B2C Ecommerce

Sector Update

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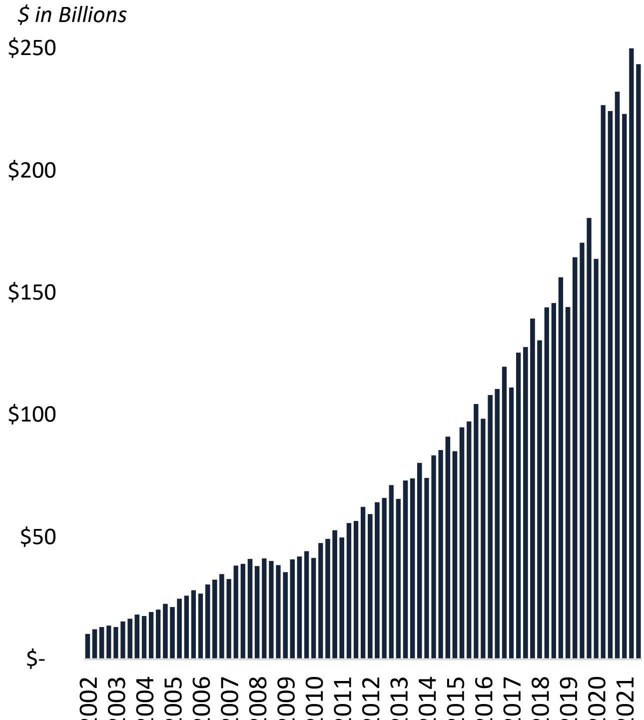
Overview

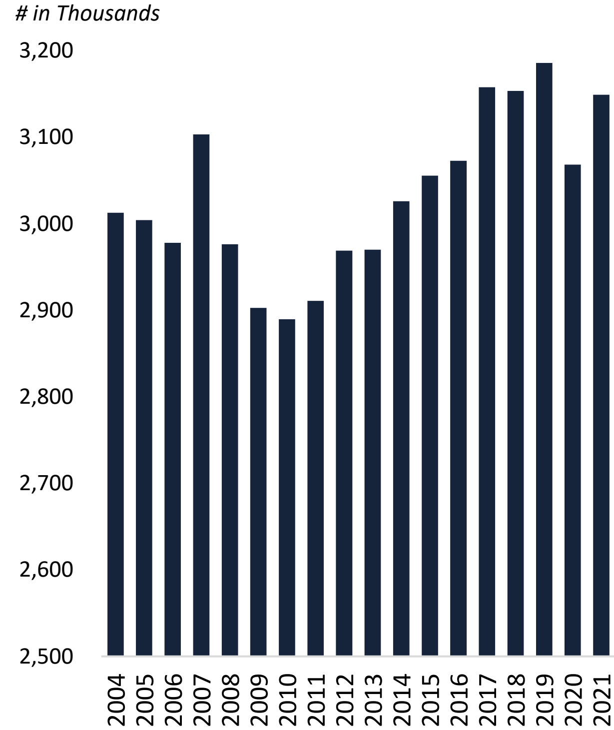
Consumers continue to aggressively change consumption patterns from making purchases at brick & mortar retail establishments to doing much of their shopping online. Because of this strong, long-term shift, we at Metronome are seeing more and more mature ecommerce businesses that are generating solid cash flows and considering selling. This newsletter examines how to evaluate these ecommerce businesses and characteristics that are desired by potential investors. Specifically, we will focus on those ecommerce companies serving consumers directly (B2C). To do so, we have enlisted the help of several private equity investors that have reviewed businesses and invested in the ecommerce space, along with several industry executives that operate daily in the sector. B2B ecommerce tends to be a very different animal with quite different customer dynamics and business models, often an extension of a Distributor, and we will tackle this sub-sector in another newsletter.

Quarterly Ecommerce Revenues – U.S.



Source: U.S. Census Bureau

Number of Brick & Mortar Retail Stores – U.S.



