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Retail Gift Card Strategies: Preparing for the Gift Card Revolution

In the last five years, consumers have eagerly adopted gift cards, buying $62 billion worth last year alone. Yet many large retailers still treat them as an afterthought. However, gift cards can generate very significant revenue and profits. L.E.K. Consulting has helped retailers and consumer goods companies design, launch and grow their gift card businesses, and in the process has identified the factors critical to maximizing gift card potential. This issue of *Executive Insights* explores the gift card opportunity, discusses which factors impact a gift card program's success, and outlines specific steps to launch an effective gift card strategy.

Gift cards were a $62 billion industry in the U.S. last year – more revenue than Costco or Target generated during the same period. Gift card revenue has been growing much faster than overall retail sales (26% CAGR between 2003 and 2005).[1] In the 2006 holiday season, American consumers spent $24.8 billion on gift cards, 34% more than the previous year.[2] The largest beneficiaries of that spending – besides the recipients of the gift cards themselves – were department stores. They accounted for 32% of holiday gift card purchases. Discount stores captured 20% of the gift card market. A few acknowledged leaders, such as Best Buy, Barnes & Noble and Target, have been capitalizing on the gift card opportunity for years. These retailers know the economics of gift cards can be staggering: Gift cards spur significant additional store purchases at redemption above the face value of the gift card itself. Consequently, the industry data on gift cards can grossly underestimate their contribution to revenue and profit. One retailer we studied believes its gift card business could generate close to $1 billion in gross profit over the next four years. Gift card programs are a business most – if not all – retailers should master, and soon. Despite the operational complexities, most retailers can capitalize on the gift card boom with careful planning, the right infrastructure and dedicated talent. Success requires shifting perspective from "gift cards are just another payment type" to "gift cards are a true product category." This shift in perspective has real consequences. It entails designing gift cards for occasions and consumer appeal, investing in marketing and promotion, capturing information on purchases, tracking program performance, and adjusting and refining the product line, just like any other product category.

Retail Gift Card Strategies: Preparing for the Gift Card Revolution was written by **Bob Neapole,** Vice President, in L.E.K.'s Los Angeles Office. Please contact L.E.K. at retail@lek.com for additional information.

1. This includes all stored value cards purchased with the intent to give or use as a gift. It excludes gift cards for food service and automobile/auto parts. The numbers come from Incentive Gift Card Council, the U.S. Gift Card Market Industry Research and L.E.K. interviews.

2. 2006 Holiday Consumer Intentions and Actions Survey by National Retail Federation.

An Unrecognized Opportunity

Why don't most retailers recognize the business opportunity that gift card programs offer? First, from our research, retailers trailing at the gift card game lack data and analytics and therefore simply do not recognize the full potential of the opportunity. They fail to see that gift cards have become many shoppers' desired way of giving and receiving gifts – no longer the option of last resort. They fail to recognize that consumers' increasingly busy lifestyles are likely to make gift cards an even more attractive alternative in the future.

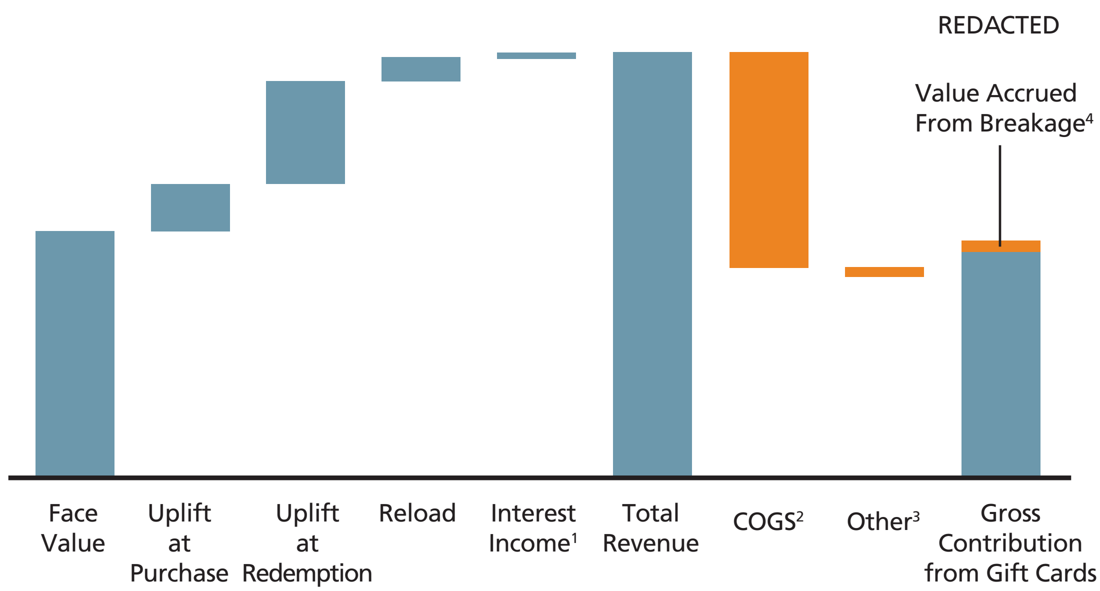
Many retailers treat gift cards simply as another payment option, rather than a key product category that needs the design, marketing, merchandising and other skills and resources that all product categories demand. Because of this "payment type" versus "product category" mindset, retailers typically do not encourage their store personnel to actively promote gift cards. In our research, which included store checks across many retailers, we often found sales clerks ignoring gift cards altogether, viewing them as an operational nuisance rather than a source of additional revenue.

