customers, meet their demands and retain them.

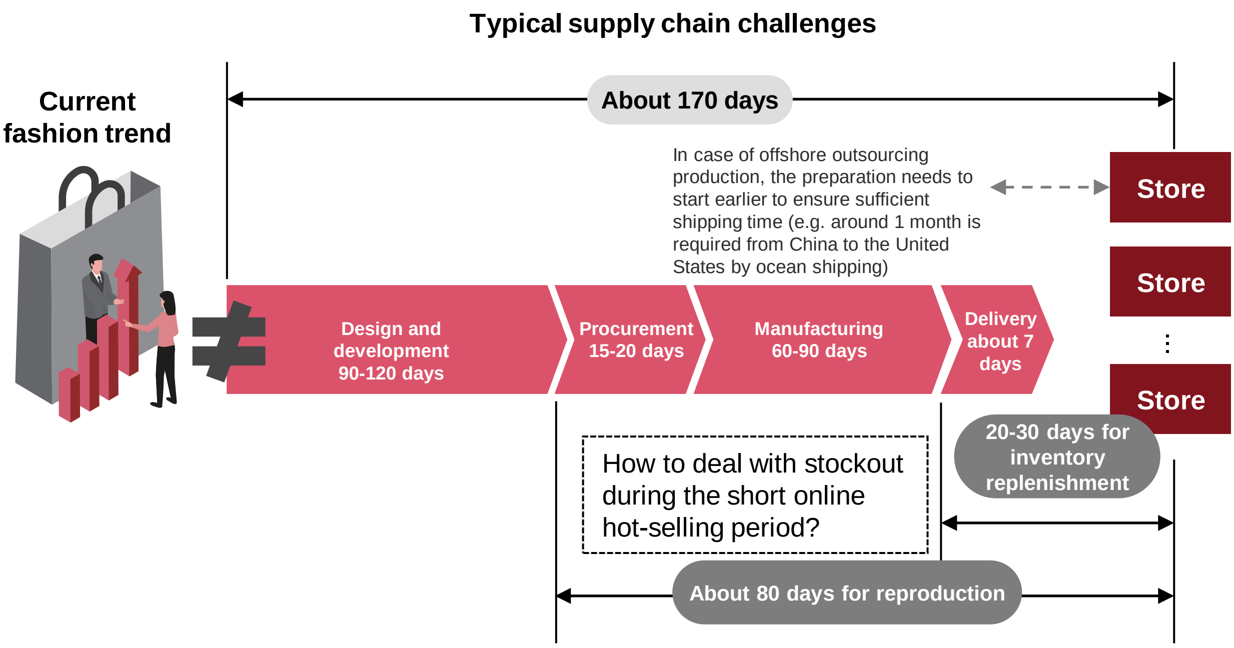
Furthermore, for self-owned channel or private traffic, brands can hardly leverage data to boost sustainable sales growth from products upgrade if they only focus on their own products and sales data, and ignore market and competitor data.

For example, designers and consumers often have different tastes in Martin boots. Designers tend to make masculine Martin boots with sharp lines, in a way different from the ideal boots for women users of e-commerce platforms. Martin boots that sell well have small and round toes, and are streamlined rather than angular heels. In summary, only brands that utilize both internal and external data can realize data-driven value creation.

5. Unresponsive supply chains: Failure to coordinate design, procurement, manufacturing and distribution

Traditionally, the supply chain of apparel & footwear is driven by order-placing conferences and personal experience instead of the market. In a typical supply chain lifecycle of this industry, for example, the preparation for the launch of new spring products in February-March of 2023, often starts in August-September of 2022. At first, the designer needs to decide new products to be developed (e.g., selecting 300-500 prototypes from 1,000 proposed ones). Then, the brands will hold order-placing conferences with distributors, sales teams and operation teams in advance where participants select new products based on their understanding of user preference, popular trends and customer characteristics in their own sales areas. After that, the brands decide which new products to launch and how many quantities to produce based on distributors' and regional sales teams' order placement. Finally, the brands inform procurement and manufacturing departments to initiate their work. It takes about 5-6 months for the new products to be officially launched (see Figure 9).

