

DEMAND STUDIES AND HOW NOT TO DO THEM: A STORY ABOUT PANCAKES (with lessons for microfinance)

A cautionary tale posted in Devfinance by Jens Reinke of IRIS on 7 October, 2004

(For the uninitiated, IHOP is the International House of Pancakes, a US pancake chain restaurant.)

Since there is no IHOP franchise in Washington DC, the IHOP Corp. decides to carry out a demand study for the pancake market in the capital. Due to the perennial shortage of private sector consultants in the District, the IHOP management searches the CGAP consultants' database and choose a small team of microfinance specialists to assess the market for pancakes.

The consultants, who have carried out numerous demand studies before (and most recently estimated the demand for microcredit in a small ex-Soviet republic at over US\$200m), decide to apply their tried and tested methodology. They carry out a two-stage survey. First, a large number of randomly selected people in DC will be asked whether they like pancakes. During this first interview, respondents learn about the price of a basic pancake (US\$3.99 for a plain pancake with butter and syrup) to help shape their opinion about their desire for pancakes at the going rate. The second round addresses a smaller group of respondents who do like pancakes. The researcher will assess the respondents' financial situation, looking at assets and cash flow projection to estimate their pancake absorption capacity (referring to financial, not nutritional absorption).

The first round of interviews will determine the notional demand for pancakes by multiplying the share of positive pancake responses with the District's population, while the second round will allow us to assess the effective demand by showing what share of notional demand cannot be fulfilled by a pancake provider under sustainable conditions.

The outcome of the demand study is extremely positive. During the first stage, over 80 percent of respondents report that they like pancakes 'a lot' or 'quite a lot'. Even more surprising, the second stage shows that the pancake absorption capacity is high, with almost the entire population able to afford at least one pancake meal a day - only school children whose pocket money is inadequate show significant absorption constraints. IHOP is advised to open at least 250 branches in the district to satisfy the forecast demand of 300 pancake meals per District resident per year. A year later, when all franchisees have filed for bankruptcy, CGAP is approached by NPR's Kojo Mnami about the quality of the consultants on their database.

What has gone wrong? There are a few factors that the researchers forgot to address in trying to understand effective demand:

1. People who like pancakes and who can afford them may still choose to spend their money on other products. For example, they may choose a sandwich shop to satisfy their breakfast requirements.

Not all people who say they want credit and can afford it will ultimately sign a loan contract. Many micro-entrepreneurs will rather save towards their investments.

2. Even people who want to eat pancakes and can afford them daily won't eat them all the time. They may choose to eat pancakes only on Sundays.

MFI demand studies often assume that borrowers want to be continuously in debt, but this may not be the case. This is particularly true when their business is seasonal, or borrowing is for larger investment rather than working capital.

3. Not all people like the quality of IHOP pancakes. Particularly, the many European residents in DC prefer thinner pancakes, similar to French crepes, to the American bubbly heap of batter.
Microfinance products are not well diversified and numerous borrowers may find them ill suited to their needs.

4. Numerous respondents who like pancakes and can afford them prefer to cook them at home with friends and never eat them in a restaurant.
Much microcredit demand is satisfied by borrowing from family and friends.

5. Seeing the frantic investment by IHOP, several other pancake-oriented restaurant chains focus on expansion in the DC area.
Microfinance demand assessments often underestimate the range of alternatives available to potential borrowers, including not only other MFIs but retail and supplier credit, banks, finance houses, consumer credit, and money lenders.

6. Some people who want to go out and eat pancakes have family members who do not. They are looking for dining options with more varied menus where all family members will enjoy the meal.
Some potential MFIs clients require savings or transfer services more than credit and will not borrow from a limited, credit-only institution if alternatives, such as full-service banks, are available.

7. Some pancake lovers recently started the Atkins diet. They will only buy low-carb pancake mix and prepare the meals at home.
Numerous potential borrowers are averse to risk and keen to avoid debt. If they have to borrow, they will do so only from 'soft' lenders such as family members.

A follow-up study by CGAP and IHOP would probably find that the first two factors are the most decisive. Even people who like pancakes and who can afford them will not necessarily buy them when they become available - there are so many alternative uses for money - and most certainly they will not buy them as often as they could afford them.

True demand was lower than the 'effective' demand forecast by the research team from the CGAP database. How much lower? Is there a way to predict demand more accurately?