SUBTA Power Hour
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Today's Guest: Richard Kestenbaum

Michelle: Hello and welcome to the SUBTA Power Hour. This is your host today, Michelle Lang. Thank you for joining us. SUBTA is the global network that helps grow enduringly fantastic subscription businesses, and we are very excited to have Triangle Capital founder, Richard Kestenbaum joining us for this week's podcast. While offering his expertise to businesses in the apparel, retail, and consumer sector as well as managing his private investment banking firm, Richard also contributes articles on retail trends and consumer product businesses to *Forbes* practically on a weekly basis. Some of his recent articles include, "Where Retail is Going Now," "Your Competitors Are Using Big Data and You Should Too," and you've gotta love this one, "How Consumer Tastes Are Changing in the Bedroom", spoiler alert, this is not what you might think;) Richard, thank you and welcome to joining us today.

Richard: Thank you so much, Michelle. It's a pleasure to be here. Thank you for having me.

Michelle: Well, totally our pleasure. One of the reasons we asked Richard to join us is because of the power of understanding what's going on in retail and knowing that we can learn a lot from retail, certainly, on the subscription side, and clearly we also have kind of been a disrupter in that line of business as well. So, first off, Richard, I say we just dive into the meat and from your point of view, what is the future of retail, and then what can we learn and what are some of the implications for subscription boxes?

Richard: Well, that's a big question, and I think there are ways in which the future of retail is very much like the past and ways in which it's quite different, and the way in which it's very much like the past is retail's about the product and delivering great product, and great product doesn't just mean things that consumers wants, that fit them right, and that work well for them. It means things that are--that have the right values for consumers that have changed over the last several years as there's been a generational shift away from Baby Boomers to Millennials and Gen Z consumers. Gen Z consumers have seen--Gen Z consumers and Millennials want different things from their product. They want values--values that conform to the values in those consumers' lives. Like, great experiences, belonging to a community, artisanal products, things that relate--ethical production, local production--things that relate to those consumers. That has been an incredible challenge for the legacy retailers, but the ways in which retail has changed is--well, subscription boxes are very much one of the examples of the way retail has changed, because the way in which things are sold is different, but one of the things that always has to be true is that the product has to work not only for the consumer, but also for the company providing it. So, that means you can't spend too much money to acquire a customer and products have to have the right margin. One of the beauties of the subscription business is you're selling direct to your consumer, so there's no middle man in taking margin like there is in the wholesale business, but that means you have to have high margins in order to have the room to acquire customers. It's very tempting to either sell at super low price or spend a lot of money to acquire customers, but it's not a long-term sustainable strategy, and we at Triangle Capital go out to sell companies and we see companies that are building revenue with low margins, or who are overspending to acquire customers, or whose subscription businesses churn their customers, they're not really saleable businesses, or they're saleable at only a very low value--a "salvage value," let's call it. What has values is customers that provide their consumers with things that the consumers want, with the values that they want, as demonstrated by the gross margins and the customer acquisition costs.

Michelle: When you're valuing a potential company for sale, how do you assess their strength in the area of community and experience--some of these other topics you brought up?

Richard: Well, every company does it in a different way. If you're selling a commodity product--let's say, for instance--well, if you're selling a commodity product, it's very hard to develop any kind of community, but if you're selling a product that's, for example, for a particular sport or you're selling a product that's for children, you can build a community by providing editorial, by giving the consumer opportunities for experiences--things that they might not have been aware of that they can do in their locality, in their sport, or with their children that make them feel like, "I'm getting more out of this than just product. This is making my life better because the things that are important to me are important to them, and they're working for me." So, community can be created unless there's a commodity aspect to the business. In which case, it's only about price, and that's not a great business. Unless you have a low cost producer, which as a subscription business, you probably are not.

Michelle: Have you ever recommended to any of your clients that they raise the price of their product?

Richard: Oh, yeah. If I see a company whose margins are not where we think they should be and we see that there's consumer demand for it, we'd say, "Look, either your costs are too high or your prices are too low," and yes, we've definitely seen that. It's not the norm, but we've certainly seen it and we know where margins should be and where the bottom line should come out if the product is desirable for consumers.

Michelle: Richard, what can we learn from how retail is working or not working with Amazon? There was a great article the other day about how Amazon is now tapping into athletic apparel suppliers to go into private label sportswear. As a result, they say, shares of Lululemon fell by 5%, Under Armour declined, Nike also slipped. So, there was a very direct impact on the market in terms of brand names that produce athletic wear right now, and some people are afraid that this sends a message to brands electing to sell their full inventory on Amazon if shoppers can't find their product. So, anyways, I'm just curious. What do you think of what's going on with retail and Amazon right now, and thinking about what can we learn from retail's response?

