Research threads: Professor Kusum Ailawadi and Potoula Chresomales T'00

Potoula Chresomales T'00 recently sat down with Kusum Ailawadi, Associate Professor of Marketing, to discuss her research on promotions in the consumer packaged goods industry.

TP: What sparked your interest in promotions?

KA: Promotions have developed a bad reputation among the packaged goods companies. Prior research has revealed that promotions increase sales through increased penetration - attracting new users to the brand. However, the marketing community believes that this positive effect is offset by substantial erosion of brand loyalty as promotions "train" existing consumers to become price sensitive. Conventional wisdom is that the net effect of promotions (increased penetration vs. decreased loyalty) is negative. I am curious about this and want to develop more insight into how consumers respond to promotions.

TP: How have you learned more about consumer response to promotions?

KA: I've been very lucky in that a natural experiment occurred in the marketplace, and Scott Neslin, Don Lehmann (Columbia) and I were able to analyze it in depth. In 1991 P&G made a significant change in their promotions policy by adopting an everyday low price (EDLP) strategy. They dramatically reduced promotion activity - consumer & trade - and increased advertising. To analyze the effect we compiled IRI scanner data for P&G and four competitors - 24 product categories, 118 brands over seven years. The data included market share, price, promotion frequency, and promotion depth, to which we added advertising spending. We then studied the consumer response to changes in promotions and advertising.

TP: How did you measure 'consumer response' in this study?

KA: In aggregate, consumer response is really the change in market share, but to pinpoint the drivers of the change we broke market share into its three components and monitored the change in all three:

1. Penetration (PEN) - the proportion of category users that purchase the brand at least once (i.e. 55% of bar soap buyers purchased P&G). This measures customer attraction.

2. Loyalty (SOR) - the percentage of the brand's customers category purchases accounted for by the brand (i.e. 49% of their total bar soap purchases are accounted for by P&G). This measures customer retention and loyalty.

3. Volume (USE) - the purchase volume as compared to the average for the category (i.e. P&G customers use of bar soap is 1.30 times that of the average category user).

TP: What did you expect to find?

Given that P&G greatly reduced their promotions I expected to find a decrease in penetration (PEN), but an improvement in loyalty (SOR).

TP: How did the consumers actually respond?

KA: Overall market share dropped due to a decrease in penetration (PEN). The introduction of a stable everyday low price was suppose to increase brand loyalty (SOR) to offset this loss in penetration (PEN), but that did not materialize. Loyalty (SOR) and volume purchase (USE) remained virtually unchanged. The decrease in penetration was probably due to fewer sales to promotion sensitive buyers. The deal prone segment engages in brand switching to achieve "transaction utility" (pleasure from getting a discounted price). In the absence of promotions, these sales were lost to competing brands.

TP: What does this research tell us about the relationship between promotions, advertising and market share in general?

KA: Promotions as a whole - trade deals, coupons, and actual price cuts - have a strong relationship with all the components of market share - PEN, SOR, USE. Frequent promotions can attract new users to a brand and serve to pre-empt current users from switching to other brands. When promotions are cut, the likelihood of repurchase is reduced. In contrast, advertising has a relatively weak relationship with market share, particularly in mature product categories.

TP: Although your research highlights the positive effects of promotions, aren't trade promotions generally unfavorable for manufacturers?

KA: Trade promotions do present two disadvantages for the manufacturer. First, they are an inefficient way to promote brands because retailers have discretion in passing through these marketing allowances to the end consumer. In many cases the retailers pocket these allowances to increase their own profit margins while manufacturers get little or no return on investment. Second, trade promotions give retailers a motive for forward buying and diversion (gray markets) which create roller-coaster production cycles that reduce manufacturing efficiency (bullwhip effect) and increase inventory handling costs throughout the supply chain. These practices while increasing costs for the manufacturer significantly improve retailer margins because goods are bought infrequently on deal and sold to consumers at the regular retail prices. Conventional wisdom is that the negatives outweigh the positives.

TP: Has your research uncovered ways in which trade promotions are beneficial for the manufacturer?

KA: Yes. By estimating the consumer demand curve, a manufacturer can identify the optimal price at which the total profits from selling a specific product through the retail channel are maximized (the channel-profit-maximizing-price). Through the clever design of trade promotions a manufacturer is able to influence the retailer's pricing decision and, therefore, total sales, total channel profit, and its own share of total channel profit. To be more specific, retailers, in an effort to maximize their own profit, tend to price higher than the optimal price thereby capturing less total channel profit for the manufacturer (they trade-off volume for margin). By designing trade deals that are contingent upon the retailers offering a certain price to consumers, the manufacturer can "coordinate the channel" and steer toward the optimal price thereby increasing total profits.

TP: Thank you very much for taking the time to talk to us about your research.

KA: You're welcome.