Source: IBISWorld

Ecommerce has grown steadily from 1% of retail sales in 2000 to 13% in Q3 2021…

…while the number of brick and mortar stores in the U.S. has remained stagnant

This document will focus on Value Drivers examined by private equity investors due to the strong growth in private equity funds over the last decade and their dominance in the lower middle market. Because of this proliferation of funds, today's market usually provides buyers for most any business, depending on valuation expectations. Strategic investors can also provide a lucrative exit, but they tend to be very focused in their acquisition appetites and more sporadic in their deal making.

B2C – Amazon & Google Are Dominant

With $470 billion in revenue as of December 2021, Amazon accounts for approximately 41% of all B2C ecommerce in the U.S. today (data from Statista as of 10/21), and 40%-50% of consumer retail purchase searches now originate on Amazon. Another 20%-25% of consumer product searches originate on Google. One way or another, most ecommerce players will need to co-exist and/or compete with both of these entities. Five years ago, the solution was relatively simple – advertise on Google to drive traffic to your website and perhaps sell through Amazon's Marketplace as a Prime Vendor and you will find the consumers that are seeking your products, correct?

The reality today for independent ecommerce businesses is much more complicated (and expensive!). Google and Amazon are both constantly tweaking their search algorithms, the proprietary software instructions they use to determine which products are listed first in a search result, and these changes come without warning. At different times, Google has altered search results to provide higher rankings to those sites that have more in-depth content, those that are more responsive to mobile purchases and those with video content, leading to the cat and mouse game of ecommerce sites beefing up different aspects of their sites to stay in the top tier of Google searches. Another inflection point came when Google started promoting a greater number of Pay-Per-Click (PPC) search ads above organic results, leading to further demotion of previously high-ranked results and greater promotion of Google's bottom line.

Completely separately, but just as compelling, 27% of all emails that are opened in the U.S. are done so on Google's Gmail platform. This means that Google can give priority to email advertising from its clients as opposed to those emails coming from other sources and leads to further advertising dollars spent with Google.

Amazon has similar dynamics – searching on the company's site now often leads to paid results topping the list of products shown to consumers or Amazon's proprietary products being placed above third-party sellers. The double whammy comes because Amazon is also an advertiser on Google, and Amazon will often blanket an entire category of goods with keyword purchases that lead to greater traffic being driven to its site. These tactical moves come without regard for immediate profit, rather often focusing on examining specific customer behavior or playing the long game. Independent ecommerce sites don't know when these ad buys are coming, nor how they will evolve…search terms can literally double in cost overnight without warning.

Coexisting with Amazon and Google requires an extremely diligent management team that is well-versed in Google and Amazon techniques. Responses to strategic changes from these dominant players must be swift and decisive, and business models sometimes need to be altered very quickly. The reality is that there is no one sure-fire way to combat Google or Amazon – management must intelligently react very quickly and expect these struggles to recur often. ***As investors review ecommerce businesses and management teams, this is often one of their main focus points – how, over time, has a business responded to and thrived in an environment dominated by Amazon and Google.***

Exploiting Niches

Given the dominance of Amazon and Google and the expense of competing with them for customers, profitable ecommerce businesses often focus on a particular niche where they can build customer loyalty and repeat business. By focusing on niches and developing deep content and products for those markets, sometimes bolstered by active online communities, niche sites build loyalty and recurring customers. Scott Gage from ShoreView Industries shared that ecommerce businesses have to have a strong differentiation for them to invest, adding, “It is relatively easy and inexpensive to put up a storefront. Building a brand is the expensive part.” Andy Cantwell from Carlson Capital furthered this sentiment, commenting that brands lead to repeat customers, and this is the key to success in ecommerce.

By focusing their efforts, rather than trying to supply everything to everyone, these businesses have seen tremendous growth and are well-positioned to continue to take market share. They also focus on end markets that are large enough to allow continued growth for the short- and mid-term. Long-term, these companies may expand their focus, customer base or strategy.