Richard: Well, I think you're asking me about that for subscription companies. Is that fair?

Michelle: Yes.

Richard: Okay. I don't think Amazon is a friend of subscription companies. Subscription companies exist and are structured to solicit interest from consumers, sign them up, and deliver product to them. You can hardly find anyone better in the world at those top--at those tasks than Amazon. So, why would you hand the keys to your kingdom to Amazon? It's true that, in the short term, they can facilitate growth, but in the end, they want to eat you because they can go into that business like nothing, and they will see that they are delivering the value to them, and eventually, they'll increase their portion of the price that they're taking and it won't be worthwhile. A subscription business--like any branded company--needs to develop value for its own brand, and overtime, that will drive consumers to their website or to their subscription, and Amazon acts against that interest. Amazon's great at certain things, but subscription businesses need to develop their own value on their own and using Amazon is not so different from being in a wholesale business and selling through Macy's. The party that controls the magic moment--when the consumer makes the purchase decision--is the party that will ultimately wind up with the power to control the margin, and if you give that power to Amazon, you're not gonna get it back from them.

Michelle: Okay. Well, that was clear. Thank you, Richard.

Richard: Well, not everybody agrees with me, but I think it's a question of short term versus long term. I think, in the long term, Amazon's not a friend of outside subscription businesses.

Michelle: I appreciate that. I love that. "The magic moment drives the margin." So, own that and you'll own the margin. Great point. We have a question that came in. "What do you consider a good gross margin percentage?"

Richard: Well, it depends on the product, but if you think about--let's talk about apparel, for example. In the wholesale business, if you have a good brand, you can expect a sustainable margin at a peak of something in the low-40s percent, but if you're selling direct to consumer, you should expect that same business to have a margin that's anywhere from 65-80%. Now, a lot depends on what the product is, and in the subscription business, there are two kinds of subscription. There's a lot of ways of breaking down the subscription business. One of the ways is to look at it two ways. What's in the box? Is it a branded product or is it your product? If it's branded, your margin can't get to that level, but it has the trade off of consumers know exactly what's in the box. In the long term, you're better off if you can have your own branded product in the box because that's a higher value add[? 00:21:12] for you. When you put other people's branded products in the box, it's merely a question of price. That is to say, they can price out the product that's in the box just by going online, and if they do that, they can see the value that you're delivering it and measure it almost to the penny. It's harder to measure when it's your own branded product, and that allows you to get a better value from your consumer. So, that margin can be a very high margin, and long term, that allows you to build your own brand, your own relationship with the consumer, and allows you to spend a lot of money to keep your consumer happy with other services, other editorial, and other ways in which you can acquire new customers and build your subscription list.

Michelle: Excellent. I was talking recently with Eric Furnee, CMO, for Winc, which is a wine club. Eric shared how they started out curating other people's wine and now they're 100% switched to their own proprietary wines and what a difference that has made to your point not only on margins, but also on branding and building unique experiences that cannot be easily copied.

Richard: Well, I think that's right, and what they've done is a very good model for how to transition. So, when you start and no one knows who you are and you put branded product in your box and you take that lower margin, that's a great way to establish your credibility, and once you've delivered month after month of box that has credibility and value to the consumer, then you start putting your own branded or private-labeled product into the box, you're riding on the credibility that you've already established and that's a great way to transition into more private-labeled product. Also, when you start, it's very hard to both develop your business and keep on designing, finding, sourcing, buying, delivering, managing your own private-labeled product. So, it's a good way to start without having as much risk as you have when you have to design and source your own product.

Michelle: Thank you for connecting the dots so eloquently, Richard. Different question. What should be keeping fast-growing subscription box companies awake at night?