Figure 9: Four stages of typical supply chain lifecycle in the apparel & footwear industry



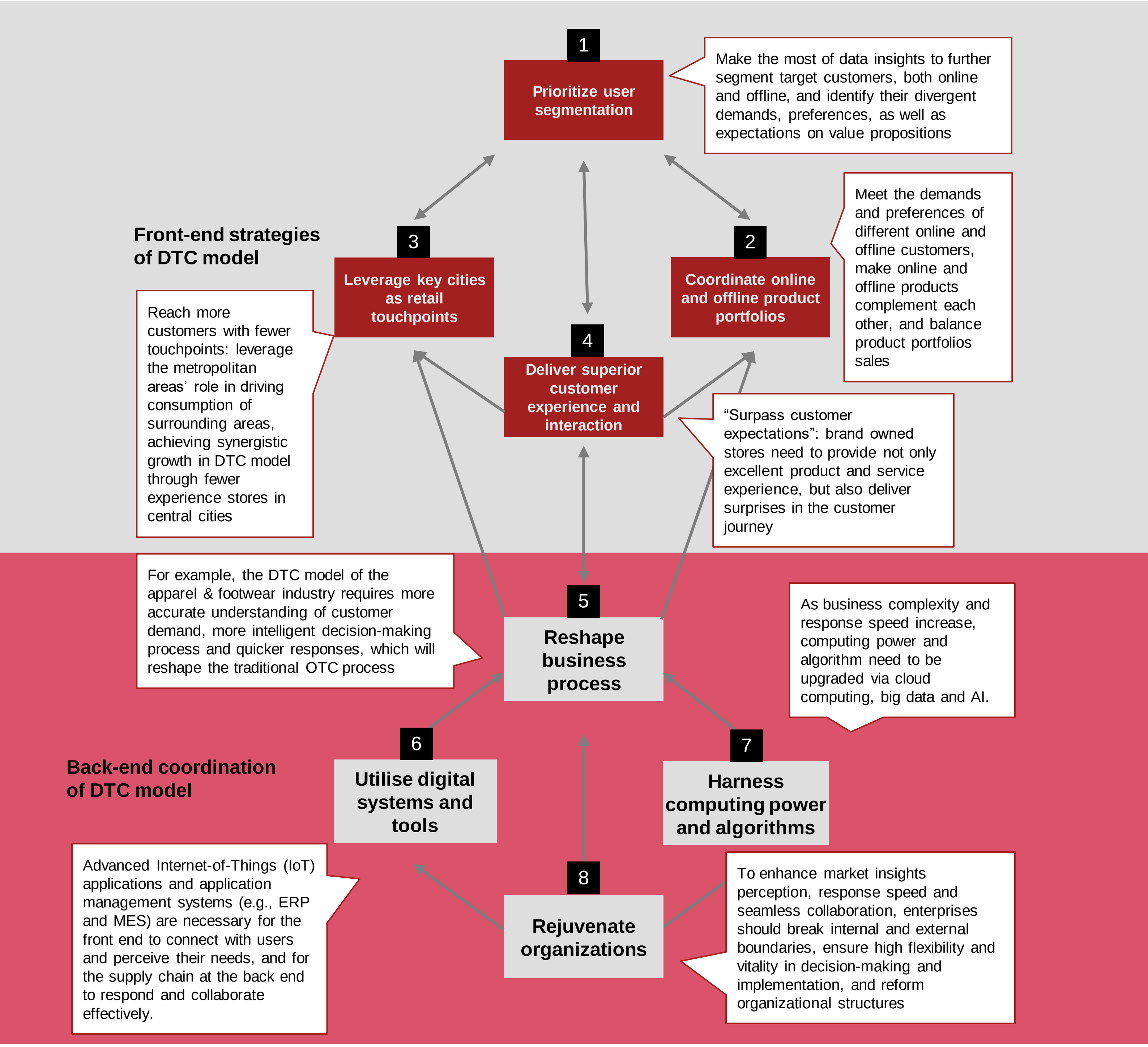
Source: Strategy& analysis

On the one hand, competition is getting fiercer on the supply side. To win the competition, brands have to stand out both in efficiency and differentiated product innovation. On the other hand, fashion trends vary according to market dynamics on the demand side. For example, weak economic growth leads to the "lipstick effect", and the colors of new smartphones may affect the fashion trend. It is incredibly hard to forecast fashion trends or hot-selling elements in a relatively distant future. Therefore, it is very challenging to boost sales by taking the DTC model only as a way of changing sales channels, if the fashion industry fails to build shorter supply chains that are more responsive in terms of speed and flexibility.

III. Eight pillars for DTC fashion brands to unleash growth

Based on our practice of empowering fashion companies, we suggest that DTC fashion brands roll out a slew of consistent business strategies to enable organic growth. Furthermore, efforts should be made in coordinating the 8 key factors through front-end strategies and back-end coordination. As for the 8 key factors of building new DTC capabilities, we call them “eight pillars” (see Figure 10).

