A New Approach to Strategic Forecasting

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Managers too often predict demand emotionally despite the importance of the decisions made as a result of the forecasts. They do not do their analytical homework rigorously enough. Forecasts are often extrapolations of historical volume trends. Or they are “hockey sticks,” projecting unprecedented upward shifts in sales. Even well-thought-out forecasts are often projected only at the aggregate level. This top-down approach limits the usefulness of the forecasts in developing strategy and limits their credibility as well. Compared to the cost-based aspects of strategy, predicting demand can appear mystical.

Business executives make many strategic decisions that are influenced by questions about volume projections. Some of these are:

- The growth in volume predicted by the marketing department is enough to fulfill our goals, but it is realistic?
- For a product that has been growing steadily, how long should we plan on adding manufacturer capacity?
- Are the trade and distribution channels we have used the right ones to reach the higher-growth customer segments within our product category?
- Should we raise prices on a product and risk accelerating maturity and/or losing share?

Perhaps the classic example of the importance of volume projections is the investment decision for new products. A new product will require investment beyond what its introductory volume will support, with the expectation that later volumes will justify increased spending. Packaged goods companies demonstrate this by introducing new brands with marketing expenses of $20 million to $100 million, money spent in anticipation of sizeable future volumes.

However, as volume behind new brands has become more difficult to capture, these firms have shifted some of the upfront investments to product pretesting, hoping to align better expectations with investment.

Take a Strategic Approach

This need not be the case, however. Demand can be forecasted to give management insight into the business and provide greater confidence in the projection. The “strategic forecasting approach” marries recent market-segmentation techniques with the conventional product life cycle concept. It is a rigorous, systematic framework, which helps to minimize major forecasting errors on the downside. More importantly, it provides insight into the upside, where risk-averse managers, more comfortable with hard numbers, often overlook opportunities. The result is a practical tool useful for a variety of product categories.

The strategic forecasting approach begins by dividing customers into segments based on buying behavior, attitudes, or demographics. Then, category demand for each major customer segment is analyzed to determine what factors drive volume. Factors to investigate include (1) inherent product characteristics and substitution; (2) demographic cycles; (3) societal trends; (4) acquisition levels; and (5) penetration rates. Demand is then projected at the segment level and aggregated to forecast the product category life cycle.

Here is a closer look at each of the elements of this approach.

Market Segmentation

There has been a growing recognition that consumer markets are not homogeneous. Managers are learning that the strategy "to be all things to all people" is just not economically viable in most consumer businesses, given the broad and often conflicting sets of consumer needs and priorities that comprise the "total market."

Consumers can be grouped according to a number of attitudinal and behavioral dimensions. They may be segmented on the basis of demographics, which provide useful descriptive information but very little in the way of strategic insight into explaining behavior. In addition, psychographics have been used to provide some guidance in developing advertising executions. Segments defined in this manner, however, are difficult to use in other marketing and strategic decisions, primarily due to the challenge in identifying customers' psychographics from "the outside."

The most advanced approaches to market segmentation are based on user needs and attitudes toward the specific product category under study. A "needs segment" is nothing more than a group of people who share a desire for some benefit from a product or service. When they are in the marketing for the product being studies, they will base their choices on the perception of whether the manufacturer's offering provides that benefit. The individuals grouped in a needs segment for a given product category may, in fact, be entirely different from one another in their desires and buying behavior for other products.

For example, a major telecommunications firm examining families of the same size and income believed that their need for long-distance service would be similar. The study showed, however, that the relevant drivers were not family size and income. Attitudes toward the telephone (i.e., hassle, pleasure, or guilt) and the geographic locations of relatives and business colleagues were much more important in determining the family's long-distance usage and influenced their subsequent selection of long-distance carriers.

Thus, because of the focus on buying behavior, needs segments are more powerful in explaining consumer behavior than are standard income- or ZIP code-based groups or even general value and attitude segments.

Whether demographics, attitudes, needs, or a combination are used, the segmentation must first be applied to people or occasions. Person-based segmentation (which clusters people) is appropriate as the primary segmentation when needs and motivations are relatively stable across

purchase or usage occasions, and when purchases are infrequent. Occasion-based segmentation (which clusters occasions) is appropriate as the primary segmentation when needs and motivations tend to vary by occasion.

For example, a large beverage manufacturer found that occasion-based segmentation added great insight into consumer drinking behavior. Research suggested that consumers' decisions are heavily driven by when and where they drink the product—at home, at a bar, or with a meal. In other words, the occasion defined the competitive arena. The set of beverage alternatives (beer, wine or liquor) and the importance of brand name in a bar setting were different from the relevant choices for a beverage bought to be enjoyed at home or with meals.

Market segmentation is a critical part of the strategic forecast approach because the analysis of demand drivers will be conducted on a segment basis. Each segment's demand is evaluated both historically and into the future (over a reasonable planning horizon of five to ten years). This has several advantages:

- Insights are developed that can be used to go beyond predicting demand and toward creating strategies for reaching segments and subgroups.
- Assumptions underlying the forecast about each segment are explicit and can be tested individually.
- Weaknesses in logic and/or data insufficiencies are revealed at a specific enough level to facilitate discrete pieces of research or analysis.