Recent Ecommerce Transactions

January 2022	December 2021	December 2021	November 2021	November 2021
throtl	TekBrands	digital room	Pink Lily	RENOVATION BRANDS
has been acquired by	has been acquired by	a portfolio company of H.I.G. CAPITAL	has been acquired by	has been acquired by
WHEEL PROS, a portfolio company of CLEARLAKE CAPITAL	WIL square	has been acquired by SYCAMORE PARTNERS	CORTEC Group	COMVEST PARTNERS
Automotive Aftermarket Parts	Quilting & Crafting Products	Customized Promotional Products	Women’s Apparel & Accessories	Home Improvement Products

See a full list of recent transactions and public comparable metrics at the end of the report

<u>Amazon as a Channel</u>
One note – even though Amazon is the 800-pound gorilla in the space and a major threat to most etailers, selling through Amazon’s Marketplace has proven a viable, often necessary, component of a competitive ecommerce business. Selling a differentiated product to the millions of daily customers on Amazon can be a great avenue for supplementing proprietary website revenues and often generates new direct customer traffic through strong branding. Because 40%-50% of consumer searches originate on Amazon and never leave the site, Bobby Kingsbury from MCM commented that “Amazon is a necessary evil – even companies with an established brand utilize the platform with so many consumers focused on the free shipping associated with Amazon Prime accounts.” However, Ryan Sprott, Managing Partner at Great Range Capital, told us that they are seeing many businesses for sale that sell the majority (or all) of their goods on Amazon, which can be a major red flag, and they have avoided investing in these businesses. Gregg Taber at Provariant summed up the situation, “Amazon needs to be a customer for any online business, but not too big, similar to how Wal-Mart needs to be a customer for any business selling at retail.”

Customer Acquisition

Customer traffic is the lifeblood of any retail operation, online or on the corner. Ecommerce sites have a bevy of well-defined tools they can utilize to drive traffic to their site. The chart below delineates different traffic sources and the average percentage of traffic derived from each source.

Website Traffic Generation Sources - Averages

Source	Percentage	Cost	Description
Direct	55.0%	Low	Direct Traffic w/o referring source
Organic (SEO)	26.9%	Medium	Search Engine Optimization
Paid Search (PPC)	5.8%	High	Google, Bing, etc. (Pay-Per-Click)
Referral	5.6%	Low	Links from non-search sites
Social	3.6%	Medium	Twitter, Instagram, Facebook, etc.
Email	2.1%	Low	Email Marketing

Source: Similarweb, April 2021

Each of these sources of traffic comes with a different cost and effectiveness, and each website will choose different sources for different business-specific reasons. For example, Fun.com sells Halloween costumes predominantly in September and October. Without customers purchasing costumes year-round, timely email marketing to prior customers and paid search are vital to the business. Other businesses with more traditional year-round traffic and purchases will receive more direct traffic from customers that return regularly and perhaps choose to invest more in social or email marketing.

Similarly important to remember, Gary Proctor at Epic Sports, which relies heavily on paid search to sell athletic apparel and equipment, said, "Traffic does not equal profits. Several years ago, we developed algorithms to shift our paid search focus from general traffic to profitable traffic, and for 60% lower spend we generated four times the revenue."

Investors will examine customer acquisition costs and the lifetime value of customers. What does it cost to obtain the first purchase from a customer, and how many purchases do those same customers return to make over what time period? Obviously, the lower the acquisition cost and the better the customer retention over time, the more valuable the customer base (and thus the business). Email marketing to existing customers using abandoned shopping cart items, discounts and repeat purchase reminders are highly effective for many products and very low cost compared to other marketing spend categories.

Social Media can create opportunities for consumers to interact with a company, or more importantly, with other consumers with similar interests. Actively sponsoring an interactive forum, Facebook page or Instagram account can foster communities of consumers that enjoy discussing interests and sharing their related projects and achievements. What could be better than your mostly loyal, avid customers generating new customers for your website?

Evaluation Metrics and Valuation Drivers

Any business will be valued predominantly on the future cash flows it can produce. New and hyper-growth ecommerce companies may be highly sought after by strategic buyers for the customer base they bring to the acquiror and the growth they are generating. Obviously, the strategic acquiror will hope to turn this growth and customer base into future profits, even if the business is not currently profitable. But, private equity investors don't have that luxury – they will be looking at future cash flows a business can produce on its own (or potentially with add on acquisitions) or through an exit at a higher value than at acquisition.

Ecommerce sites that are producing solid profits will be valued more highly if they are growing and have loyal customers that keep coming back. The following metrics will be considered by any acquiror as indicators that can drive customer retention and cash flow.