Richard: Well, there are a few things I'd worry about. I would worry about product, and my product always has to be great. I'd worry about my gross margins. If your gross margins suffer, your profit will suffer and the value of your business will suffer. I would worry about churn because the lengths of subscription is very important to the profitability and the success of the business, and I'd worry about customer acquisition cost. What's happened in the valuation of businesses is that the change in consumer behavior and the new innovative ways to sell have created changes in what's valuable. So, a business that's a subscription business doesn't have to measure up by traditional metrics of book value and earnings before interest tax of depreciation and amortization, but they do have to have a way to show that the way they're pursuing their business now will lead, inevitably, to a highly-profitable high growth business. If they do that, then the business is not just sustainable--not just sustainable--it's very valuable. So, if you have great profit of high gross margin, and you have growth, and you have relatively low churn, high length of time that consumers stay with you, and you have customer acquisition cost that has a short term payback, you have a very valuable business, and scale is not as important as each of those elements. You'd rather have those elements be right than have a bigger business where one of those elements isn't right. Now, each of the silos of X that you have in the subscription business is not hard for a person of reasonable intelligence to understand, but it's very hard to get all those things right simultaneously, and that's the difference between the businesses that are successful and the ones that aren't--it's execution in all those things simultaneously. You know, startups are very challenging--no question about it--but executing on an effective startup concept is also very challenging, and execution is often where companies fail. Doing all those tasks simultaneously and well is the execution, and that's the most important driver to value.

Michelle: How about capital? What do you see is that a driving issue? Should people look to be able to get more capital early on, at what point should they be thinking about capital, where do they need it, where should they put it? Is too much too much?

Richard: There is such a thing as too much, sure, because you wind up diluting your most important asset, which is your equity and that goes right to the heart of the wealth of the founders. So, should they be raising outside capital? You know, I go to a lot of trade shows and I was standing in one trade show, and there were a bunch of men's woven shirt providers. About three dozen of them all in one area, and I walked around and they all wanted to sell to the same customers and they all had product that was very good, priced in a reasonable range, and I asked myself, "What's the difference between the ones that are successful and the ones that aren't successful?" And the difference is the successful ones had raised capital where they had a founder who had a deep pocket. They used capital to develop their business, because let's say you develop a concept and you create a subscription box that is effective--it has a high gross margin, it has great product, you develop a great system for creating more product, you have a great way of reaching consumers so that they sign up. Without the loud speaker to reach consumers, you'll never develop traction for that business and you can't develop the value. It's not just creating the concept, it's getting enough people to hear about it and that takes money. So, if you have a way of getting consumers to sign up that involves a reasonable customer acquisition cost--both for first time customers and repeaters--it's a killer system, no question about it, but you need the money to be invested to make it happen. Now, you'll say, "How much?" Look, there are companies that fail from their own success because they're growing too fast. That's up to management, and how much they think they can handle, and how strong their team is, how many hours there are in the day for them to execute, and they have to decide how hard to push the pedal. You know, that's up to each individual manager, but going along without capital and growing by 20% per year when you have small numbers, that's not gonna be exciting to an acquirer and it's not a great to develop value.

Michelle: Along those lines, we just received a question about from Ray, "I see many new startups testing subscription with no compelling (meaning, catch the consumer's eye with a good value), but with no compelling introductory offer. Do you see this as good?"

Richard: I don't think the introductory offer is necessarily the key. If you're a consumer and you see something that you want, you'll buy it because you want it, and if you're buying it because it's cheap, that's not a sustainable customer. Now, what your questioner is asking is "How much risk do I want the consumer to take," and when you lower the price, what they're trying to do is lower the risk for the consumer, but what you may be doing is cheapening the product and the perceived value that makes it very hard to convert them to the full price customer. So, I would--you have a choice of where you invest your money. One of the ways to invest is in dollars off. I would be concerned that that cheapens the value and makes it hard to convert the customer. What I like to see the investment in is, "Let me show you how great these products are. Let me make a video that you can click on that explains the use of the product, how we make it, why it's relevant to your life, why it's a great product, the stitching, the fabrication, the origin, the ethical production--all the things that are important to consumers." I think you'll get consumers to pay for that.

Michelle: Richard, we're gonna just take a short commercial break and share with the audience what our next topic is, and we'll be right back with you.

Richard: Okay. Great.

Michelle: Okay. Don't go far. Next week at 1 PM ET on October 25, we're going to have Alex Brown, who is the Beard Club cofounder and he's going to share what he's learned in his journey to nine figure growth and beyond. Alex is a serial entrepreneur and specializes in marketing, strategic and vision development, corporate, development, and operations management. He has been behind the launch of multiple brands, including the Beard Club, which went from zero to 13 million in revenue in their first year. Alex will be joining us next Wednesday. So, make sure you sign up through the normal channels. Okay. So, now, going back to Richard here. Welcome back.

Michelle: We are back. Richard, you published an article back, I believe, late August that I still refer to, and it's called, "Your Competitors Are Using Big Data and You Should Too," and I know one of the stories that you shared in there is that Under Armour had acquired a company called Map My Fitness, which is an app--probably many people have used it that are online currently--and you shared how Under Armour is using the data from Map My Fitness to better understand the runner's habits and when to target product and even energy drinks aligned with their timing, and interests, and length, and location. How can subscription box companies use data better?

