Kaizen Thought Leadership:

USING ANALYTICS TO CREATE PROFITABLE PROMOTIONS

KaizenAnalytix.

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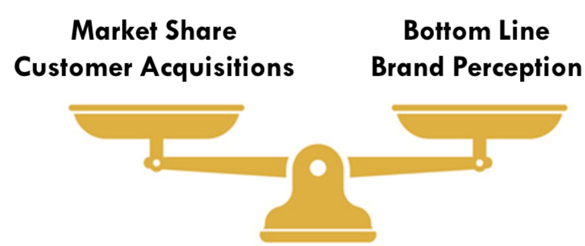
The Importance of Promotions for Goods and Services

A "promotion" is something that motivates you to take action. In the business world, a promotion – commonly referred to as an incentive - is intended to boost a company's revenue by motivating consumers to purchase their products, purchase more of them, and/or purchase them on the company's timetable.

Promotions help companies attract customers who otherwise would not have been able or willing to pay for their product at their standard pricing. For example, a bottle of your favorite ABC Vineyards wine may cost $30 at the grocery store, but given the plethora of other options on the shelf, you may not be willing to spend more than $20. ABC might attempt to win your business by either dropping its price or offering a promotion or discount. Dropping price is a risky proposition because they could be leaving money on the table for consumers willing to pay the full $30. Offering a promotion allows ABC to maximize their revenues across all consumers. Additionally, many consumers show higher purchase propensity to promotions and discounts than to pure price drops. For example, when you see a $20 bottle of wine next to a $30 bottle of wine that is on currently sale for $20, many consumers would pick the wine they perceive to be "a deal." Similarly, promotions allow companies to boost demand while maintaining the perceived price integrity of their product (many would still perceive it to be a $30 bottle of wine that is temporarily on sale – not a $20 bottle). In addition to the level of discounting, customers are also influenced by the way the discount is communicated or offered. Offering a $6 discount, 50% off, or buy one-get one free are all essentially the same thing, but in many cases, customers will respond differently to the different ways the offer is marketed.

The Perils of Poorly Designed Promotions

When designed haphazardly, promotions can limit a company's net revenue by cannibalizing sales they would have otherwise achieved at a higher price. The tricky thing about offering promotions is that it's a balancing act of driving market share and new customer acquisitions, while ensuring that your promotions are not negatively impacting your bottom line, damaging your brand, and/or becoming too predictable in the marketplace (e.g., conditioning your customers to "wait for the promotion").

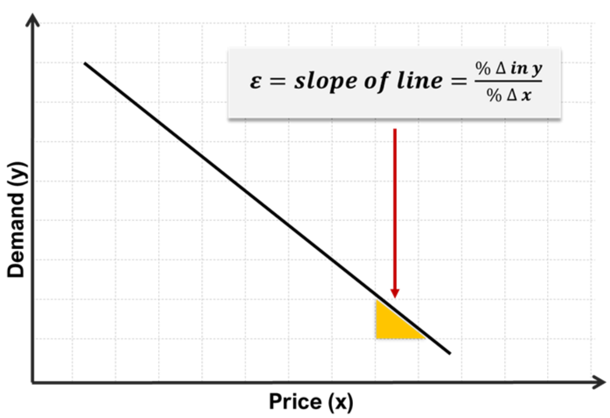


Publications from Independent UK to [The Hustle] have covered one of the most well-known examples of a poorly designed promotion, which was concocted by the UK division of vacuum manufacturer Hoover. Hoover UK offered an unusually generous promotion in the form of two free international flights with a purchase of £100 or more. Hoover products of course sold like hot cakes, but the company failed to identify a few major flaws in their promotion planning. While the campaign generated about £30 million in gross sales, the promotion's cost by far outweighed it's profits. With the cheapest vacuum priced at £120 per unit and the cost of two international flights at £600, Hoover was set up to lose £570 per customer who redeemed the flights. Eventually, the cost of the promotion became too great and led to lengthy legal battles – and ultimately the demise of Hoover's British operations. Not every promotion will end as disastrously as it did for Hoover UK, but it is still critically important to ensure your promotion strategies are not negatively impacting your overall profitability.

So how can you be sure that you aren't hurting your bottom line by offering promotions that are too rich or risky? In our experience, taking an analytically driven approach to this question will give you a clear answer that maximizes your profit and promotions effectiveness. At the core of this approach is granular analysis of your historical data to truly understand how your customers are responding to your promotions – with a specific focus on how price effects demand, which is also known as the Promotion Elasticity of Demand.

Kaizen's Approach to Balancing the Cost of Promotions While Maximizing Revenues and Sales

Promotion Elasticity of Demand is the percentage change in quantity demanded in response to a 1% change in price through promotions. By calculating promotion elasticity, you can better understand how customers are responding to your promotions and ultimately determine the price discount to offer in your promotion to maximize net revenues.



$$\textbf{Promotion Elasticity} = \frac{\%\ \textbf{Change in}\ \boldsymbol{Demand}}{\%\ \textbf{Change in}\ \boldsymbol{Price}}$$

In the table below, we show how a promotion (price discount) affects demand, within the context of our earlier ABC Vineyards wine example

List Price of ABC Vineyards Wine Bottle	Promotion	Effective Price	Demand (# of Customers)	Gross Revenue	Promotion Spend	Net Revenue
$30	0%	$30	200	$6,000	$0	$6,000
$30	5% off List	$28.50	215	$6,450	$323	$6,127
$30	10% off List	$27.00	230	$6,900	$690	$6,210
$30	**15% off List**	**$25.50**	**245**	**$7,350**	**$1,103**	**$6,247**
$30	25% off List	$22.50	275	$8,250	$2,063	$6,187
$30	50% off List / BOGO	$15.00	350	$10,500	$5,250	$5,250

Elasticity in this example is 1.5:1 as calculated by **KaizenValueAccelerators™*

- A 5% discount translates to a demand increase of 15 customers; a 10% discount translates to a demand increase of 30 customers; etc.
- As the value of the promotion (or discount) increases, the demand for the product also increases

So, at what point does our promotion begin to hurt our bottom line? Revenue is increasing with demand when the promotions/discounts are set at 5%, 10%, and 15%. Once the discount reaches 25%, we observe revenues starting to decrease due to the deep discounting outweighing the incremental demand gains. This tells us that a promotion set at 25% is too high and the promotion's realized sales are not worth the cost. Of the options considered, a 15% discount achieves the highest net revenues and drives 20+% incremental volume.

This analytically driven approach will help you not only better understand customer behavior, it will help you offer more profitable promotions. Of course, in practice, measuring price or promotion elasticity is more complex than our example above. There are typically a number of factors influencing your demand, and simply plotting the relationship between promotion and demand may not paint the full picture or provide an accurate interpretation of your customers' buying behavior.

Kaizen Analytix has extensive experience helping clients take a more analytically-driven approach to promotions and discounting by isolating the impacts of pricing and promotions, measuring elasticities at granular levels, and making data-driven recommendations on how our clients can achieve their objectives – whether those are maximizing profit or maximizing market penetration within their promotion budget constraints. We have employed approaches similar to the above within our ***KaizenValueAccelerators***™ to have rapid impacts of 3+% revenue for our clients across a variety of industries.

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