In essence, this approach gives each segment its own projected volumes and its own product category life cycle.

Demand Drivers

The demand driver analysis consists of three major steps:

- Examine the inherent product characteristics and possible substitutions. This includes evaluating the product's degree of differentiation, its uniqueness in benefits provided, and the economics of delivering these benefits compared with alternatives. This helps measure substitution. For example, as an apparel fabric, taffeta is inherently dressy, with limited degrees of differentiation and application in clothing usage. For holiday dress, however, its unique feel and look give it a distinct advantage over other fabrics. For these occasions, taffeta is relatively insulated from substitution.
- Examine forces outside the control of the manufacturer (the macrodrivers). This step includes looking at basic social trends and changes in demographics. For example, the size and aging of the baby boomer segment has helped to fuel product and service categories as diverse as at-home exercise machinery, convenience cook-at-home foods, financial planning services, and the rise of a boomlet in baby clothes, diapers, and cribs.
- Assess the velocity drivers. This covers the penetration of customer segments (the percentage of people buying), the acquisition level (how much of the product is brought by each customer), and the size of the underlying customer demographic segment.

For example, consider the velocity drivers in the jeans category. About 70 percent of teenage girls (penetration rate) bought on average two pairs of jeans (acquisition level) in 1976. In 1985, the penetration was only 41 percent of teenage girls buying jeans; however, the acquisition level increased to 5.1 pairs, probably driven by a heavy user subsegment. Whereas the number of teen-age girls declined from about 14.5 million in 1976 to about 12.5 million in 1985, the increase in acquisition level, due primarily to the introduction of different styles of jeans, offset the decline.

Product Life Cycle

The volume projections resulting from the segmentations and demand driver analyses are then examined for impacts based on product life cycle dynamics. The product life cycle concept charts the flow of a product through stages: introduction and growth, broad acceptance, and maturity. It delineates the relationship between profit margins and sales volume over the life of a product.

By identifying where products are along the product life cycle, management can gain important strategic insights, such as when and how to invest.

How to Use the Strategic Forecasting Approach

A good illustration of the strategic forecasting approach is to apply it to the category of casual wear tops. Apparel represents a fast-turn, fashion-sensitive product, which is difficult to predict.

Segmentation is the first step. The casual wear tops market can be segmented in several ways. A viable segmentation need to be complex. Occasion-based segmentation can be combined with age and sex, an approach for which there is significant, publicly available data. The wearing occasions can be identified as athletic, at-home, and social-work. Care must be taken because garments may have multiple uses. Then usage by sex and ages can be broken out within each segment and demand built up for each subsegment.

Each of the occasion segments was affected by different demand drivers. For example, the athletic segment was heavily driven by the fitness movement, which had been increasing during a period of the product's growth. However, the fitness craze appears to have peaked. In addition, the number of teenage boys who make up the core user group for these casual tops is expected to decrease as a result of lower birthrate trends. These factors, along with other drivers, suggest that volume in the purely athletic usage of these casual tops will decline.

By contrast, the use of casual wear tops is expected to grow in the at-home segment. This is due to the increase in baby-boomer adults who are staying at home or "cocooning" during the limited leisure time available. Most of the activities conducted during non-work time are not social but around the home. The casual wear top product is ideally suited for this usage—comfortable, inexpensive, and washable, with few substitutes today or on the near-term horizon.

The strategic forecasting approach suggests that the casual wear top category is in the saturation, slower-growth phase of the product life cycle. The product had entered the growth phase when there was increased athletic usage by boys and social use by teen girls. Societal trends of

casualness and the flexibility, comfort, convenience, and low cost of the fabric also contributed to growth. Demand accelerated as a new customer segment, the baby boomers, found the top comfortable and inexpensive for at-home use. Demand growth slowed in the original athletic and social segments because of fewer teens and an increase in the popularity of substitutes such as cotton sweaters.

The strategic forecasting approach adds significant insight to the management of the casual wear product line. For example, the results may suggest limiting investment in fixed assets as capacity catches up with the leveling growth. Acquiring capacity from within the industry could also be an appropriate response. Joint ventures or importing may be more viable ways to obtain the tops given the maturing of the business. The results also focus attention on product innovations such as elastic waists and on different distribution channels, including mass market retailers designed to reach the higher-growth baby-boomer customer segments.

There are also pricing implications for casual tops. The insight provided by the by-segment analysis allows pricing decisions to be made at a level closer to the market. For example, the traditional approach would have suggested broadly reducing prices to stimulate demand as the casual top enters maturity. However, there may still be substantial growth and the opportunity to sustain margins within the at-home segment, which may be captured by pricing differentials by channel.

This strategic forecasting approach is versatile. The concept has been used to forecast several apparel markets, from athletic attire to at-home lounging wear to accessories. The approach has potential for broad application even outside the consumer goods spectrum and has been used in the insurance market and in fast food.

The approach could help predict volume for home services, health care, and financial services. All rely on the same type of underlying drivers (i.e., product substitution, societal trends, and demographics), which create fairly predictable penetration and acquisition rates within consumer segments.

The strategic forecasting approach provides a logical and systematic way to project demand and enhance decision making. It needs to be an ongoing part of the planning process, since consumers and competitors change over time.