Figure 10: Eight pillars for building new capabilities of DTC fashion brands



1. Front-end strategies of DTC model

Pillar 1: Prioritize user segmentation

Even in an era of personalized and diversified consumption, the rule of "birds of a feather flock together" remains unchanged, especially in the fashion industry. Fashion consumption represents the pursuit of specific popular elements and value propositions shared among a particular group of people. For DTC retail, consumers of different channels, online or offline, are diverging. Yet, it is impossible for enterprises to use digital technologies to satisfy the unique needs of every customer, considering the substantial operation cost and the inherent collectivity of fashion consumption.

Therefore, to realize DTC transformation, fashion brands should further segment existing and potential customers to develop differentiated strategies and tactics (see Figure 11).

Figure 11: Examples of user segmentation at different marketing levels

Typical segmentation:

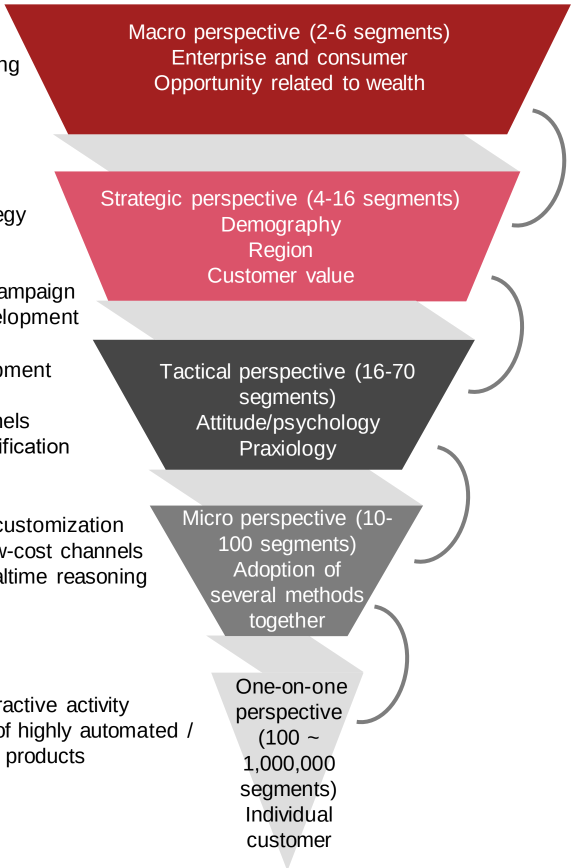
- Business strategy
- Branding/mass marketing
- Retail/consultancy

- Overall marketing strategy
- Business and resource allocation
- Direct mail marketing campaign
- High-level product development

- Typical product development
- Direct marketing via low/medium-cost channels
- "Pocket" behavior identification

- Product differentiation/customization
- Direct marketing via low-cost channels
- Marketing driven by realtime reasoning

- High-value / highly interactive activity
- Supply and marketing of highly automated / large-scale customized products



Source: Strategy& resource library

Each segment can be defined from aspects below:

Level of wealth

- Level of wealth: Rich, fairly well-off, average, etc.
- Categories of investable assets or financial assets
- Tendency to increase or decrease financial assets

Geography

- Region: continent, country, state, community, etc.
- Scale of metropolitan city
- Density of population: downtown, suburb, rural area, etc.

Population statistics

- Age, generation
- Gender
- Family size
- Marriage status
- Family information
- Income
- Occupation
- Education

Attitude / psychological characteristics

- Activity/interest
- Opinion/demand
- Attitude
- Value

Prefered purchase / interaction channels

- Preference for online or offline purchase
- Knowledge sharing platform
- Short video platform
- Social media platforms such as WeChat

Profitability / customer value

- Revenue, cost, profitability, customer lifetime value
- Profit contribution of individual customers or families
- Tendency to increase profit margin/or value

For example, when evaluating market opportunities and positioning a new self-owned store for market entry under DTC model, enterprises are more concerned about macro factors such as regional demographic characteristics, consumption level and demand. However, from the point of brand marketing, it is impossible to impress all target groups identified by marketing strategies. Therefore, enterprises should further segment consumers from the perspectives of attitude, motivation, etc., thereby locating further segmented customers that highly identify with their brand value propositions. Then, it is much easier to acquire a wider range of consumers with the influence of these precisely reached and deeply impressed groups of consumers.

As mentioned above, online and offline consumers of DTC brands are differentiated and diversified. It is inevitable that online and offline stores have overlapped customers in regard to customer convenience and coordination between channels. However, considering complementarity and differentiated competition, online stores need to target different customers from offline stores. In particular, to avoid the phenomena of "price is everything" or "online stores compete for offline hot products", it is crucial for the brands to engage differentiated and segmented online customers, and closely connect them with brands' value propositions.