Ecommerce Valuation Metrics

Valuation Metric	Description
Product Categories	Generalist etailers are most susceptible to Amazon's dominance
Growth Rate	How fast are revenues growing compared to peers?
Gross Margins	How much value are you adding to the products you sell, either through design, branding or services?
Customer Acquisition Cost	How much are you spending to acquire each customer? Specifically, compared to the value of their spend on your site.
Customer Retention Rate	What percentage of customers make repeat purchases and for how long?
Customer Lifetime Value	How much will a customer spend on your site over time?
Average Order Value	Revenue/orders – this depends on the types of goods being sold, but generally, higher is better.
Cart Abandonment / Order Conversion	What percentage of filled shopping carts are purchased versus abandoned?
Email Marketing – Open, Click-Through, Subscribe & Unsubscribe Rates	Is your email marketing effective at generating additive revenues?
Mobile vs. Desktop Sales (1)	What percentage of your customers are purchasing on mobile platforms versus desktop computers?
Cash Flow	**Future Cash Flows are vital to valuation**

(1) Mobile devices account for the majority of ecommerce purchases today (50%-75%, depending on the data source). Investors will want to confirm an etailer has properly optimized its site for mobile transactions.

Evaluation Metrics and Valuation Drivers (Cont.)

There are dozens of other business characteristics that are more nuanced and viewed by investors differently depending on individual business models:

Proprietary Products vs. Resale
Private equity investors generally prefer proprietary products and direct sales to consumers. Direct control over both products and marketing allows for very nimble adjustments, when necessary, that can generate much quicker results than if one of these components is not in-house. Resale of other products is often not proprietary and usually generates lower margins, meaning less room for error and likely lower valuations (though there is still significant interest in these business models).

Logistics & Shipping (3PL vs. self-perform, who inventories products and where, etc.)
Most ecommerce businesses we have evaluated handle their own warehousing and shipping to enable more direct control over the customer experience. As Gregg Taber points out, “Same day fulfillment, top-notch customer service and two-day shipping are table stakes in ecommerce.” Because of the difficulty in managing a world-class logistics operation, smaller businesses may utilize 3PL services. This also requires inventory to be located at the 3PL provider, or perhaps in duplicate locations, creating additional costs. However, Will Grindell from Brass Ring shared that, in his experience, business with low-priced products don’t have much choice but to handle their own logistics – there just isn’t enough dollar margin to pay an outsourced 3PL provider.

Multiple Websites
Funneling revenues from multiple online store fronts into the same internal software system for orders and logistics can make sense in many markets to differentiate products, brands and consumers. As an example, Fun.com owns hundreds of domain names with specifically curated product selections that all point to the same back end, including the URLs:

www.halloweencostumes.com www.starwarscostumes.com www.wizardofozcostumes.com

Different Products or Brands for Different Channels
Those ecommerce businesses with proprietary products may choose to sell only generic product on Amazon and branded product on their own website, or they may choose to sell only branded product on Amazon, depending on their specific business strategy. Similarly, product pricing on Amazon will likely be higher than on a company’s website to account for free shipping, while shipping will be charged on their own website, allowing lower product pricing.

Sales through Amazon or other third party resellers can provide an introduction to a brand, but there is no direct connection to the customer and no feedback loop. Darren Acheson from Mill City Capital explained, “By selling directly to consumers, we are able to gather data that allows us to customize products and approaches to what our customers want,” rather than management making educated guesses as to the proper course of action.

Recent Effects – COVID, Supply Chain Disruption and Tightened Labor Market

As COVID led to worldwide lockdowns starting in March 2020, consumers increasingly turned to online retailers for basic goods, such as food and household consumables. Ecommerce spiked from 9.5% of total retail revenues in Q2 2019 to 15.7% in Q2 2020. This high level lessened to 13.3% by Q2 2021, but it proved out the promise of ecommerce to be an even more pervasive purveyor of a much wider selection of goods.

This spike also drove consumers to try new etailers, creating an organic, if unfortunate, source of new customers. Keeping these same customers in the post-COVID world will be key for these companies. One of the main tasks in selling an etailer today is proving that the "bump" that came during COVID is sustainable. While some etailers have clearly gained new customers that will remain post-COVID and will benefit from going to market now, others will need to prove out this sustainability.

