HOW TO BE AN INFLATION WINNER

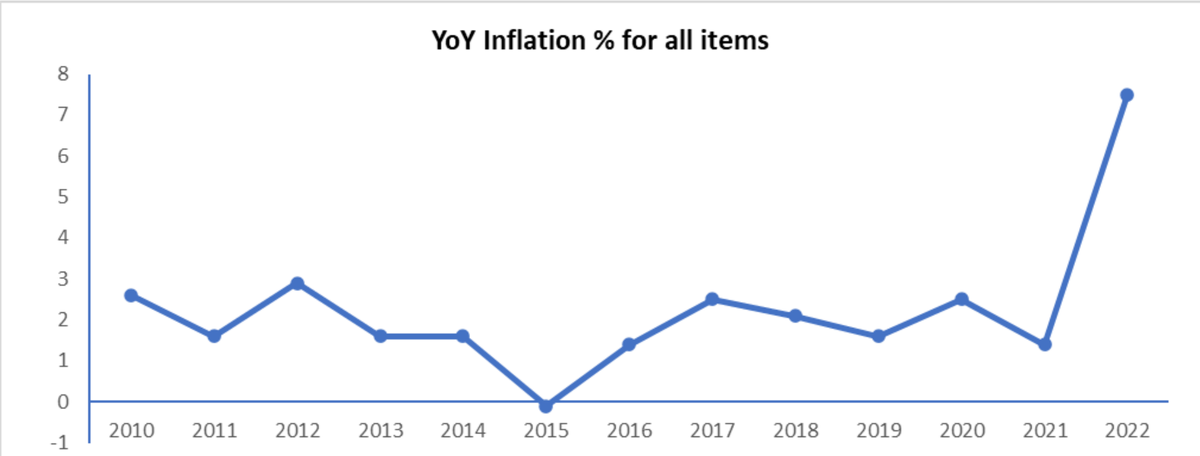
PRICING IMPERATIVES FOR QSRs IN A POST COVID WORLD

Inflation isn’t going away anytime soon

The US is facing an all-time high inflation not seen in the past few decades with prices rising as high as 7.5% as of January 2022 compared to last year. There are a variety of reasons behind this increase - strong demand after the coronavirus outbreak, persistent supply and labor shortages, increasing energy prices, and more. Further, this trend of increasing prices and volatility is now expected to continue due to the Russia-Ukraine war.

The below chart shows the year-on-year increase in inflation rates from 2010-2022 taken every January. As can be seen, the year 2022 inflation is like no other seen in the last decade.

Figure 1: Chart showing YoY inflation percentage from 2010-2022



Source: Bureau of Labor Statistics, CPI index reports

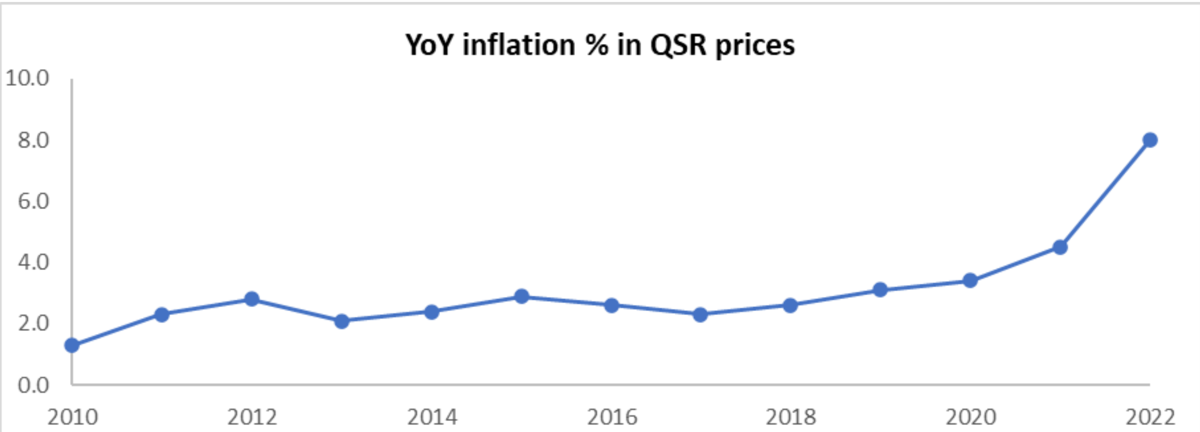
There are many different reports providing forecasts about inflation trends, and when we can expect a return to normal. As per a forecast by Bloomberg, inflation is expected to remain high in the year 2022 with normalization to ~2% expected as late as 2024. However, there is still a lot of uncertainty in the market, which has left QSR players to seek out solutions as they feel pressure building up on their margins. In the coming years, QSR players will need more agile and flexible pricing models to help them navigate this unprecedented inflationary environment.