Overall, to meet granularity requirements for customer segmentation at different business levels, the brands should collect multi-dimensional customer data for DTC transformation by leveraging digital technologies and direct connection with customers. This requires the brands to collect and update the data through more customer interactions. Furthermore, on the premise of data security and privacy protection, the brands should effectively integrate and utilize the data to explore segmented and extended consumer behavior insights.

Pillar 2: Coordinate online and offline product portfolios

Many offline shoppers have turned to online stores due to the recurrent outbreaks of Covid-19. In the third year of the pandemic, these new online customers have become regular ones. Therefore, the DTC channels have seen a growing number of customers shopping both online and offline, besides those that switch between online and offline channels for price differences. In light of this, fashion brands should provide a certain proportion of SPUs to sell both online and offline to meet the demands of overlapped customers, considering traffic direction, availability and convenience.

In 2022, there were over 840 million online shoppers in China, of which Millennials and Gen Z made up the majority. They are willing to pay premiums for the appearance, experience, quality and reputation of products. Meanwhile, young online shoppers are more willing to evaluate products through various online social platforms, search engines and e-commerce platforms. Then they can make independent purchase decisions rather than just take the advice of salespeople at physical stores. This brings new opportunities for DTC brands to develop online SPUs with differentiated experience and quality.

To build more responsive supply chains, it is practical and effective to provide a certain portion of the same SPUs for all channels, and develop differentiated product portfolios for different channels. In terms of traditional procurement and production, scale is a top priority. Keeping an appropriate proportion of SPUs to sell both online and offline can expand production scale, improve capacity utilization and reduce unit production cost. Moreover, the scale of differentiated online SPUs will be relatively small, hence, more flexible production and inventory management are required. Although flexible production and inventory might increase the overall cost of the supply chain, these products' high gross profits rate can cover the extra cost of the supply chain, making sustainable profits.

In conclusion, brands should meet the demands and preferences of differentiated online and offline customers with product portfolios for complementarity and differentiated competition, and balance product portfolios for sales growth according to market trends.

Pillar 3: Leverage key cities as retail touchpoints

To leverage the consumption-boosting effect of city clusters (metropolitan areas), fashion DTC brands often open a limited number of experience stores in first- and second-tier cities to drive the consumption of surrounding areas and the sales growth of online channels. Unlike linear growth achieved by adding the number of stores, this model helps to gain strong growth momentum and a high conversion rate.

PwC recently released *Cities of Opportunity 2022*. The report analyzed 47 cities, covering central and node ("radiated") cities of China's major city clusters in the Beijing-Tianjin-Hebei region, the Yangtze River Delta, the Guangdong-Hong Kong-Macao Greater Bay Area, the Chengdu-Chongqing economic circle, the middle reaches of the Yangtze River, the central Henan province, the Guanzhong Plain, etc. Three noteworthy features of city clusters strongly support us to leverage key cities for consumption-boosting effect: cities within the cluster are closely linked in terms of economy and infrastructure (about 1-hour travel by high-speed railway between cities); culture and customer preferences are similar in the region; the brands of central cities have dominant advantages in leading and driving the consumption of surrounding cities.

Leveraging key cities as retail touchpoints, the DTC brands can invest resources for stores in central cities and rely on these stores to reach customers of surrounding cities. But if the brand operates a store in the central city with a traditional model, the store cannot deliver a leverage effect. As previously mentioned, more and more high-performance DTC brands are opening experience stores, so as to realize multi-dimensional interaction with customers.

We have summarized the major functions of experience stores as "RCES":

Retail:	Sell core products and their spin-offs
Customization:	Provide offline body-measurement service, booking for tailored and personalized product customization
Experience:	Provide brand, product and lifestyle experience
Service:	Provide fashion outfit advice, personalized product selection, membership service, etc.

Diversified interactions in the store will further enhance customer acquisition and conversion. Meanwhile, user-generated content (UGC) and media communication will strengthen the role of central cities in driving surrounding cities: on the one hand, a rising number of visitors from satellite cities will be attracted to visit the offline experience stores; on the other hand, more online followers can be converted into fans and purchasers directly through the "shortest link" (i.e., DTC e-commerce stores). Therefore, brands should stick to enhancing customer acquisition and conversion by establishing touchpoints for a close-loop business, so as to provide leverage for the DTC retail model.

Pillar 4: Deliver superior customer experience and interaction

We have described the importance of experience and interaction for self-owned stores. The stores should deliver not only products and experiences with high quality, but also surprises in the customer journey, so as to outperform their competitors.

