

BEAUTY AND THE BEASTS

What are the next steps for two female entrepreneurs and their indie beauty start-up?

Gail Cook Johnson, Ph.D.
Mentor-in-Residence & Senior Fellow

The Ted Rogers Leadership Centre

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Introduction

Joan Lighthouse and Elena Eustace, co-founders of uBe, an indie beauty start-up, soon discover as they arrive at O'Hare Airport in Chicago that their day is just not going to get any better. Due to bad weather, their flight home has been cancelled. Rather than being back in New York celebrating a big win with their families, they are now sharing a room in a slightly seedy airport motel contemplating the consequences of their unsuccessful last-resort pitch to yet another venture capital firm. Just as the two partners are coming to terms with how they will wind up uBe, dreading the need to tell their angel investors (many of them close friends and family) that all is lost, the phone rings. A mentor, who encouraged this last pitch, is calling to follow up. When learning the bad news, she makes an astounding proposal: she offers a financial lifeline to provide uBe enough funding for another six months, potentially giving the partners time to regroup and find the seed funding uBe needs to move forward. Joan and Elena now cannot wait to get back to New York: there are plans to formulate and decisions to be made.

Beauty and the Independent Beauty Industry

In 2017, the global Beauty & Personal Care industry, which includes care and wellness products for skin and hair as well as colour cosmetics, fragrances and so much more, was worth around US\$530 billion. This market is dominated by the large established brands like Estee Lauder, L'Oréal, Revlon, and Elizabeth Arden.

Fuelled by the growth of online shopping, the greater availability of outsourced manufacturing and a growing consumer demand for products that fit a more diverse beauty aesthetic as well as for more natural, socially responsive products, the independent beauty market (also known as indie beauty) is strongly challenging the status quo. Prior to the pandemic, indie brands were claiming about 40% of the Beauty market, taking share away from the big companies in all categories except deodorant. Approximately 55,000 indie brands catered to about 50 million beauty consumers, seeking authenticity, efficacy, and information on "how-to's."

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Heretofore thought of as a recession-proof industry due to the “lipstick effect,” McKinsey has estimated that store closures and slackened demand for cosmetics during the pandemic have caused the beauty industry to shrink by as much as 20%-30%, although indie beauty, which operates primarily online, has been less damaged. As the industry comes out of the pandemic, it is anticipated that it will continue to favour indie beauty with growth rates in the double digits over the next five years, compared to a CAGR of 4 to 5% for the traditional brands, given an increasing demand for brands that fit indie beauty characteristics, including:

- inclusivity, reflecting the needs of a diverse population.
- clean beauty, with one recent poll assessing that as many as 60% of consumers now want natural products.
- Sustainability.
- authenticity, where the merits of the product are supported by fellow users, respected bloggers, and experts, rather than staged advertising. Data has shown that the use of reputable influencers reap a \$11.45 return for every \$1 of investment, and
- a comfort with on-line shopping, which, following the pandemic experience, now brings in more older consumers who are more able to afford masstige pricing than the younger consumers first targeted by indie beauty, potentially allowing indie beauty to be more competitive with the luxury lines of the established brands.

On the downside for indie beauty, the pandemic has shaken the established companies out of their complacency. During the pandemic, the traditional brands significantly upgraded their on-line presence, took actions to improve sustainability and expanded their clean beauty options. For example, Estee Lauder negotiated a deal to purchase the Toronto-based Deciem Beauty Group, which is behind The Ordinary, an indie skin care brand with an almost cult-like following.

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Other developments and trends are impacting both the established and indie beauty markets:

- A shift in product mix. Eye make-up is expected to replace lipstick as the high growth beauty product in cosmetics; and skin products, which grew at an astounding 600% during the pandemic, will continue to capture more market share, along with a shift to hair care and self-care with do-it-yourself options welcome. Within the skin care category, demand for cannabis-based beauty products (known as the CBD market) are expected to rise as a remedy for acne and other skin conditions.
- A reorientation to what is beauty. The aging population is more frequently defining beauty not as “looking younger” but as “aging well,” which puts more of a focus on holistic beauty products and intimate wellness. Colour cosmetics as well as skin and hair products that are more suited to a diverse population and aesthetic also will continue to be in demand.
- The “must have” applications of digital innovation, such as the use of VR and AR technologies to provide the “virtual tryout” and a highly personalized shopping experience. Alibaba, for instance, after deploying such innovations, reports that their conversion rates increased by a factor of four.
- The leveraging of ‘big data’ to activate customers, followers, and fans not only to evaluate a product, but also to engage in the development of new products.

