Building Your Loyalty Program ROI

A loyalty program has one purpose: increasing profits. Find out how to structure your program so that it will generate a beneficial financial return.

Loyalty programs generate strong financial results by engaging guests and creating powerful incentives that encourage more frequent visits and increased spending. Before you set out to develop a loyalty program that will help you increase guest spending and visit frequency, there are several questions that need to be answered, such as: What costs and revenue do I include when calculating my return? And, how do the benefits offset the program costs?

When you find the correct balance between your particular cost structure and your guest preferences, you will be able to achieve success and improve upon your program’s return. Understanding how you can manage the program levers, including the applicable costs and revenues, will enable you to not only sharpen your return calculation, but also build consensus among your internal stakeholders – all while developing a financial-gain-maximizing program.

Calculating the return on investment (ROI)\(^1\) on projects within your restaurant is as unique as your brand itself. Since there are so many variations in the way organizations calculate ROI for projects (e.g., how you treat costs that constitute an investment, such as the cost of capital), we have focused this Loyalty Improvement Series article on the return portion of the calculation.
Understanding the levers involved in the return aspect of your loyalty program’s ROI will assist you in creating a program to maximize that return.

**Your Loyalty Program Return**

Loyalty programs initiate advantageous buying behaviors for members and drive winning financial results. The potential for a 4% boost in profitability as a result of motivating 20% of your guests to visit 20% more often is compelling.

When the benefits of increased member spending and visits offset the costs of incremental food and labor, rewards, and program administration, program returns are realized, creating a positive loyalty program return.

A well-designed core loyalty program will motivate guests to visit your restaurants more frequently and spend more with you during each visit. In addition to revenue generated from a core program, with the data collected, you will be able to deliver relevant, targeted promotions to your loyalty program members, resulting in an additional source of revenue.

**Understanding the Factors of Loyalty Return**

A closer look at each of the factors and their relative influence will help define the return calculation and allow you to see how you can make adjustments to improve your ROI.

**Sources of Incremental Revenue**

**Buying More.**

On average, members generally outspend other guests by 5% per visit. Loyalty program incentives drive changes to buying behaviors, which translates to your members spending more than non-members at each visit. For instance, the lure of extra loyalty points entices members to buy additional menu items, such as appetizers and desserts. Members are also more likely to bring friends, colleagues, or business associates when they visit.

**Visiting More Frequently.**

Members not only spend more when they visit, they also visit about 20% more often than non-members. Increasing visit frequency stands at the core of every loyalty program. By joining your loyalty program, guests declare that your restaurants are a preferred destination. Membership in your program keeps your brand at top of mind when guests select a dining-out destination.

Moreover, rewards act as an effective motivator. Members visit more often because every time they visit, they earn points and get closer to a reward. Researchers Drèze and Nunes report that as people progress toward a goal, their effort will increase, and thus completion time will decrease. Paytronix has observed a similar effect in its data, with guests tending to visit more frequently the closer they get to a reward.

**Promotions.**

Promotions keep members engaged and active in loyalty programs and compel members to both “buy more” and “visit more.” Adding targeted promotions to your loyalty program can drive incremental member visits by more than 4%.

Periodically sending relevant offers to your members can increase their visit frequency and influence their buying behaviors. By leveraging your member data, you can provide special offers that are aligned with specific member attributes, behaviors, and preferences. A broad range of promotion types, including limited-time offers, instant-win games, and social-networking-based incentives gives your restaurants an additional method by which to deliver relevant offers that drive measurable incremental purchases.
Sources of Incremental Costs

Your cost structure is unique to your concept. For the purpose of calculating program return, we focus on the incremental or variable costs associated with the incremental revenue derived from a loyalty program. Fixed costs like those for rent and equipment should not be included in this exercise, since those costs are present regardless of the existence of a loyalty program.

Sources of incremental costs include food and labor costs, reward costs, and program costs.

Food and Labor Costs.

The majority of the costs associated with your loyalty program are a result of the increased volume of sales. Incremental food and labor costs normally account for between 40% and 45% of your gross incremental revenue. You will need to find out what this cost is for your organization in order to accurately calculate your financial return. Include only the food and labor costs that are associated with the increased volume initiated by your loyalty program.

Reward Costs.

Member rewards also contribute to the cost of a loyalty program. Successful programs balance enticing rewards with smart “pricing” plans. In other words, motivational rewards should be provided only at an acceptable expense.

For instance, to encourage incremental member spending, rewards should be attractive and attainable in a reasonable amount of time. At the same time, the cost of the rewards must be feasible and financially responsible – typically within the range of 8% to 12% of the member’s spending. A “buy 10, get 1 free program” provides a 10% reward that is appealing from the member’s perspective.