Richard: Well, of course, there's the analysis of what gets returned and what gets capped by whom, and how that correlates to the demographic data in the finest detail, and there's all kinds of ways to do that, but let's talk about technology. Technology is changing very rapidly, of course, and I am besieged every day by multiple technology companies relating to retail who wanna either by financed or be written about or whatever, and some of them are not good ideas, but most of them are very good ideas, and I think that--as I was talking about execution before, execution is very important in the subscription business, it's very important for any startup, and it's very important for these technology businesses and I think most of them that are good ideas will rise or fail based on the execution of their ideas and their business and how well they can manage it. We don't know right now which of those ideas are going to be successful, but we do know that technology's gonna be placing an increasing role in the development of product and the building of businesses. When you look at what the giants are doing--the people with the most human resources and the most financial resources--let's talk specifically about Amazon and Walmart--they're doing things, and sometimes you scratch your head and you say, "Why are they doing that? What can they know that convinces them that what they're doing will work?" And the answer is they don't know. They are spending this money because they know they can't stand still, they know they have to do something, they know the things they're doing have something going for them, and they're not sure what will work. So, they're trying everything they can judiciously, but everything they can, and some of them will fail. That's true for technology, too. In particular, I wanna talk about artificial intelligence to answer that question. Artificial intelligence will help you figure out what goes in the box because it will learn from its past experience and it will develop product that should go in the box that wasn't immediately apparent to the rest of us. Artificial intelligence is still in development, and every company has to develop it on its own in a way that relates to their particular business, and the people who don't develop it will be behind because they're gonna have higher returns. So, the answer is we don't know yet how technology will affect subscription businesses, but we do know that there are people out there who are trying everything, and if you're not trying as much as you can, you're gonna fall behind. I foresee a world where you--it's kind of what is was, I imagine, in the 19th century. You walk into a store, and they know you, and they say, "We think these four things are right for you," and they do that because they know who you are, they recognize you technologically, and they know your history, they know your demography, and they have made some assumptions about what you want, about what you want and what you will need, and they can bring you those things. Well, a subscription box is exactly that, except it comes to your home. It needs that technology, too. It needs to understand what do people want--not in a mass way, but in an individual way, and technology will help them do that.

Michelle: Are there any particular technology companies in the AI arena that you think would be a good place for people start in the subscription box world? Any vendors you recommend?

Richard: In an earlier part of my life, I was very involved with technology and that helps me be conversant in it, but I see so many good ideas it's hard for me to say what works better than something else. I've kind of made it my business not to choose and just to be open to listen to what I'm seeing.

Michelle: We have a question from Jeff. "Are there any large omnichannel retailers or specific CPG brands who you think, Richard, should launch a subscription to improve their business and/or connect better with their customers?"

Richard: I think subscription--you know, we've identified subscription as businesses of their own, but we're starting to see subscription businesses be a part of other companies. So, that's a really interesting question. Yes, I think it's applicable to almost everyone. Let me give you an example. There's a retailer by the name of New York & Company. They developed a subscription rental business called Endless Closet, and the way it works is--if you remember how Netflix used to work when there was only DVDs, you paid them a price for one disc, a higher price for two discs, three discs, etc., and you kept the disc for as long as you want. You could keep it for one day, you could keep it for a year if you wanted. You just pay the monthly fee for that disc. So, they do the same thing with women's clothing. You pay them to hold an outfit of theirs, and if you're done with it, you can keep it as long as you like. When you're done, you send it back and they send you the next thing on your list just like you did with Netflix. Well, it turns out that when women rent clothes, they rent different clothes, and it turns out that the clothes that they rent rather than buy are the clothes that are risky, and it turns out that those clothes are just the clothes that the store has trouble selling. So, they've said to themselves, "Let's take the clothes that would otherwise go on markdown and put them into a subscription rental service, and that way we'll get our full markup." It's a way to use subscription to reduce markdowns in stores. There are a lot of ways that subscriptions can be used. I think we're only at the beginning, and that brings me to another point about subscriptions and the state of the market. We are very much early in the life cycle of subscriptions, and that makes it a wide open field. When a business is mature--like we saw happen in the flash sale business--we see people come in, we see the market grow, we see people get excited. Eventually, the growth tops out. In the case of flash sale, it topped out at a lower level than people were expecting, and hence, we saw a lot of people who put money into gilt groupe get a negative return because it wound up being sold for less than the final rounds of capital raising, but the business becomes mature, and then it consolidates. The subscription business is very, very far from that consolidation stage, and the people who are the leaders in the subscription business today do not have a firm foothold on that leadership position. It can change. We've seen people even so far in the life of subscription--in the subscription industry, if I can call it that, who were leaders and who are losing position, whose website is visited less than it was a year ago, and we're seeing people who are very, very small gain entry and are seeing their traffic explode. So, it's volatile right now, and that means there's opportunity for the people who can put forward their great product or plan and execute.