Gift cards are also far more profitable than many retail executives believe. The generally available market statistics can be misleading or incorrectly interpreted. L.E.K. believes that they underestimate the value of gift cards' full "uplift" (the value of sales in excess of the face value of the gift card) because their calculations are typically based on each gift card's last transaction rather than all transactions made with the same card. Our research has found that leading retailers' gift cards can generate an additional 60% to 90% in revenue above the face value of the card over its lifetime – over double what the market statistics typically report (see *Figure 1*).

Another widely held misconception among retail executives is that because gift cards are often redeemed during the post-holiday markdown period, they shift purchases to lower-margin products, and thus erode profitability. L.E.K. research found otherwise: The margin of products purchased through gift cards can be equal to or higher than those of other products. Many consumers feel shopping with a gift card is shopping with "free money" and often "treat" themselves by buying higher-priced and often higher-margin products than they would otherwise.

Figure 1

Example Gift Card Economics



Note: 1 Average of XX days between issuance and redemption at XX% interest
2 Average gross margin on merchandise of XX%
3 Including Cost of gift card program ($XX/card)
4 Average breakage of XX% of total issuance (face value and reload)

Source: L.E.K. analysis

The revenue driven by gift cards (including the revenue generated above the face value) comes at minimal cost. Gift cards have a very different cost structure than traditional retail products and represent significantly less inventory risk prior to sale and activation. If a certain card design doesn't sell, it is simply eliminated from the mix, leaving nominal cost in unsold inventory. Furthermore, selling gift cards requires minimal in-store real estate. For one major retailer, we estimated the cost to execute a full-fledged gift card program at 60 cents a card.

Building a Successful Gift Card Program

Several factors impact the success of a gift card program. First and foremost is the need for retailers to understand the true economic potential of gift cards. Once they do, they will be more willing to dedicate the appropriate resources to creating sales strategies, product development, marketing support, and distribution plans. We discuss these key factors below.

Determine the Economic Potential

Retailers must first understand their gift card performance by rigorously analyzing the card's lifetime revenue and uplift. In our experience, we have found that the economics of gift cards are often misunderstood, and the way the economics are reported or calculated often lead to an underestimation of gift card potential.

Why Retailers Are Tapping Gift Card Distributors

Over the last six years, third-party networks have emerged to become the fastest growing gift card distribution channel, accounting for nearly 10% of gift card sales in the U.S. and bringing retailers' gift cards into the aisles and checkout counters of other retailers. Such networks generated $4.6 billion in 2005 U.S. sales.

One of the innovators in this business is Safeway Inc. In 2001 the grocery chain launched a third-party gift card distribution business, Blackhawk Network Inc. The company is expected to generate $100 million in operating profits in 2007[4], double from the previous year. Blackhawk has granted gift-card distribution exclusivity to a host of retailers including Best Buy and Home Depot, which sell their gift cards through Safeway stores and other channels. One of Blackhawk's rivals is InComm Inc., an Atlanta-based firm that moved into the gift-card market after entering the prepaid phone card market in the early 1990s.

Third-party distributors offer three key advantages: large existing distribution networks, expertise in designing gift-card programs, and the resources necessary to launch and manage programs with the greatest potential for success. The decision to engage third-party gift card distributors largely comes down to how quickly and broadly retailers need to get their gift cards to market and what resources they have at their disposal. Blackhawk, for instance, claims distribution in 60,000 stores that deliver 135 million consumer brand impressions every week. Leveraging such networks can help companies build a gift card program quickly and efficiently without making a significant investment in internal capabilities.

4. From a Bloomberg article by Josh Fineman, "Safeway Racks Up Fees Selling Home Depot, Best Buy Gift Cards," Dec. 22, 2006. Safeway's total operating profit in 2006 was about $1.6 billion, which if constant in 2007 would mean that Blackhawk would contribute about 6% of operating profits.

To build a successful gift card program, retailers must compare their gift card performance with that of other retailers that are aggressively pursuing a gift card strategy. Such an analysis should identify how the current gift card program is performing against key criteria and where there are opportunities to capture a retailer's maximum share of card-related market growth.

