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Something Free or Something Off? A Comparative Study of the Purchase Effects of Premiums and Price Cuts

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Abstract

As an alternative to promotional price cuts, retailers and manufacturers often rely on non-price promotion techniques, such as premium promotions, where consumers receive a free gift with the purchase of a product. We compare the effectiveness of premiums to that of price cuts, and study moderators of this comparative premium effectiveness. We use data from a large online shopping simulation study with more than 2,000 participants to model consumers' purchase decisions in response to premiums and price cuts. Results indicate that the impact of premiums on purchase behavior is systematically lower than that of equivalent price cuts. However, a premium's smaller sales impact may be offset by a cost advantage. This is especially true for private label brands where the premium's purchase effects do not differ too much from those of a price cut. We calculate how large the cost advantage has to be for a premium to be more profitable than a price cut, and show that premiums entail risks as well as opportunities, for both manufacturers and retailers.

Keywords: Sales promotion; Premiums; Price cuts; Retailing; Purchase decisions

Introduction

Although price-based incentives remain the most common type of sales promotion, non-monetary techniques have become increasingly popular (Buil, de Chernatony, and Montaner 2013). The use of premium promotions is one such technique, where consumers receive a free gift (the premium) with the purchase of a product (d'Astous and Jacob, 2002). For example, McDonald's Happy Meal comes with a free toy, and beer is often promoted with a free glass. In the US, the industry for promotional products used as free gifts for customers, had revenues of $21 billion in 2016 (IBISWorld 2016).

Like promotional price cuts, premium promotions are often initiated by manufacturers (Ailawadi and Harlam 2009; Kumar, Rajiv, and Jeuland 2001; Walters 1989). In a survey of marketing managers of FMCG manufacturers in Germany (Rudek 2008), 82% of the respondents indicated that they use premiums in their strategic business units. Still, similar to price cuts (Ailawadi and Harlam 2009), premiums can also be the sole initiative of the retailer. The retailer is the final gatekeeper in deciding which promotions to offer in his stores, but a manufacturer can provide premiums or trade promotions to the retailer and encourage pass-through.

Both manufacturers and retailers need to trade off different promotion forms. Therefore, it is a crucial question how a premium's effectiveness compares to that of an (equivalent) price cut under various conditions. Yet, research to date does not offer clear answers. Like promotional price cuts (e.g., Ailawadi and Gupta 2014), premiums have received substantial attention in the marketing literature (e.g., d'Astous and Jacob 2002; Low and Lichtenstein 1993; Shimp, Dyer, and Divita 1976). Nonetheless, there is a striking paucity of research *comparing* the impact of both promotion forms. A few studies tap into "comparative premium effectiveness," which we define as the purchase effects of a premium relative to those of an equivalent price cut (e.g., Chandran and Morwitz 2006; Darke and Chung 2005). However,

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these studies mostly focus on subjective evaluations (e.g., the promoted brand's perceived quality) and not on consumers' purchase decisions. Moreover, little is known about the moderators of comparative premium effectiveness.

The objective of this paper is to compare the immediate effects of premiums and equivalent price cuts on consumers' purchase decisions. In addition, we examine two potential moderators, the importance of which has been shown for the effects of either premiums or price cuts, but not for *comparative* premium effectiveness. These moderators are characteristics of the premium promotion (i.e., its functional relatedness to the category) and the promoted brand (i.e., national brand versus private label). In line with many previous studies and examples in practice, we focus on premiums that are meant to increase the sales of the product to which they are tied (i.e., they are not samples for other products) and that are not part of a collection (e.g., Chandran and Morwitz 2006; Nunes and Park 2003; Palazon and Delgado-Ballester 2013).

We set up an online simulated shopping environment, in which more than 2,000 participants made fictitious purchase decisions in four fast-moving consumer good (FMCG) categories: orange juice, cereals, margarine, and milk. A shopping simulation experiment offers complete control over the purchase environment and at the same time provides realistic buying behavior data (Campo, Gijsbrechts, and Guerra 1999). We use our data to model the effects of premiums and price cuts on consumers' brand choice decisions (which in a nested logit model carry through to purchase incidence decisions) and purchase quantity decisions.

