Success can depend on the small details (or insignificant variables)

One of the fundamental virtues of direct marketing is its measurement base. The statistical base means that tests yield valid projection data for future mailings. There are also many variables that remain relatively constant. Such factors as fixed and variable overhead, cost per piece and even average order size are stubbornly fixed even when change is attempted. The statistical base plus the constant variables enable the construction of long-range projection models.

Computer models allow testing of the impact of proposed or suspected changes in specific variables. When all of the seemingly insignificant changes combine, the effects can be dramatic. The interaction of small changes makes models interesting. Because the success or failure of nearly all business lies in the attention to detail (the insignificant variables), good modeling can be very important.

Before constructing anything, it is important to identify the objective. It may be to examine the relationship of prospect mailings to long-term profit or investment in list rental to space advertising. Every business has sales minus costs equal profit. Every break-down model must therefor contain the same basic variables and equations. The good models allow extensive tinkering to demonstrate which variables influence profit most.

The easiest variable to manipulate in direct mail is the quantity mailed. With a successful formula, just rent more names and run the press! This variable becomes the focal point of this model. The question is: How many pieces can be mailed and the business remain profitable?

The model described was developed over several years, working with business-to-business catalog companies. The version shown was presented as part of a case study for the 1987 Direct Marketing Association convention. It was enhanced with the help of Jack Miller, Quill Corp., and Howard Bernstein, Laventhol & Horwath.

For each equation listed above, each variable is split into buyer-, house-, and rented-list segments. Most mailers make money on their buyers and lose money on house and rented lists. By isolating the profit and loss for each list segment, the model can be fine-tuned to show how many names to rent for an optimum profitable growth rate.

This splitting of the model also allows some segments to bear greater cost burdens. The house file does not have list-rental charges. Rented lists are not burdened with fixed overhead or catalog production expenses because a catalog would be produced with or without additional prospecting.

One of the most difficult variables to calculate (with or without a model) is fixed and variable overhead. This is particularly true when the direct mail operation is only a part of a larger company.

The most common calculation takes such variable costs as WATS, telemarketer, order-entry personnel and

management expenses and divides these by the number of orders processed. Fixed expenses would be the percentage of workload for the direct mail division multiplied by indirect labor and management, heat, electric, plant and maintenance expenses. The greater the number of expense items considered fixed, the greater the savings when more orders are processed. However, the fixed costs climb fast if a new building is needed!

The buyer and house files are shown as net numbers mailed several times (rather than total mailed, like rented lists). This detail helps in validating the model against actual growth data in real companies. Fixed overhead and catalog-development cost are applied in proportion to the percentage of business done by the buyer and house segments.

These variables build a basic break-even analysis. This is still far from being a long range planning model; additional variables are necessary for the model to grow from year to year. These variables reflect real growth and decline dynamics.

Mailing rented lists generates new buyers, inquirers and ship-to's. To a lesser extent, buyer and house-file mailings also generate new names. These ratios determine how quickly house and buyers files grow from year to year.

Rented-list response rate is the most important variable for generating house-file growth. If a mailing pulls 10 percent, the buyer file will grow much more rapidly than with a 0.2 percent response. Inquiries can be calculated by multiplying the response rate by the quantity mailed, but inquiries tend to be proportional to buyer response rates.

Because of buyer questions, computer supply companies used to generate four inquirers for every order taken. As buyers have become more familiar with the products, that ratio has declined. A 4-to-1 inquirer ratio will build the house file relatively quickly. Outside advertising can boost the house-file ratio independently of the order-response rate.

Within each response rate there is one additional variable, the ratio of new to old names. Not every buyer generated by a rented list will be a new one, nor will every buyer generated by the buyer list be an old one. Mailing pieces often get passed along (particularly catalog and business-to-business mailings). Frequently, 90 percent of the rented-list-generated buyers will be new, but 90 percent of the house- and buyer-file-generated names will already be on file.

Finally, the model includes a buyer file drop-off rate. This variable simulates the aging of the buyer list. Some buyers do not continue to purchase, and after, say, two years of regular mailings without buying, such subsegments should not be considered buyers but should be retested on a less frequent basis.

One of the most important parts of modeling is portraying the information clearly and dramatically. The spreadsheet layout is important, but it is even more important to have interesting graphs built into the model. It often takes 10 to 15 roughs to get one really good illustration, but more than anything else, graphs make the point to non-financial people.

This model includes information showing sales growth, profit by segment, shareholders' equity, etc. One of the best graphs shows sales by segment (in a stacked bar graph) and total annual sales. The other interesting

graph shows profit by segment (side by side) by year. (See the segment profit performance chart.)

An income statement can easily be generated by combining existing information. The sales and costs are added across buyer, house and rented segments. To look really professional, zeros are striped out (divide all cells by 1,000), and a 36 percent tax rate is imposed on all profits.

A balance sheet can also be built (see the project model) but requires several assumptions in addition to existing numbers. Cash requirements are generated by two months' variable expenses. Accounts receivable is 1 1/3 months' sales, because there is always more receivable than received. Inventory can be two months' sales (six turns per year). Prepaid advertising is the advertising expense times the life of the catalog (usually two or three months). Fixed assets can be built from fixed overhead times the sales increase. Accounts payable comes from three-quarters of one months' cost of sales, variable expenses and taxes.

To build a case-study model, some numbers become plugged, in this case, the bank loan. In the real world, shareholders' equity fluctuates with corporate performance.

Additional ratios used in business evaluation can be built. Current ratio is current assets divided by current liabilities. Acid test ratio is cash plus accounts receivable divided by current liabilities. Debt to equity ratio is total liabilities divided by shareholders' equity.

The fundamental reason for building a model is to be able to evaluate quickly different courses of action, without actual making the out-of-pocket investment. Even when only constructing the numeric shell, it is important to focus on the objective before setting out. If a direct mail distribution division is to add incremental revenue without significant increase in overhead, a break-even scenario would be appropriate. If, on the other hand, the evaluation is for competition with other divisions in a corporate structure, it must be evaluated on the basis of the target return on investment of the other divisions.

Whatever the financial objectives, a good model also allows necessary targets to be identified and quantified to reach stated objectives. It may take a 0.5 percent response and a $250 average order; but a 0.25 percent response and a $480 average order would also work. Quantified targets allow evaluation before the end of the year.

Though current business projections are being met, a good model will illustrate what would happen if response fell or average order size rose. The exercise can become too academic, but a little fiddling may give a jump on the competition before changes happen.

The best single benefit to model building has been to explain the dynamics of direct mail to non-profit marketing people. Bankers do not always understand how sending out literature and waiting for customers to call can constitute a legitimate business. Graphic illustrations coupled with accurate historic data demonstrate how dozens of factors interact to build a successful direct mail business.