Into this dynamic and increasingly competitive landscape, Joan and Elena’s indie start-up enters the marketplace.

Your Beauty Exchange: Its Beginnings

After raising \$800,000 in angel investment, Joan and Elena start Your Beauty Exchange (affectionately known as uBe among its dedicated followers) in the fall of 2019. uBe is an online marketplace bringing indie beauty brands to indie beauty seekers. As one reviewer said, “uBe is the Etsy of beauty.”

uBe provides to indie producers with less than \$10 million in sales, most being in the range of \$2 million to \$5 million, a welcome marketing arm, allowing them to focus on product innovation and quality. For the consumer, uBe provides a carefully curated array of indie products, marketed through a variety of social media channels, daily blogs, influencer feedback and how-to videos. With the innovation of the uBe Guide, uBe consumers can tailor their shopping choices to those most efficacious to their beauty needs as the guide identifies how each product addresses particular beauty wants, skin colours or skin conditions. In terms of uBe’s selling strategy, new products are launched daily with seven-day promotional pricing. When products are being specifically promoted, uBe takes 50% of sales, otherwise 30% of sales.

Before becoming business partners, Joan and Elena followed very different paths. After completing an MBA at Columbia University, Joan, a petite brunette who radiates charisma and intelligence, becomes the first female partner in a well-established boutique firm specializing in advising entrepreneurs on how to develop and grow their firms. Elena, a statuesque Jamaican, who is discovered by a scout for the Eileen Ford modeling agency when she was sixteen while visiting New York, develops, alongside her modelling, a parallel career as an influencer providing beauty advice and cosmetic how-to’s to an inclusive audience. She also completed a degree in digital marketing at New York City University.

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Joan and Elena finally connect when a high-worth investor approaches Joan to develop a specialized chain of nail and personal care salons which have a commitment to indie brands and the indie philosophy. Joan, through a competitive search, hires Elena as her COO.

Inspired by their experience with the salons, which the two successfully develop and profitably sell, Joan and Elena identify a gap in the market for women who are “beauty junkies” with a defined beauty philosophy wanting to buy indie products but have difficulty sourcing the products.

At its inception, uBe’s target market is female, between the ages of 18 and 35. Given the respective skills and experiences of the two partners, uBe’s angel investors anticipate that uBe will be a runaway success. No one, however, anticipated the pandemic which brings with it an explosion of online competition.

While uBe has been nimble enough to accommodate a change in product mix by shifting to more skin care and self-care options as the pandemic deepens, growth has not met initial expectations. uBe desperately needs an infusion of \$2 million to provide the personalized shopping experience that competitors are beginning to offer, develop the consumer engagement capabilities that will fuel future product selection, and expand into new demographic markets. Assuming funding is found, the following chart projects uBe fundamentals from their first-year end in 2020 through to 2024.

uBe Business model fundamentals

	# of Members	Member to Buyer Conversion Rate	Average Order Value	Average # of Orders per Year	Total Revenue
2020	70K	4%	\$46	1.5	\$139K
2022	1.5M	7%	\$57	3	\$20M
2024	6M	7%	\$57	3	\$92M

	Total Revenue	Average Gross Margin	Gross Margin	Operating Expenses	Total EBITDA
2020	\$139K	28%	\$40K	\$662K	\$(403)K
2022	\$20M	37%	\$7.6K	\$6.8M	\$907K
2024	\$92M	37%	\$34K	\$19M	\$16M

To obtain the needed funding, Joan and Elena have made a countless number of pitches over the last year to a variety of venture capitalists, never succeeding.

The Problem with Venture Capitalists

Joan and Elena’s experience with venture capitalists (VCs) is not unique. The industry has long been accused of systemic racial and gender bias. According to Pitchbook, in 2018, companies founded by female entrepreneurs garnered only 2.2% of the VC capital invested that year.

Recent studies published by the Harvard Business Review¹, have documented that:

- Only 10% of VC deals are sourced through cold calls. The other 90% are referred by someone from a VC’s network of trusted personal/professional relationships.