Michelle: When you were talking about Endless Closet, you mentioned both the consumer and company's pain point. So, I just think that's very healthy is it's not just about looking at your consumer's pain point. It's about also understanding your own pain point and finding those intersection for it's a win-win. I appreciated your example, Richard.

Richard: Well, that's right because if you are providing a product and you're losing money or you're not getting the good enough margin, that's not a great service to your consumer because it's not sustainable.

Michelle: You started talking a little bit about the future. So, let's go back to Bill Gates' book *Business at the Speed of Light,* and he shared that people tend to overstate what will happen in the next couple of years, but they understate the potential for change in ten years. So, we don't have to look out as far as ten years, because I think that's rather difficult, but when you just look at those--let's say, beyond the two years--but in those 3-5 year window-ish, what do you see people should be thinking about that are in the subscription industry?

Richard: I think we're--we touched on it a minute ago. I think we're gonna see many wider applications for subscription businesses not just as pure subscription businesses, but as adjuncts to other businesses and many more uses for them. We're going to see the market solidify so that leaders and followers will be established, and that's going to lead to consolidation where the leaders acquire the followers or crush them. So, now is the important time to develop leadership, to invest in acquiring customers for an effective box because if you can establish leadership at this stage, then it become sustainable when the right stage happens. That's what I'd be thinking about.

Michelle: Wonderful. Before today's call, we were talking about the questions "Are you the seller or are you the buyer?"

Richard: Oh, yeah. Well, let's say it's a number of years from now and subscription is an established business and there are leaders, and then there are companies that aren't the leaders. So, the--you know, this goes to the question of, "Should you raise capital in your business?" If you're a leader and you have the resources, you can acquire the other subscribers, you can create a platform of multiple subscription businesses, and you can develop a lot of value from the efficiencies that can be created by having different subscription businesses. You can move consumers from one to the other if they're related, and many other advantages in cost and operations. Those are the ones who will have the greatest return on their investment, and how do you set yourself up to be one of those people? Well, it goes--it starts with having a great business, but it also starts--it also continues with having enough capital to be able to merge other people now. That has a number of challenges. Not the least of which is integrating businesses that are run by entrepreneurs can be scary because sometimes entrepreneurial businesses are built around the entrepreneur and don't exist without them. So, you have to be really careful about the culture when you make acquisitions and consolidate businesses, and you have to due diligence and study, and make sure that this thing will work and not break when you acquire it, but building a platform of subscription businesses is, I believe, where this business has to go because eventually the number of people who are subscribers will reach a peak, and it will be stable, and then the industry will have to consolidate, and the people who are most efficient will win and have the greatest success.

Michelle: Excellent. Thank you, Richard. Do you have any final words you'd like to share with today's SUBTA audience?

Richard: Well, I was reading something earlier that just amazes me. There's a hardware store in Wister, Massachusetts called Elwood Adams. They went into business in 1782. They survived the War of 1812, the Civil War, the First World War, the Great Depression, the Second World War, the Korean War, the Vietnam War, and everything else that happened. They just went out of business, and they went out of business because they can't seem to adapt to the environment that we're in now. I find that unbelievable, but what it says is we've never seen more change than we're seeing right now among consumers, and being able to adapt and being willing to look outside our own four walls is, apparently, a key to success. We're seeing that the legacy brands and legacy retailers are having a super hard time, and that is leaving the door open for niche brands to hack away at them, and providing an incredible opportunity. But it's easy to become calcified in your own world, and that's the risk, and that's the thing that has to be avoided when you have a successful business, even if it's small.

Michelle: Richard, thank you so much for that powerful ending and thought-provoking story. Thank you for your many gifts of wisdom and insight that will help our subscription companies, and we really appreciate you being with us today, and look forward to having you on again.

Richard: Michelle, it's a pleasure to talk to you any time. Thank you so much for having me.

Michelle: Right. Have a great day, Richard, and to our audience, thank you for joining us.