As you calculate the reward costs for your return, be sure to account for the expenses you actually incur, not the price a member would normally pay for reward items. For example, a complimentary entrée that sells for ten dollars may cost you only four dollars, while a merchandise gift will include the cost of the item plus fulfillment expenses.

Program Costs.

When calculating your program’s return, consider the final program costs. All of the incremental costs associated with creating and running your loyalty program constitute the final program costs. This includes agency fees and money spent on processing, member support, production and distribution of loyalty cards, etc. Aggregated, these expenses normally represent between 5% and 10% of incremental spending.

An Illustrative Return Calculation

Assumptions:
Single Restaurant Location.
Annual Sales in Millions $2.5
Total Guests 10,000
Total Members 2,000
Average Guest Check $50
Average Visits Per Year 5

Rewards: Spend $250 per year; receive a $25 rewards card
No promotions to motivate additional visits or accelerate rewards.

Incremental Revenue as a Result of the Loyalty Program:
Visit More Frequently (20% increase in annual visits): $105,000
Buy More (5% increase in average check): $ 25,000
Total Spending Increase: $130,000

Costs:
Marginal Food & Labor (45%): $ 58,500
Rewards Costs ($25 x 50% reward redemption X 45%): $ 11,250
Program Costs (7%): $ 9,100
Total Cost Increase: $ 78,850

Total Return: $ 51,150
Achieving Balance for Financial Success

Obtaining a suitable return depends on striking a balance with your particular operational structure and guest profiles. Creating a successful loyalty program means understanding the sensitivity and interdependencies of each cost and revenue lever within the context of your restaurant.

For instance, some restaurants operate with higher-than-average food and labor costs. To compensate, the restaurant may lower its reward level to 7% to 9% of member spending from the normal target level of 8% to 12%.

Projected guest responses will require similar consideration. If the breakeven point of the core program requires boosting visit frequency much more than 15%, perhaps your rewards are too generous. Make sure that your reward costs are in the desired range.

Adjust your “buy more” assumptions appropriately. If your restaurants feature a menu with many complementary purchase options, you can expect members to be motivated to earn more points by adding selections. A more limited menu may not offer the same opportunities and may call for you to decrease your “buy more” figure.

Promotions add another potent lever in your loyalty program return calculation. Sending regular, targeted email promotions keeps members engaged and enthusiastic about coming to your restaurants, thereby driving further incremental sales without adding significant program costs.

In future Loyalty Improvement Series articles, we will dig deeper into the interdependencies of each return lever and demonstrate how to optimize your program for success.

Know How Your Return Impacts Your Bottom Line

From planning and launching a loyalty program to managing it over its lifetime, it is crucial to know how the interactions between costs and revenue in a return calculation impact your bottom line. A clear understanding of how loyalty programs produce revenues and related costs enables restaurateurs to adjust program levers until they strike a profitable relationship between incremental revenues and incremental costs. Armed with this information, decisions regarding the value of reward levels and subsequent promotional offers can be justified with quantified results.

To learn more about building a profitable loyalty program, contact us.
Do Loyalty Programs Cannibalize Sales?

This is a valid question that is asked frequently. Restaurateurs worry that they may be rewarding guests who would have visited anyway. While this may be true for a small group of members, in aggregate, loyalty programs provide incentives designed to motivate guests to change their buying behavior. Data shows that as a group, members visit more frequently and buy more than non-members. The increase in buying behavior more than offsets the cost of rewards given to all users.

What Indicators Can You Watch to Prevent Cannibalization?

In running a loyalty program, there are two primary indicators to monitor:

1. **The average check net of rewards given.** As long as the average check net of member rewards compares well to non-members, the loyalty program is motivating guests to buy more at each visit. Having members buying more and driving incremental revenue compensates for any low levels of cannibalization that may be occurring.

2. **The increase in visit frequency of targeted members during promotional periods.** Member visit rate is more difficult to measure relative to non-members because non-member behavior cannot be tracked. However, an increase in visit rate among members during promotional periods means the incremental revenue generated is more than making up for any guest activity that would have occurred in the absence of the promotion or the program itself. If, on the other hand, you are not motivating incremental guest visits with promotions, you are most likely not offsetting the cost of the incentives and might be experiencing cannibalization in the core program.

Endnotes

1. As defined by Investopedia®, “return on investment” is a performance measure used to evaluate the efficiency of an investment or to compare the efficiency of a number of investments. To calculate ROI, the benefit (return) of an investment is divided by the cost of the investment; the result is expressed as a percentage or ratio.
   
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   \text{ROI} = \frac{\text{Gain from Investment} - \text{Cost of Investment}}{\text{Cost of Investment}}
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2. While program incentives account for most of this gain, self-selection may also contribute, since big-spending guests recognize the potential to quickly earn rewards and are more inclined than occasional guests to become members. Encouraging still larger purchases and motivating their continued loyalty is obviously advantageous.


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