¹ See Kamal Hassan, Monisha Varadan, and Claudia Zeisberger, “How the VC Pitch Process is Failing Female Entrepreneurs,” *Harvard Business Review*, January 13, 2020, and Paul Gompers, Will Gornall, Steven N. Kaplan, and Ilya A. Strebulaev, “How Venture Capitalists Make Decisions,” *Harvard Business Review*, March-April 2021

- Discrimination against female applicants for VC funding is most evident when the pitch is made. While males get “promotional” questions about how they will address the upside and potential growth issues, female entrepreneurs tend to be asked “preventative” questions about how they will manage losses and mitigate risk. In part this is also because, it is noted, men and women have different styles. Men tend, in their presentations, to focus on the big picture, with “hockey stick metrics,” whereas females, in contrast, tend to be less bold and undervalue the progress that can be made.

While VC funding for a female owned or co-owned company has been trending up from 2018, progress has been stalled by the pandemic as, in the face of uncertainty, VC firms have retreated even more to whom they know and what they know best. The misdeeds of Elizabeth Holmes of Theranos, a prominent female entrepreneur who was heavily funded by VCs until she was charged with fraud, also has fed this retrenchment into known networks, away from female entrepreneurs.

For Joan and Elena this is particularly bad news as, not only are they female entrepreneurs, but they are also launching a business which caters largely to female consumers, foreign territory for most VCs.

Brainstorming

When Joan and Elena get back to their office in New York, they convene a day-long session with a group of trusted advisors and colleagues as well as respected industry and technology experts. After reviewing for their audience their pitch deck, detailed financial data and forecast assumptions, they invite those assembled to frankly discuss and debate the options available to them. The key question they ask is: “What do we need to do to ensure we not only survive for the next six months, but also succeed in getting the next round of seed money we need?” Not spoken, is a second question that the partners think they must ask themselves: “Is closing uBe now the most responsible thing to do?” They hope feedback from the day will give them the perspective and answers they need.

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The conversation during the brainstorming is wide-ranging and, at the end of the day, the two partners realize that they have a lot of food for thought but no clear recommendation. To aid their own decision-making, the two women summarize the feedback they received as follows:

- A few from the outset caution not to be too compelled by the industry pronouncements about a double-digit rebound. They argue that the uncertainty raised by the pandemic will continue, impacting just how much “beauty junkies” can spend on beauty and personal care, on the one hand, and, on the other hand, the willingness of VCs to jump into an industry many do not know well. “The slump experienced in the industry over the pandemic debunks the long-held belief that this industry is recession-proof.”
- Following up on this sobering forecast, the group suggest they explore three streams of thought: 1) Is the market opportunity originally envisioned for uBe still viable in terms of size and trajectory? 2) Is uBe’s business model as viable as it can be? 3) What needs to be done to better sell uBe to potential funders?
- With respect to uBe’s market opportunity, some felt more research was needed to establish the potential scope given the increase in competition. Those most skeptical of uBe’s chances suggested that uBe might be better off trying to be acquired. Most, however, rebut this idea saying that selling out is not an option: “If that is where you want to go, you might as well give up and do something else as uBe will be subsumed into some other enterprise when it is still too small to get much of a return through an acquisition.”
- In a review of uBe’s fundamentals and forecasting assumptions, most note that they are too cautious, with projections not improving fast enough in key categories. “Why, for example, do conversion rates and gross margins not continue to improve in the uBe fundamentals?” Others question how uBe gets from 70,000 members in 2020 to 1.5 million members in just two years. They challenge the partners to demonstrate how investments in key areas will exponentially improve fundamentals over time.

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- This discussion leads to several avenues of thought about how uBe's go-to-market strategy, that is, its business model, might be revised. There is a lot of discussion, for example, about product mix. Some argue that the array of products being marketed by uBe is confusing and leads to "preventative" questions about cannibalism among proffered uBe products: "The curation process needs to be better explained as a first step." Others relate how it will be impossible to explain the plethora of products in a way that will make sense for a start-up. This group argues that uBe should take a page from Glossier, the beauty firm that has garnered a great deal of VC funding, by streamlining its offerings to a limited set, which can be easily explained and understood in a pitch.
- What the limited mix might be is heatedly debated. Some say the mix should build on Elena's reputation as a respected v-blogger on colour cosmetics and the partners' history with hand/nail care. This will allow them to continue to target "beauty junkies" and a diverse clientele looking for beauty options, both markets known to the partners. In other words, they should go back to their roots and do what they know best, particularly as the competition in indie skin care is heating up and this market will potentially become over-saturated. "As people begin to meet up with friends and family more," this group argues, "women will return to wanting to use colour cosmetics and nail care".
- But the discussion on product mix also has challengers who argue: "No, you are better off building on the industry expectations for skin care and related options, perhaps even exploring a focus on CBD products as this segment will attract a higher price point and a broader demographic." Although, another says, "Why don't you go for a whole-body product line, from head to toe, but with a carefully curated few in each category. That way the VCs will get the whole point of your vision here."
- The technology experts advise: "If uBe goes with an emphasis on colour cosmetics and nail care, uBe needs to either invest in or find a partner to develop AR and VR

technologies as virtual tryouts will be an essential selling feature. A focus on skin products will not rely on this so much as on uBe's innovation of the Guide.