Above all, we suggest that brands “build omni-channel service platform” (see “a” in Figure 12). Online and offline stores are not separate but sharing customers. It is essential for these stores to render consistent online and offline DTC experiences, e.g. offline store pickup for online orders, delivery from nearby stores, online booking for in-store fitting, and other services. Even the simplest coordinated services require the brands to realize system integration, enable data sharing and align sales management at front- and back-ends (we will discuss it from the aspect of back-end coordination later). Otherwise, no progress will be made.

Figure 12: How to deliver consistent DTC experience

Differentiated online customer journey
- Localized content for the homepage of brand and store
- Personalized search result
- Customized online product
- AR/VR (virtual fitting room, etc.)
- AI (personalized recommendation, chatbot, virtual agent, etc.)

Differentiated offline store experience
- Unique characteristics of the store
- AR and 3D holographic product category
- Intelligent in-store fitting room mirror
- Customized product display
- Scanning by mobile APP to add to favorites, search, buy and share
- Booking for in-store fitting
- In-store experience of presale items
- Digital service area
- Home delivery for in-store purchase

Omni-channel retail platform
- Adequate in-store stock
- In-store return and replacement
- Home delivery
- Loyalty
- Real-time customer support

Moreover, brands should deliver differentiated and customized experience for online and offline customers (see part “b” in Figure 12). The key is to overcome the limitations of online and offline shopping experience. For example, virtual reality (VR) and augmented reality (AR) technologies, such as virtual fitting rooms, can provide highly immersive and multisensory customer experiences and facilitate more informed decisions. A home-furnishing retailer integrates AR technology into its App to help shoppers visualize products in their homes, which contributes to positive consumer reviews and a higher conversion rate.

Digital technologies can also be used by brick-and-mortar stores to improve product selection experience and service efficiency. On the one hand, due to the limited shelf space of traditional fashion shops, most of the products are stacked on the shelves instead of being fully displayed to attract consumers. Also, apart from product appearance, consumers are increasingly concerned about details such as fabric, material source, design philosophy, etc. If users can scan the display shelves and see the 3D presentation of related products via AR technology, they will get extraordinary experience and detailed information for product selection. On the other hand, processes such as payment, product return and replacement in fashion shops used to be handled manually. At peak hours, customers cannot be served in time, resulting in long waiting time. Based on the application of radio frequency identification (RFID) and other smart label technologies, brand-owned stores can install self-service cashiers, which can improve payment and packaging efficiency and collect user profiles and data seamlessly, leading to further digitalization.

2. Back-end coordination of DTC model

Pillar 5: Reshape business process

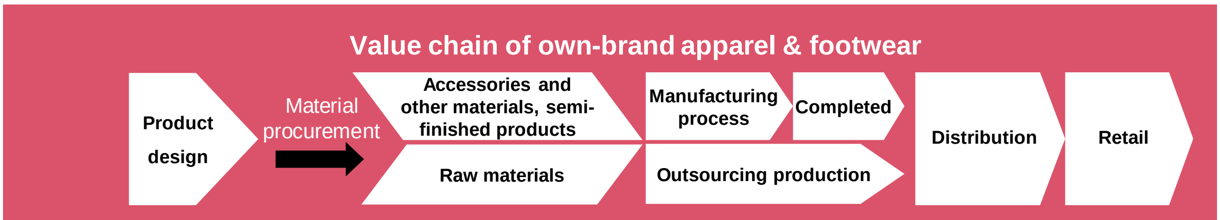
DTC brands need more agile business processes to stay ahead of the competition and meet fast-changing customer demands. For example, to adopt the DTC model, apparel & footwear companies need to have more accurate understanding of customer demand, more intelligent decision-making process and quicker response to the market. They should also reshape the core business process regarding the "order-placing conferences" (i.e.,45 the process from order-placing to cash flow generating) to better match the business strategy at the front end.

Enabled by digital technologies, DTC brands should establish an agile supply chain that can dynamically perceive demands and market changes to optimize product design, procurement and production, making product portfolio and production more flexible.

Brands can adjust product design and procurement according to the changes in consumer demand, while adopting the flexible production principle of “multiple batches and small quantities”. For hot products, brands should follow up existing orders and arrange production for additional orders in a timely manner, while utilizing materials of unpopular products to manufacture popular ones. This can greatly reduce unsaleable inventories and increase the profits of best-selling products.

As is shown in Figure 13, if the business process can be reshaped based on customer demand rather than the traditional order placing meeting, the production cycle of the initial order for new products can be shortened to 1-2 months. Brands can lower the proportion of products manufactured for the initial order (for certain brands, the ratio is <20%), which is for trial sale. After receiving feedback, the proportion of best-selling items should be increased, and materials for SPUs with poor performance can also be transferred to manufacture more popular products. Therefore, the sales of popular SPUs in season will rise sharply, and the gross profit margin will grow due to less discounting.