Impact on QSR

In the QSR space inflation rose by 8.0% over the past 12 months, due to rise in input costs as well as challenges from other overheads (delivery partners, labor wages, infrastructure costs, etc.). QSR chains are struggling to keep up with the inflation dynamics since chains have traditionally revised prices only once or twice a year. Misjudging inflation can lead to either big hits to margin, or big risks to demand.

According to National Restaurant Association survey data, 95 percent of restaurants have experienced significant supply delays or shortages of key food items in recent months and 75 percent have made menu changes because of supply chain challenges. Market volatility and frequent input cost changes are putting pressure on these chains to find more flexible ways to incorporate these changes in their prices, otherwise they might end up with margin misses.

Figure 2: Chart showing YoY inflation percentage of QSR product prices from 2010-2022



Source: Bureau of Labor Statistics, CPI index reports

To bring things into perspective, Goldman Sachs research finds that nearly 40% of food and hospitality businesses expect to take a loan or line of credit for their business this year.

As the impact of inflation becomes more visible, there are some emerging trends we see happening–

- **Shift in the way customers order food** – Customers are adjusting to increased menu prices, by opting for QSRs offering take-out or Drive-Thru or curb-side pickup options. Bars and Restaurants are the most popular choice for discretionary spending cuts regardless of purchasing power. A new report from Numerator finds that 74% of consumers plan reductions in Bar and Restaurant spend with further inflation. Example: PJ's coffee experienced 53% higher sales in their drive-thru occasions compared to locations without a drive-thru.

- **Demand for bundled or value offerings** – The pandemic has brought a switch in the way customers order food – according to Mintel, 62% of the customers want restaurants to continue selling meal kits (burger, fries, drink) or bundled mix and match options as it provides convenience, variety and value for money. Example: Taco Bells is increasing focus on combo meals that are exclusively available online or McDonalds or Burger King provide bundle offers of burgers, fries, soda drink at a value price.

- **Focus on loyalty programs -** Carefully crafted loyalty programs attract customers to buy their favorite food items from select stores since the frequency of visits is high and QSRs tend to create a routine among customers. As per Colloquy, 5% increase in customer retention can produce as much as a 100% increase in annual profit and loyal customers spend as high as 67% more at restaurants than new customers. Companies like Starbucks (13 million active users), Panera Bread (21 million active users), Dunkin Donuts (7 million active users) have the best customer loyalty programs which are easy, convenient and provide the best mobile experience.

- **Shift towards an enhanced digital experience** - Customers now look for a more enhanced digital experience - scrolling the menu, placing an order, completing a payment, opting for promotions and discounts and much more. QSR players need to upgrade their digital platforms to improve digital experience through more automation and bringing onboard state-of-the-art technologies. For example, Track My Macca – An Australian McDonald's app can scan an order & give ingredient detail, with farmer's story & things that went behind the scenes to make the order happen.

- **Shift towards healthy offerings** - Food and beverages that provide a combination of both health and indulgence are gaining attention from customers. Offerings that have focus on immunity, stress, mood, mental acuity are in demand. QSR's will have to work to keep their menus current to stay relevant in the market. Cheesecake Factory introduced a "Skinnylicious" menu which had dishes under 600 calories compared to their 2,500 calorie belly buster meals. Aggressive marketing along with creativity played a major role in making this healthy menu a success.

- **Demand for sustainable packaging** – With surge in off-premises and contactless delivery, demand for disposable cutlery and packaging has increased. Consumers are demanding products that are more sustainable and safer for the planet. QSR's will have to respond and offer more sustainable solutions.

It is important for QSR players to remain flexible as the ability to pivot and react to this rapidly changing environment is what will separate winning brands. This means an end-to-end evaluation of everything—from staffing, menu offerings, location layout, geographic positioning, customer satisfaction, marketing strategies, technology, automation, delivery/take-away, digital-only restaurants, etc.—and determining what works and what doesn't. Hence, it is critical for QSR chains to price right and avoid mistakes.

- **Protection of margins:** With staffing shortages, raw material input cost increase, operational complexities, labor pressure, delivery partner shortages and other supply chain challenges, QSR chains are struggling to meet margins and are feeling the pressure to increase prices but at the same time meet customers' demands.