Create a Gift Card Business Unit

After they shift their view of gift cards from payment type to product category, retailers must then organize the necessary resources. They need to establish a gift card business unit and equip it with design, promotion and advertising, distribution and in-store placement capabilities. Furthermore, for gift card programs to flourish, executives must communicate the importance of the category throughout the organization, from regional and store managers to sales clerks.

Designate a Gift Card Champion in the Organization

Retailers should appoint a category manager with profit-and-loss responsibility to lead the gift card program. Our experience shows that the responsibility for gift cards is often distributed across multiple departments and is simply added onto individuals' existing "day jobs." This is a natural consequence of how gift cards have evolved within most retail organizations. However, to increase gift card sales substantially, retailers need people focused on making the right commercial decisions necessary to maximize the opportunity. Retailers with the most successful gift card programs typically put senior managers in charge to oversee design and development, procurement and production, logistics (e.g., order quantities, store allotment and replenishment rules), store operations, and third-party and corporate sales.

Such resource dedication not only strengthens internal coordination, but also improves crucial communications with suppliers. A gift card supplier to one major retailer told us he had to deal with 25 different people at that retailer to handle the account. Additionally, centralizing gift card activities builds in-house competency in gift card design,marketing and distribution, which will support more sophisticated operations in the future. It also reduces duplication of effort and thus costs. Finally, establishing a product category helps senior management measure its effectiveness on a profit-and-loss basis.

Pursue Innovation, Product Development and Marketing

Innovation and product development are critical to gift card growth. The retailers with the best gift card programs have highly innovative gift card designs and packaging options. Their cards look like attractive gifts that you would be pleased to give or to receive. They feature appealing graphics and innovative features that fit their brand image. Target, a leader in gift card innovation, creates unique designs through die-cuts, holograms, and textures, and has patented some of its gift card features. Consumer electronics retailing giant Best Buy has created multiple gift card designs, including die-cut and holographic versions. These retailers create a portfolio of event-specific cards to personalize the nature of the gift further, such as birthdays, anniversaries, Mother's Day, Father's Day, Valentine's Day, Bar Mitzvahs and baby showers.

Our research suggests that the retailers with the most successful gift card programs do not rely exclusively on in-store displays to market their cards. Instead, they aggressively promote them in advertising campaigns, often tying them into larger initiatives. They co-brand cards and jointly promote store merchandise with suppliers. For example, Wal-Mart and Sony Music have teamed together on gift cards to promote the sale of DVDs. Barnes & Noble, in conjunction with several publishers, has created cards to promote new books.

Retailers with superior gift card programs also utilize sophisticated in-store tactics, including prominent point-of-purchase displays, highly visible advertising, and proactive selling. Best-in-class retailers also advertise their gift cards outside the store. Retailers with lackluster or poor-performing gift card programs tend to display them just at the cash wrap, if at all. Surprisingly, four of the retailers whose stores we visited – which included several well-known and highly regarded companies – did not display or advertise their gift cards in-store at all. In fact, sales personnel, when asked, were unable to sell us a gift card.

Maximize Distribution

Many of the most successful gift card programs use third-party distribution channels. Best Buy, Barnes & Noble, Blockbuster and others have used the biggest third-party gift card distributor, Blackhawk, to place their cards in more than 60,000 grocery, drug and convenience stores.[3] Such distribution gives them much broader coverage than is available in their stores alone and has helped stimulate market growth. To date, third-party distributors have given category exclusivity to retailers, providing significant incentive for merchants to move quickly in order to capture these distribution opportunities or potentially be shut out in the future (see inset on page 3).

Preparing for the Gift Card Revolution

In our opinion, even retailers that run superior gift card programs can capitalize on untapped growth opportunities. The next significant, yet untapped, opportunity from gift card strategies will likely involve capturing data and using it to supplement loyalty and affinity programs. Even retailers with the most advanced gift card strategies do not have the systems in place to collect data from gift card purchases – either about the purchaser or the redeemer – and integrate it into their customer relationship management systems. However, like private-label credit cards, gift cards could give retailers deep insights into customers' preferences, purchasing patterns and socioeconomic levels. That data could then be used to improve existing CRM strategies and increase the growth of gift card – and other – programs through targeted marketing, loyalty rewards and other initiatives.

Despite the fast growth in gift cards over the past decade, we believe these are actually the early days of the business. Consumer attitude and behavior change is providing huge momentum for gift card growth. Any stigma once connected to gift cards is largely a thing of the past, and as the time that consumers have to shop for gifts continues to decline, gift cards are becoming a more attractive option. Retail executives should no longer view gift cards as an afterthought but as a sizeable opportunity to create an entirely new product category and to generate significant incremental revenue and profit.

3. Blackhawk press release, "Every Card Tells a Story," Nov. 28, 2006. http://www.blackhawknetwork.com/tabid/102/Default.aspx

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