Figure 13: Digitalization of core business process



	Production cycle of the first batch of orders	The proportion of the initial order to the estimated sales in the season	The proportion of additional orders to the estimated sales in the season	Average discount rate
Traditional supply chain	4–6 months	70%–80%	20%–30%	30%–40%
Digital supply chain	< 2 months	< 20%	> 50%	10%–25%

Note: We do not include factors such as brand diversification, product and regional market penetration in the business growth strategy

Pillar 6: Utilise digital systems and tools

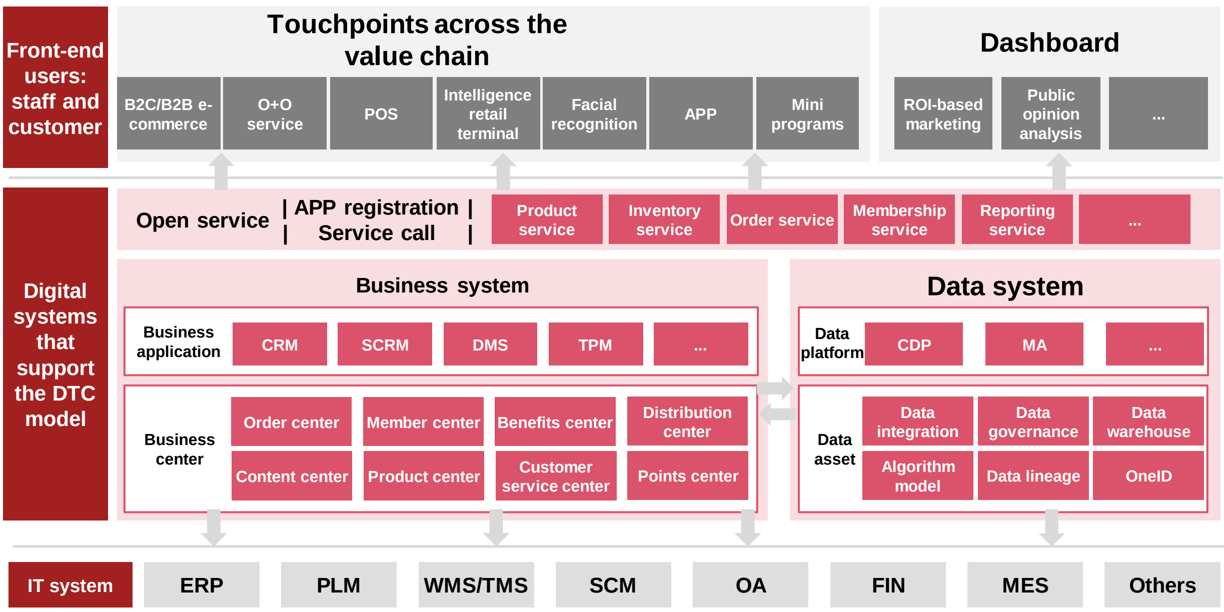
Enterprises need systems and tools for continuous DTC empowerment after reshaping business process. Application of IoT applications and management systems, such as ERP (enterprise resource planning) and MES (manufacturing execution system), is necessary for the front end to perceive consumers' demands, and for the supply chain to respond and collaborate at the back end.

Notably, the traditional front-end digital systems are fragmented and isolated, as different channels and regional teams may have their own digital systems and platforms. It creates difficulties for front- and back-end coordination. Besides, it is detrimental to business expansion due to the lack of responsiveness to market changes, and is challenging to improve operational efficiency due to insufficient data sharing(e.g., membership management, inventory, orders and products) .

Therefore, a digital platform is attached with great importance to utilize digital systems and tools. It can make data links shorter and operational response quicker, and facilitate efficient and coordinated digital management, as well as continuous innovation (see Figure 14). Essential functions of a digital platform include:

- Quickly adapt to different channels and customer service platforms
- Flexibly manage business lifecycles
- Quickly integrate multi-source heterogeneous and discrete information and share business data
- Innovate for flexible expansion, and simplify the logic of back-end development
- Broadly utilize realtime computing, big data analysis and coordinated planning

Figure 14: The digital platform for DTC



Source: Strategy& analysis

Pillar 7: Harness computing power and algorithms

It is impossible for an analyst to constantly generate front-end insights through one-time data analysis. Instead, algorithms are required to discover, respond to and solve problems. In addition, large-scale computing relies on computing power. Due to the complexity of business and the demand for quicker response, computing power and algorithm need to be iterated and upgraded, with the help of cloud computing, big data and AI.

