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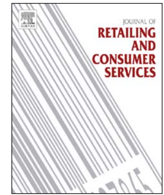

Gift card program incrementality and cannibalization: The effect on revenue and profit

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ABSTRACT

Many retailers have not measured the magnitude of cannibalization or its impact on revenue and profit when existing customers use a gift card for purchases they would have made without it, particularly when the card was purchased through a 3rd party at a discount up to 15%. We conducted a survey among gift card redeemers of a national casual dining restaurant chain to determine how the gift card affected their purchase behavior. We used this information, combined with operating margin, to model the impact of three different gift card discount scenarios on firm revenue and profit. Although the revenue effect was positive under all scenarios, the same was not true for profit. The profit was much lower than anticipated, even in the best case scenario, and was negative in the worst case scenario.

1. Introduction

Gift cards allow consumers to pre-purchase credit at restaurants, retailers, and other businesses and may be used by the purchaser or be given to others as a gift or incentive. According to a CEB Tower Group report (2015), gift card sales were projected to reach nearly US$130 billion in 2015, which is a 6% increase over 2014 sales of $122.1billion. For almost ten years in a row, gift cards are the most requested holiday gift, with 58.8% of respondents stating that it is their preferred gift (NRF Holiday Spending, 2015). And in the 2015 holiday season, 59% of consumers surveyed reported purchasing a gift card (Smith, 2016).

As the popularity of gift cards continues to increase, the variety of purchase options associated with these gift cards also grows. Consumers can choose between closed – loop cards which are designated for one firm or group of firms listed on the card (ex: Gap gift cards) and open-loop gift cards which can be used at a variety of firms (ex: Visa gift cards). The focus of this paper is on Closed-loop gift cards since these are what consumers are primarily buying today (Menke, 2012). Closed-loop gift cards can be purchased through the focal retailer either in person or via the firm's website or they can be purchased through a 3rd party gift card reseller.

Gift cards in any form offer an opportunity for retailers. Offering gift cards may help firms win new customers, increase brand awareness, increase incremental spending, and reduce price sensitivity. Gift cards may also offer reduced competitive intensity, as gift card holders may be "locked in" to purchasing from the gift card issuer rather than making a purchase from a competing firm (Horne, 2013). However, the variety of costs and benefits of gift cards present a unique problem as to how retailers conceptualize and account for the true incremental returns associated with gift card use. The purpose of this research is to further understand the gains and costs associated with gift cards and to offer suggestions as to how these incremental returns can be accounted for and properly managed, particularly in the instance of cannibalization.

2. Gift card spending

Gift card sales may, at first, appear to offer only advantages to a retailer. As long as the gift cards purchased is a closed-loop (used for one store or group of related retailers), the amount of store credit on that card is guaranteed to the firm at the time of purchase. In addition to the direct gains through the sale of a gift card, studies have shown that customers spend more when shopping with a gift card than shopping without a gift card. Seventy-two percent of consumers spend more than their gift card's value, with the average gift card user spending 20–40% more than their gift card value (Horne, 2007). Therefore, the stores are not only receiving the initial purchase value of the gift card, but, in many cases, they are receiving additional revenue as a result of the gift card sale.

The concept of mental accounting may help explain this increase in spending. As customers engage in metal accounting, they pre-allocate their spending into categories that correspond to various expense accounts (Thaler, 1985). As the customer spends assets, they deduct the spent amount from the specific accounts and re-compute the amount

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remaining within each. These budgets are typically set in advance of purchase (Heath and Soll, 1996), and are based on several factors, including internal reference prices and store characteristics (Mazumdar et al., 2005). A customer's mental budget then sets the anticipated expenditure level as a prior expectation for a specific purchase occasion. For example, a customer might know how much they are expecting to pay for a pair of blue jeans before they enter the store. But, customers may consider the value of a gift card as a savings in their mental budget, and therefore be willing to spend more during that visit to reach their budgeted amount for that category. Receiving a gift card may also be interpreted as windfall gains (an unexpected gain in income), which tend to get allocated to "spend now" accounts and may be spent immediately if customers have opportunities to make additional purchases (Hodge and Mason, 1995).

In addition to altering a customer's mental budget, the use of gift cards may also reduce the pain of paying, thereby encouraging gift card holders to spend more than they typically would in a given consumption situation. Although the concept of pain of paying was explored in a credit card vs. cash context by Prelec and Loewenstein (1998), recent studies have extended this research to gift card spending. Both Raghubir and Srivastava (2008) and White (2006), through a series of experiments, find that gift cards have a lower pain of paying than paying with cash, and that this results in gift cards being more easily spent. White (2006) notes that funds received as gift cards are more likely to be considered "fun money" and are more likely to spend their gift cards on hedonic purchase. Also, customers are more likely to spend above the gift card value and later report higher satisfaction with their purchases than users who are given and spend cash. So, for these reasons, firms can expect that at least some of their customers who are gift card recipients will make purchases in amounts greater than the original value of their gift cards.