- In a rare moment of consensus, however, all recommend that uBe, whatever the product mix, invest in technology that garners on-going customer feedback for product assessment and product choices.
- This leads to a discussion about the proportion of the budget that should go to various marketing streams, again with no definitive conclusions.
- Finally, there is a lot of discussion about how to get funds over the next six months. In this regard, many remark that the partners have been too cautious with the capital uBe did have from its angel investors, saying Joan and Elena should have made bigger bets. One advisor, in fact, bluntly pronounced, "Your aversion to risk has been your biggest stumbling block for success. While we should explore which VCs and other sources of funding will be most receptive to a beauty offering, all will be for naught if you don't behave differently and more courageously in the next six months." "Ouch," think Joan and Elena, "Do they have what it takes?"

There is a lot to think about.

Joan and Elena's Options

After summarizing the feedback, Joan and Elena make a list of the questions they need to answer before moving forward. At the heart of it, they need to ask themselves if they should take the lifeline offered by their mentor. In the process of this soul searching, they add two options to additionally explore:

1. Only the week before they were approached by a tech firm developing an on-line shopping presence for socially responsible products (the "Amazon" for those wanting to save the planet). They want Joan and Elena to fold in uBe and expand it to be the Beauty

& Personal Care arm of the organization. The deal being proffered offers far more stock options than cash, meaning they will have to bet on the success of this tech start-up for a return. This option, if it plays out as it is projected, will allow them to at least pay their angel investors their original investment without interest in the next 18 months. Are there other possible merger or exit options that would provide a better return?

2. Recently, Joan and Elena have been exploring the option of both finding alternative employment. “We haven’t paid ourselves in the last 18 months,” they both say, “and, we are running out of spousal equity as long as we continue this way.” Prior to founding uBe, they had stellar resumes. But in the process of trying to build uBe, have they exhausted the goodwill of their network by reaching out to all of them for advice and funding? Their angel investors invested in them, not uBe. If uBe fails, will they be viewed as tarnished goods on the job market? Will they be able to obtain good executive leadership positions? Perhaps, most importantly, if they continue for the next six months and still fail, will their reputations with their network be fatally fractured?

Both the lifeline and the acquisition offers are time-limited and must either be accepted or rejected in the next two weeks. Joan and Elena need to weigh the odds. “So, we have fourteen days to make up our minds about what we are going to do!”

Questions

IMPORTANT NOTE TO THE TEAM ON HOW YOU SHOULD FRAME YOUR RESPONSE:

In your presentation in response to the questions below, please respond as Joan Lighthouse and Elena Eustace, co-founders of uBe, providing a follow-up response about their next steps to their brainstorming group. In your analysis of the case, in addition to whatever else you may want to say, please be sure your presentation, in an order of your choosing, includes your perspective on the questions asked below.

Questions

1. What are the relevant facts of this case and the issues and challenges uBe and you, as the two founding partners, face?
2. Who are the key stakeholders that you need to consider in your decision making? What are the ethical issues you face should you not be able to meet the needs of each stakeholder? In other words, what are the risks of failure? How do these risks balance against the opportunities?
3. What is your SWOT analysis for uBe? When lined up against the competition, do the fundamentals of uBe make sense? Are they viable?
4. Can the trajectory of the business be improved by a change in the business model? Why or why not? If so, among the options you should consider, what should uBe's focus be with respect to its product mix, its selling strategy and its marketing and technology strategy going forward? With minimal funds at your disposal, what areas of the business would you invest in most heavily, and where would you place the speculative bets with your capital? How will these changes impact uBe's business fundamentals?
5. What will be your approach to finding the funding uBe needs? What sources of capital are you going after? How does your going-forward strategy change your approach to fundraising? What other changes, if any, do you need to do?
6. Putting it all together, to what extent are you hopeful that uBe will be able to raise the capital it needs in the next six months? Why?
7. At the end of the day, should you take the lifeline? How do you address the risks with the mentor willing to provide money for the next six months? Are other options open to you more viable? More ethical?
8. What, if anything, should you be communicating to your angel investors?