Fashion brands can use cloud computing, big data and AI to make the DTC model more intelligent, with respect to users, products and services.

01 User level

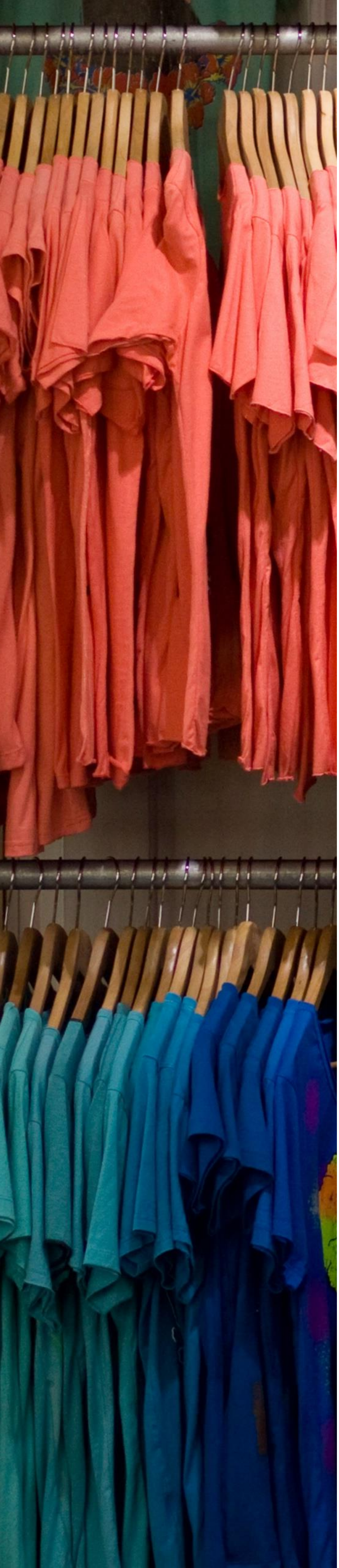
- Analyze customer preference and behaviors through big data, segment customers according to brand strategy, and forecast customer behaviors for products recommendation.
- Realize data harmonization and integration among different platforms, develop 360° customer profiles, and identify customers' pain points and insights through multi-channel collaboration for experience optimization.

02 Products level

- Track sales of goods, forecast shelf sales ratio and adjust supply chains in a timely manner.
- Develop new products by digging into trending products from different dimensions such as color, silhouette and fashion trend.

03 Service level

- Deliver excellent in-store experience with technologies. For example, use robots to interact with consumers and serve as shopping guides.
- Realize omni-channel customer interaction, connection and transfer, such as differentiated membership management, and mutual traffic-direction of customers between online and offline channels.