3. Costs to firms

While these increases in customer spending can potentially offer great rewards to firms, the costs associated with gift card use can be quite high. The manner in which unused gift cards must be accounted for in the retailer's state, and the way in which consumers spend their gift balances may all impact the potential profitability of gift cards for a retailer (Khouja et al., 2011). There are also other costs that firms must consider when determining the profitability of their gift card program. First, there are the operational costs to the firm; those associated with the design, creation, and administration of the cards. In addition to operating costs associated with gift cards, the manner that consumers are choosing to purchase their cards may have additional costs for firms. In one study, fifty-one percent of consumers report buying at least one gift card directly from the retailer at which the card could be used, while another forty percent report purchasing at least one card from a drug or grocery store with a selection of gift cards (Menke, 2012). Gift card kiosks are gaining in popularity, and may be found in a variety of larger retailers, including Wal-Mart, Target, and Home Depot, among others. These kiosks offer customers the choice of purchasing gift cards from many different retailers, restaurants, and service providers all in one location. This third- party phenomenon offers advantages and disadvantages to firms.

One positive outcome of distributing one's gift cards through a third party is the convenience to the customer. In a recent NRF Gift Card study (Allen, 2015), the ease and speed with which a gift card can be purchased was one of the most popular reason to purchase a gift card. Gift card kiosks, whether online or in store, may add to the convenience of gift card purchasing. The customer does not have to make a separate trip to the retailer or retailer's website to purchase the card, but can purchase gift cards from multiple retailers in a central location. In addition to this, having your card displayed with others in a kiosk may add your firm to the gift card consideration set, where it might not have been had it not been included in the display.

However, to every benefit there is a cost. While the popularity of gift card purchasing at gift card kiosks and malls makes this option a smart choice for some firms, they are also faced with the reality that the third party can demand a 10–15% discount on the gift cards, a cost that must then be recouped through sales.

The two other smaller distribution channels for gift cards are business to business and online sales. Most business to business sales are to credit card companies like Discover, Visa, Master Card and American Express who offer these cards to their customers through a rewards or points system. The discounts provided through this channel range from 8% to 12%. The online channel consists of companies like Giftcard.com which typically requires a 5–7% discount. The amount of the discount given through each of the channels is driven by the volume of gift cards sold by the issuing retailer. Larger firms that generate considerable sales negotiate lower discounts from those that sellers.

Finally, there is the cost charged by the company that processes the card payment. Its purpose is to transfer the funds from the place where the gift card was purchased to where it was redeemed (if different). These companies charge a fee for card activation, redemption/funds transfer and balance inquiries. The prices for each of the transactions vary because of negotiated prices based on the volume of gift cards sold by a specific retailer. However, the cost, on average, is about 2% of the gift card amount.

4. The role of breakage

Another consideration that retailers offering gift cards face is breakage (unclaimed gift card value). This value, which has been purchased from the firm by the gift card purchaser, may go unredeemed for a number of reasons including forgetting the card, losing the card, or failing to use the whole value of the card (Garner, 2013). Historically, breakage was regarded as a bonus for the firm, as this un-recouped value would serve as windfall gains for the firm (Horne, 2013). In the typical accounting process (Feinson, 2011), firms claim a percentage of gift sales as income based on historical breakage rate. However, the breakage rate across the retail industry has declined significantly over the past 8 years. According to the CEB Tower Group (2015) the breakage rate dropped from 8% of total gift card value in 2008 to about 0.8% in 2015 (CEB Tower Group, 2015). This decline has resulted in firms taking financial charges on their balance sheets. For example, according to their respective 10-K reports, Brinker International recorded a charge of $5.2 million in 2012 and Red Robin recorded a $1.3 million charge in 2015 for overestimating the breakage rate. Some organizations, such as Walmart and the sponsor of our study, do not account for breakage and only record the income when the gift card is used. Others, such as Starbucks, take a very small percentage as breakage ($39 million breakage on $5 billion in gift card sales in 2015).

A contributing reason for the declining breakage rate is the growth of gift card exchange companies (i.e., Cardpool, CardCash.com, Monster Gift Card, and Raise) which enable consumers to sell unwanted cards or remaining balances for as much as 92% of the card's value. The amount the exchange is willing to pay is based on the retailer's popularity. While many exchange firms do have a minimum amount (typically $10), others do not. Even Target has added a gift card exchange program in its stores providing consumers even more outlets to sell unused balances. The cards purchased by the exchanges are then resold to other consumers at a discount.

Coupled with regulations, which include the CARD Act of 2009, many states now include gift cards in escheatment laws. Escheatment laws vary from state to state; but they can require that breakage, classified as unclaimed property, be turned over to the state rather than kept by the firm and can impact the ways in which firms handle unused cards (Garner, 2013). To avoid turning over unused balances to the states, many corporations have set up gift card entities in escheatment friendly states.

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