Sequoya Borgman from Borgman Capital shared that, for companies that have seen strong momentum during COVID, they have proposed a full multiple on 2019 results with an earnout that gets paid if business continues at elevated levels. Bobby Kingsbury at MCM takes a different approach, "For businesses that were positively affected by COVID, we would have to understand the sustainability of those earnings and make sure we can clearly identify levers we can pull to continue the growth of the business during our ownership."

COVID and trade tensions with China have created chaos in the supply chain. The tight labor market is making it harder and harder to find retail workers. As component shortages continue, supply channels remain unreliable, and stores are not open when convenient for consumers, consumers will continue to turn online to search for goods unavailable on brick & mortar shelves. Converting these customers into repeat purchasers and keeping them long term after these crises pass will be key for etailers.

Summary

Ecommerce has been around for roughly 25 years, growing each year as the Internet has become pervasive in our daily lives. While Amazon and Google have grown into massive businesses that dominate the sector, there are thousands of ecommerce businesses that co-exist with them. Niche business models can be very profitable by utilizing deeper content and communities to develop a loyal, recurring customer base.

We are seeing many ecommerce businesses now reaching critical mass and evaluating an exit. Investors are extremely excited by the growth and nimbleness associated with ecommerce, and investment dollars are flowing into the sector. While different investors will like/dislike different models, most of them will start their evaluation by looking at the business strategies and valuation metrics we have discussed here. If we can be helpful in terms of discussing business model, strategic direction or valuation metrics, please feel free to reach out.

Metronome Contact

Please contact the Joe Lavely below if you would like to discuss how the transactions and trends described in this report will affect the outlook for M&A and other capital markets opportunities for ecommerce participants:

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Thank you!

We appreciate the time and energy so graciously shared with us by the following sources for this article:

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Sequoya Borgman, Borgman Capital
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Bobby Kinsbury, MCM Capital Partners
Allie Sacks Klazkin, Cortec Group
Gary Proctor, Epic Sports
Ryan Sprott, Great Range Capital
Gregg Taber, Provariant Equity Partners
Bill Willhite, WILsquare Capital

Transaction Comparables

Representative Industry Transactions

Date	Target	Acquiror	Description
Jan-22	Appleson, LLC	Boosted Ecommerce, Inc.	Beautician tools manufacturer and etailer
Jan-22	Furhaven Pet Products, Inc.	Worldwise, Inc.	Pet accessories etailer
Jan-22	Throtl, Inc.	Wheel Pros, LLC	Automotive parts marketplace
Jan-22	Fresh Heritage, Inc.	Branded E-Commerce Holding GmBh	Men's grooming products
Dec-21	Goodtimes, Ltd.	Weedbox Inc.	Cannabis and alcohol online marketplace
Dec-21	Digital Room, LLC	Sycamore Partners Management, LP	B2B Printing services for various categories
Dec-21	Daily Steals	Snapcommerce	Ecommerce marketplace for various product categories
Dec-21	TekBrands, LLC	WILSquare Capital, LLC	Quilting and crafting products
Dec-21	Jimmy Jazz Ecommerce, LLC	Snipes SE	Apparel and shoe etailer
Nov-21	Casper Sleep, Inc.	Durational Capital Management, LP	D2C Sleep products
Nov-21	Pink Lily, LLC	Cortec Group, LLC	Women's apparel and accessories
Nov-21	Renovation Brands, LLC	Comvest Partners	Home improvement products
Oct-21	Bespoke Extracts, Inc.	Infinity Management, LLC	Cannabis products
Oct-21	Natura Market Ecommerce, Inc.	Freshii, Inc. (TSX:FRII)	Online retailer for health and wellness
Sep-21	Olive Tree Bible Software, Inc.	Gospel Technology Limited	Online religious products marketplace
Sep-21	Rachel	Nolk Enterprise, Inc.	Subscription-based female apparel products
Sep-21	ESP Auto Auction, Ltd.	eBlock, Inc.	Online automobile auction services
Aug-21	Mountain Green, Inc.	Metatron, Inc. (OTC:MRNJ)	Electronic and nutritional supplement ecommerce marketplace
Aug-21	Friendly Gummy Co., Inc.	Vegano Foods, Inc.	Chewy gummy supplements etailer