We find that premiums systematically generate smaller purchase effects than equivalent price cuts, at the choice as well as at the quantity level. However, a premium's smaller sales impact may be offset by a cost advantage. We calculate how large this cost advantage has to be for premiums to be more profitable than price cuts. Our results suggest that premiums may be a cost-effective alternative to price cuts, especially when the focus is on SKU sales, rather than on overall category sales, and when the promoted brand is a private label. Interestingly, a premium's functional relatedness to the category usually does not influence comparative premium effectiveness.

In what follows, we first discuss our contribution to the literature and develop hypotheses. Next, we describe the experiment, present our model, and discuss the results. We then use our estimates to compute the impact of price and premium promotions on brand and category sales, and to derive premium indifference costs. A discussion of implications for management and research concludes the paper.

Previous Literature and Contribution

A vast body of research has studied the purchase and sales effects of promotional price cuts and the features and displays that support them. Since this literature has already been summarized, for example by Ailawadi and Gupta (2014) and Neslin (2006), we refrain from reviewing it again. In general, researchers find large sales boosts from price cuts. Yet, price cuts come at a huge cost because they decrease profit margins. Analyzing 93 million trade promotions in different countries around the world, Nielsen finds that 59% of trade promotions were unprofitable for FMCG manufacturers in 2015 (Nielsen 2016). For grocery retailers, this number ranges from 50% (Ailawadi et al. 2006) to 94% (Srinivasan et al. 2004). Interestingly, Ailawadi et al. (2006) show that drivers which increase a promotion's sales impact, typically decrease its profitability for a retailer.

Given the concerns about the cost-effectiveness of price cuts, research has explored the potential of non-monetary promotions such as sampling (e.g., Bawa and Shoemaker 2004; Gedenk and Neslin 1999) and cause marketing (e.g., Arora and Henderson 2007). Similarly, researchers have examined the effects of premium promotions. They show that premiums can improve consumers' attitude towards and preference for the promoted brand (Chang 2009; Low and Lichtenstein 1993; Shimp, Dyer, and Divita 1976), generate favorable brand associations (Palazón-Vidal and Delgado-Ballester 2005), and increase the perceived value of an offer (Darke and Chung 2005). At the same time, previous work has found that premiums with little or no value can *reduce* the purchase likelihood for the promoted brand, for example, because consumers perceive them as a blunt marketing gimmick designed to boost sales (e.g., Gedenk, Hartmann, and Schulze 2000; Gedenk, Hoffmann, and Fantapié Altobelli 2013; Simonson, Carmon, and O'Curry 1994).

Our work contributes to the premium promotion literature in two ways. First, we explicitly compare the purchase effects of premium promotions with those of price cuts. The few studies that compare premiums and price cuts (see top part of Table 1) have produced mixed results, with premiums having stronger, weaker, or similar effects than price cuts (e.g., Chandran and Morwitz 2006; Chou and Lien 2012; Darke and Chung 2005). Moreover, these studies almost exclusively consider the effects on consumers' subjective evaluations (e.g., attitudes), collected through highly-stylized scenario-based survey experiments, and ignore purchase behavior. However, purchase behavior involves mechanisms that may go unaccounted for in subjective measures. For instance, more so than a price cut, a premium may cause reactance effects whereby consumers refuse to choose the promoted product because they feel manipulated by the marketer. Also, consumers may be less inclined to buy large quantities of a premium-promoted product because the marginal value of a typical gift decreases with each additional unit. Interestingly, Nunes and Park (2003), who provide the only study based on objective performance data, find the effectiveness of premiums to be worse than or at best similar to that of price cuts. Still, Nunes, and Park study aggregate brand sales, and thus cannot, for example, distinguish between choice and quantity decisions.

Second, we study how the effectiveness of premiums compared to that of price cuts is influenced by two moderators. Previous research has tried to explain the variance in comparative premium effectiveness by variables like price or package size of the promoted product (e.g., Nunes and Park 2003; Palazon and Delgado-Ballester 2009). We focus on moderators that have been shown to be important for the effectiveness of either premiums or price cuts, but have not been studied in the context

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