    - **Move towards data and understanding customer behavior** – Customers ordering online spend more while ordering online since they have more time to browse through the menu. QSR's should try to upsell and provide special offers via digital platform to attract customers. As prices continue to rise, quick-serves

need to consider how sudden shifts in costs will impact the customer digital experience. Price rise may be avoidable but digital friction is not.
  - **Blanket price increases do not work** – Most companies plan to increase prices, citing reasons for increase in inputs such as food raw material, delivery partners margins, staffing shortages. While across-the-board price increases in the QSR space are commonly deployed, this is a blunt instrument that leaves money on the table by both underpricing items that could handle larger increases and overpricing items that create overall demand friction by becoming less competitive.
  - **Track real time input costs** – QSRs need to keep a tap on real time input costs (fresh fruits & vegetables, proteins, condiments, oil, gas, etc.) and map these to changes in final menu prices accordingly. Effective forecasting is critical to staying ahead of supply surprises.
  - **Selective price taking maximizes sales and margin** – Based on careful measures of elasticity for different offerings (appetizers, beverages, salads, main course, etc.) and a thorough understanding of consumer behavior, QSR chains can take bigger price increases on select products while minimizing increases on the most important trip drivers. Example: McDonald's, is allowing franchise operators to sell sodas for higher prices after they were kept at a dollar for several years as part of a nationwide promotion.
  - **Increase market share and sales while preserving margins** – When competitors take blanket price increases because they don't know better, smart QSR chains will selectively price to preserve margin, and lead with winning prices in the categories that matter for price comparison and to drive traffic.

How can AI help?

AI driven pricing can help predict the ups and downs in the market in terms of input costs, demand fluctuations, supply bottlenecks and provide a more agile pricing strategy.

- **Determine accurate estimation of elasticities** – AI models and machine learning can help determine the price sensitivity for each menu item and calculate close to real-time consumer price elasticities. This will help in understanding which income group customer is sensitive towards price increase/ decrease of which category of food/ QSR menu items.

- **Track input costs through cost indices** – AI can help track real time costs of all the inputs as well as competitor pricing and suggest price forecast for all the key ingredients. This will help QSR players to plan their price changes better.

- **Targeted price rises and estimate impact well** – AI driven solutions can help determine price increase/decrease across food categories along with optimizing profit margins. Since a uniform inflation impact cannot be transferred directly to consumers via prices, AI will help optimize target prices across different categories based on their elasticities.

- **Track channel wise output** – AI solutions will help QSR players forecast the right mix between different channel sales (dine-in, drive thru, online). Once the food outlet owners are aware of the forecast from different channels, they can plan inventory, staff, and other overhead costs more efficiently.

- **Roll out changes through test and learn** – Before QSR's take pan-chain pricing or menu change decisions, they should use best practice AI and machine learning pricing to test multiple pricing options in select representative outlets to determine optimal price levels. AI can help select the right portfolio of test-outlets (location, size, menu items, customer profile), items, and promotions that can yield the most powerful pricing outcomes. Once the test-outlet results are optimized, pricing decisions can be rolled out chain-wide.

At Impact Analytics we have built solutions to accurately forecast demand, test pricing strategies and pick the best portfolio factoring in all the external variables including volatile consumer trends and micro & macro-economic behavior. Our tools such as PriceSmart, TestSmart and ForecastSmart, are automated platforms backed by robust analytics, artificial intelligence and machine learning to help organizations run seamless experiments, design pricing strategies, design menus, to maximize gain and deliver highly accurate forecasts for quick decision making.

Impact Analytics has also pioneered a real time price index which tracks top moving QSR menu items across the elasticity spectrum. This price index will help firms make a more realistic prediction about average pricing across competitive products and categories so they can make better business decisions related to pricing.

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www.impactanalytics.co

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info@impactanalytics.co

About Impact Analytics

Impact Analytics is a proven leader in enterprise AI SaaS solutions, that combine the art and science of merchandising and supply chain optimization. Our cloud native integrated platform's planning, pricing & promotion, inventory management, and intelligence suites, are built on the foundation of an innovative AI & ML guided forecasting engine with robust predictive algorithms. Impact Analytics is a trusted partner for top retailers, CPG and manufacturing companies across the globe, and is empowering them to make smart data-based decisions, unlock process efficiencies, transform their businesses, and achieve unparalleled business benefits. Our unique engagement model allows for implementations to be executed in a quick and cost-efficient manner.