Public Comparable Listing

Public Ecommerce Companies

Ecommerce Marketplaces	Closing Price 02/17/22	Stock Price % of High	Enterprise Value (MM)	EV/ Revenue LTM	EV/ EBITDA LTM	Margins Gross	Margins EBITDA
ABOUT YOU Holding AG (DB:YOU)	$16.91	55.3%	2,295	1.2 x	NM	37.3%	NM
Amazon.com, Inc. (NasdaqGS:AMZN)	$3,142.01	83.3%	1,652,361	3.5 x	27.9 x	42.0%	12.6%
Alibaba Group Holding Limited (NYSE:BABA)	$126.59	46.5%	318,511	2.5 x	NM	38.8%	19.1%
AO World plc (LSE:AO.)	$1.26	27.2%	738	NM	30.5 x	17.8%	1.1%
boohoo group plc (AIM:BOO)	$1.28	25.2%	1,564	0.6 x	NM	54.0%	6.8%
CarParts.com, Inc. (NasdaqGS:PRTS)	$8.99	42.2%	502	0.9 x	NM	34.0%	0.3%
Chewy, Inc. (NYSE:CHWY)	$47.26	40.6%	20,389	2.4 x	NM	27.2%	0.6%
FIGS, Inc. (NYSE:FIGS)	$17.87	35.5%	2,925	NM	NM	72.2%	2.3%
JD.com, Inc. (NasdaqGS:JD)	$75.75	70.0%	97,808	0.7 x	NM	7.3%	1.1%
Kogan.com Ltd (ASX:KGN)	$4.44	36.9%	477	0.8 x	20.5 x	26.4%	4.0%
Lulu's Fashion Lounge Holdings, Inc. (NasdaqGM:LV	$10.37	68.7%	626	1.9 x	22.2 x	47.0%	8.5%
Newegg Commerce, Inc. (NasdaqCM:NEGG)	$6.06	7.7%	2,227	0.9 x	NM	13.4%	1.7%
Overstock.com, Inc. (NasdaqGM:OSTK)	$41.59	37.4%	1,494	0.5 x	16.9 x	22.4%	3.1%
Ozon Holdings PLC (NasdaqGS:OZON)	$20.98	30.9%	4,426	2.1 x	NM	33.6%	NM
PetMed Express, Inc. (NasdaqGS:PETS)	$26.50	56.8%	422	1.5 x	14.2 x	28.4%	10.7%
Rent the Runway, Inc. (NasdaqGS:RENT)	$5.74	23.2%	381	2.2 x	NM	70.6%	NM
Revolve Group, Inc. (NYSE:RVLV)	$56.71	63.3%	4,198	NM	44.4 x	55.2%	11.9%
Stitch Fix, Inc. (NasdaqGS:SFIX)	$13.31	16.0%	1,365	0.6 x	NM	45.7%	NM
Vipshop Holdings Limited (NYSE:VIPS)	$10.55	22.9%	5,081	NM	NM	20.4%	6.2%
Wayfair Inc. (NYSE:W)	$132.19	37.1%	15,798	1.1 x	39.5 x	28.9%	2.8%
zooplus AG (XTRA:ZO1)	$531.94	94.7%	3,752	1.6 x	NM	26.6%	0.5%
1-800-FLOWERS.COM, Inc. (NasdaqGS:FLWS)	$15.62	40.4%	1,069	0.5 x	NM	40.1%	7.1%

	Stock Price % of High	Enterprise Value (MM)	EV/ Revenue LTM	EV/ EBITDA LTM	Gross	EBITDA
Min	7.7%	381	0.5 x	14.2 x	7.3%	0.3%
Average	43.7%	97,200	1.4 x	27.0 x	35.9%	5.6%
Median	38.9%	2,261	1.2 x	25.1 x	33.8%	3.5%
Max	94.7%	1,652,361	3.5 x	44.4 x	72.2%	19.1%