Pillar 8: Rejuvenate organizations

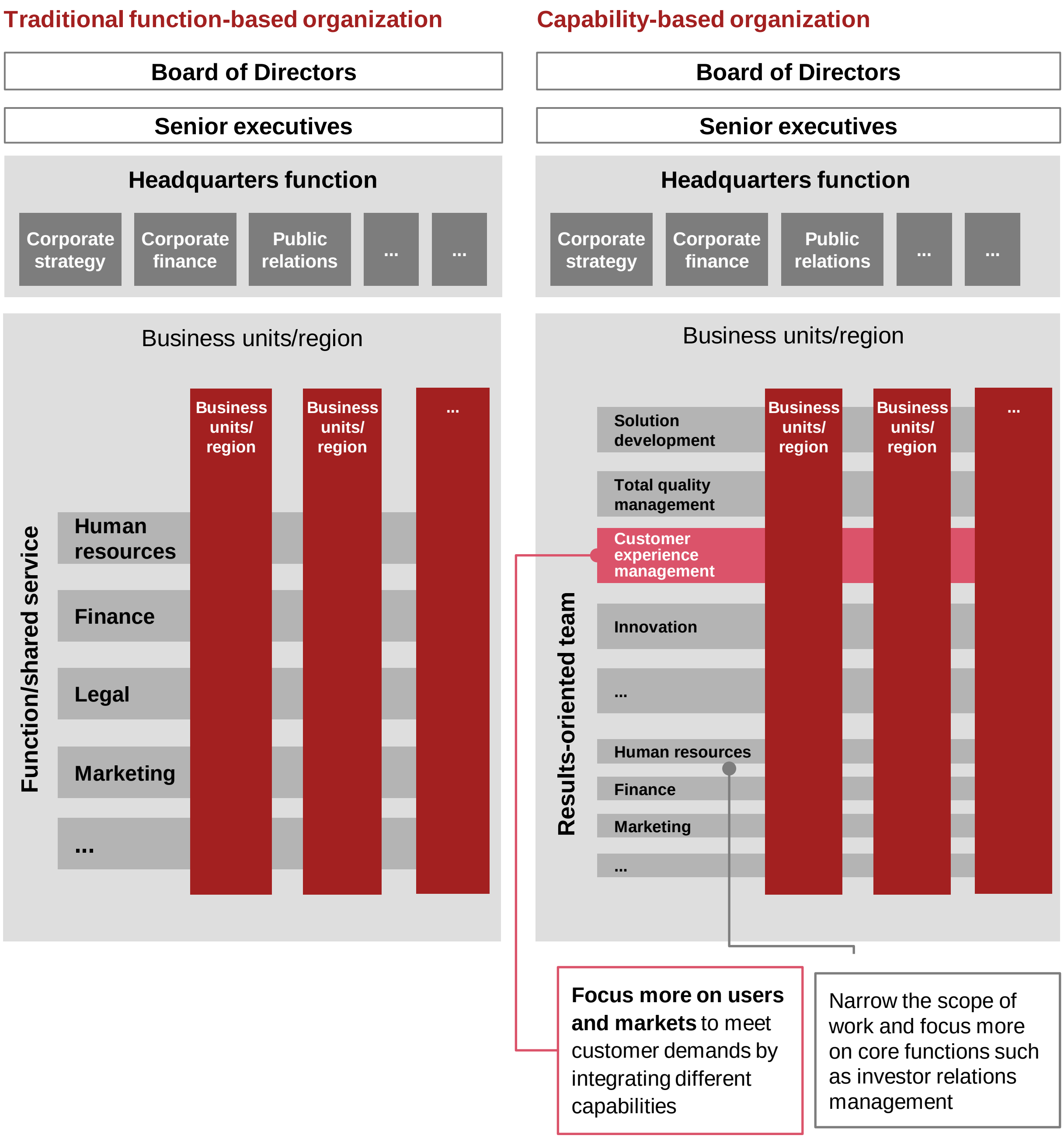
To enhance market insights, response speed and seamless collaboration, enterprises should break both internal and external organizational boundaries, build flexibility and vitality into decision-making and implementation, and reform organizational structures. As the DTC model functions via organizational arrangements, it is crucial for brands to optimize organizational structure and make it compatible with the DTC model to realize cross-sector coordination.

We have two recommendations for companies to optimize organizational structure:

1

Build user-centric organizations. Generally, business units are divided based on staff's functions and specialization. For a complex business that requires cross-function coordination, it sets positions like product managers and brand managers to coordinate different teams, e.g. product design team, marketing team and sales team (see Figure 15). However, the DTC model imposes new management challenges. For example, a specialized user experience management team is necessary for the whole customer journey (i.e., being attracted – purchasing – promoting products to others - interacting with brands – becoming loyal customers), which is ignored by many brands. Under the DTC model, organizations need user-centric and results-oriented management across multiple functions. Therefore, a new organizational structure is needed to promote seamless internal coordination and execution.

Figure 15: Transform into a user-centric organization



2

Align organizational goals with performance management. DTC practice does not mean simplifying its organizational structure. If enterprises only divide sales teams based on online and offline channels and set separate goals for them, these teams can easily become potential competitors of each other. DTC brands can set consistent goals for sales teams and help them gain a holistic view. On the one hand, brands should develop a top-down holistic strategy to facilitate front-end coordination, including the coordination between product portfolios, touchpoint cities, and delivery of the experience. On the other hand, brands should break the overall goal into several sub-goals for better coordination. For example, all the online and offline sales teams should have two KPIs—the revenue goal of their own channel and their contribution to the revenue of other channels. As for performance evaluation and incentive mechanism, brands can evaluate business units and staff based on these KPIs and their weights, and use them as key indicators for performance rewards and other variable incentives.

Conclusion

Fashion brands, and even all consumer goods companies, cannot improve their sales performance overnight via DTC transformation. They should respond agilely to market dynamics regarding emerging consumer segments, consumption paradigms, channels, and marketing approaches, while making trade-offs based on their existing business models, organizational capabilities and digital technologies.

Therefore, we suggest fashion brands strengthen the top-level design, make a clearer strategic positioning, and transform step-by-step under the guidance of a business roadmap, to better implement the aforementioned “eight pillars” for DTC transformation. Realize front- and back-end transformation and business coordination at a fast but steady pace; rely on digital technologies, computing power and algorithms; pivot on user experience management, membership-specific operation and data insights; and create new competitive moats by constantly accumulating and utilizing user pool and data assets. All of these enable companies to outperform their competitors in the surging wave of digital transformation.

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