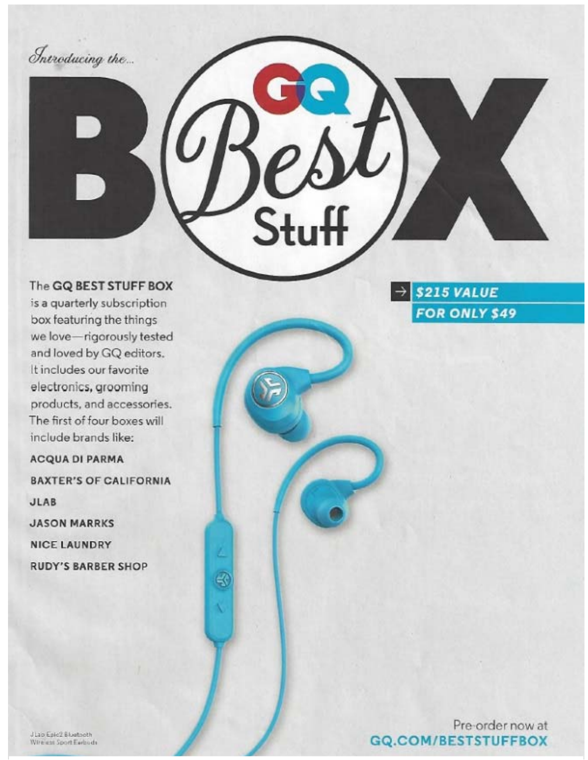
<u>Selling by Subscription: Should We, Could We?</u>

It seems like every company on the planet wants to sell products by subscription – to businesses and consumers. Pet food, clothes, "healthy" snacks, software and ready to prepare/serve meals are just some of the subscription businesses we have been asked to invest in.

These are all versions of the same concept: Sign up "members" who pay to receive a curated "box" of goods or services on a regular schedule. Keep it all or keep some/return some. Sell once, bill forever. What's not to like? Many companies with this model have been tantalizingly successful, at least to begin with - and at least based on what you hear!

But there have been some unfortunate failures as well. Here are just a few examples. A large company we work with closed their test of a subscription snack food business, after investing perhaps $10MM in "proving" it could work.

- One company in which we passed on investing produced a monthly "surprise box" for dogs. It was acquired by a large retailer - but at a loss to the investors.
- A men's clothing company where we are a small investor has had to repurpose its business model three times – as dozens of competing companies have rushed into the "stylist's select, you decide" business model. Stitch Fix notwithstanding, this company failed completely.
- Even the famous Birchbox® cosmetics subscription service has had issues. Citing a downturn in the market, the company had to cut staff and shut down its Canadian operations.



Another popular subscription application is for "paid" sampling boxes. Here, <u>GQ</u> tried to get men to sign up for an unknown package of products at a "great value."

In case you are considering this business model as a distribution channel for your company, here is some of what we have learned about this approach:

- **<u>Subscription selling is more about the technology of subscription selling, and less about selling your product by subscription</u>.** There appears to be a certain type of buyer who is open to this marketing approach. While it would be nice to think of them as "harried, modern Millennial consumers who don't have time to go shopping," it turns out that many users are either bored, don't like to shop or just like to get packages addressed to them. Said another way, finding the right people to sell to is, broadly speaking, much more important than what you sell them.

- **<u>Boomers may be more interested/familiar with the subscription model than Millennials or Gen-Xers</u>**. Younger consumers seem to want everything "by the bite" and don't want to be tied down the way Boomers were. Consider that the Metropolitan Opera in New York continues to deliver an incredibly compelling artistic product. But ticket sales have fallen to all-time lows, principally because of reduced subscription sales. As the percentage of Boomers decline, the Met is only delivering about 60% of its possible box office revenue – down from 90%+ in years gone by. Today, the Met can only survive because an increasingly small number of huge donors cover more and more of its operating costs. True, young opera fans buy tickets when it suits them. But as Yogi Berra never observed, "If people don't want to come to the opera every Friday night at 8PM, there's no way you can stop them."

- **<u>You can't outsource the technology in a technology business</u>.** In a world of outsourced everything, you can't use contractors to manage a web-based presence which attracts and retains subscribers. Rather, you have to hire in the expertise. Key reason: The cost of using contractors to make the cost of changes you need to keep making is just too high. Every change you make to fine-tune your subscription offering – and you have to make hundreds a day to keep re-aiming your "subscribe now" message. When you pay contractors "by the change," not fixed (salary) dollars, the company's economics fall apart.

- **<u>Your "product" is the subscription</u>.** The fact that you have a superior product or service offering is of some value, but your real "business" is selling subscriptions. Magazine publishers already knew this, but it's hard to make money only by selling subscriptions to anything. Fishing for subscription customers online is a science, not an art. It requires data scientists who can execute very efficiently. Unlike retail, there are millions of dials to be constantly adjusted. This requires expertise you must have in the company.

- **<u>Marketing content has to be constantly, endlessly refreshed</u>.** In the subscription business, your product stories are really important. It's not what you sell, but how you got here and why you are selling it. But you can only use your best story once – you have to create, create, create on the themes which engage your audience.

- **<u>Strong 3rd Party Logistics suppliers (3PLs) are essential</u>.** Here, "strong" translates to "cheap," as logistics are the highest non-product cost for subscription businesses. When they start up, most subscription-based marketers try to do things in-house, then move to a 3PL. Only the highest volume retailers get to the point they can bring the business back in-house – even though this is the point at which the business really becomes profitable. As an example, a clothing rental subscription service we know in the northeast was unable to succeed until they got big enough to offer 150,000 dresses at any time – with 70% of them "checked out" each weekend and in-house dry cleaning to ensure maximum "uptime" for their fleet. What really worked for Rent the Runway? When they moved to an "all you can wear" model at a fixed monetary fee.

- **<u>The subscription financial model is very restrictive</u>.** Surprisingly, there is a lot of commonality across the businesses we have learned about; this despite the fact that every entrepreneur believes their business and their category is unique. These three rules seem to define the "profit box":

    1. You have to have gross margins of at least 50%.
    2. Your CAC (Customer Acquisition Cost) can be no higher than 10% of the Lifetime Sales Value (LTV) of each subscription.
    3. You can't tolerate monthly churn rates above 10%; most successful plans are below 5%.

<u>Perspective for Early State Companies</u> – Selling by subscription is more than a choice of channels. Starting a business is hard and doing it behind a subscription model may make it harder, not easier. We recommend careful consideration before taking on this net-extra burden.

<u>Source</u>: LCM Interviews, <u>NYT</u>, 181012.

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