Assortment Optimization under the Sequential Multinomial Logit Model

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Abstract

We study the assortment optimization problem under the *Sequential Multinomial Logit* (SML), a discrete choice model that generalizes the multinomial logit (MNL). Under the SML model, products are partitioned into two levels, to capture differences in attractiveness, brand awareness and, or visibility of the products in the market. When a consumer is presented with an assortment of products, she first considers products in the first level and, if none of them is purchased, products in the second level are considered. This model is a special case of the Perception Adjusted Luce Model (PALM) recently proposed by Echenique, Saito, and Tserenjigmid (2013). It can explain many behavioral phenomena such as the attraction, compromise, and similarity effects which cannot be explained by the MNL model or any discrete choice model based on random utility. In particular, the SML model allows violations to the *regularity condition* which states that the probability of choosing a product cannot increase if the offer set is enlarged.

This paper shows that the seminal concept of revenue-ordered assortment sets, which contain an optimal assortment under the MNL model, can be generalized to the SML model. More precisely, the paper proves that all optimal assortments under the SML are revenue-ordered by level, a natural generalization of revenue-ordered assortments that contains, at most, a quadratic number of assortments. As a corollary, assortment optimization under the SML is polynomial-time solvable. This result is particularly interesting given that the SML model does not satisfy the regularity condition and, therefore, it can explain choice behaviours that cannot be explained by any choice model based on random utility.

1 Introduction

The assortment optimization problem is a central problem in revenue management, where a firm wishes to offer a set of products with the goal of maximizing the expected revenue. This problem has many relevant applications in retail and revenue management (Kök, Fisher, and Vaidyanathan, 2005). For example, a publisher might need to decide the set of advertisements to show, an airline must decide which fare classes to offer on each flight, and a retailer needs to decide which products to show in a limited shelf space.

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The first consumer demand models studied in revenue management were based on the independent demand principle. This principle stated that customers decide beforehand which product they want to purchase: If the product is available, they make the purchase and, otherwise, they leave without purchasing. In these models, the problem of finding the best offer set of products is computationally simple, but this simplicity comes with an important drawback: These models do not capture the substitution effects between products. That is, they cannot model the fact that, when a consumer cannot find her/his preferred product, she/he may purchase a substitute product. It is well-known that choice models that incorporate substitution effects improve demand predictions (Talluri and Van Ryzin, 2004; Newman et al., 2014; van Ryzin and Vulcano, 2015; Ratliff et al., 2008; Vulcano, van Ryzin, and Chaar, 2010). One of the most celebrated discrete choice models is the *Multinomial Logit* (MNL) (Luce, 1959; McFadden, 1974). Under the MNL model, the assortment problem admits a polynomial-time algorithm (Talluri and Van Ryzin, 2004). However, the model suffers from the independence of irrelevant alternatives (IIA) property (Ben-Akiva and Lerman, 1985) which says that, when a customer is asked to choose among a set of alternatives S, the ratio between the probability of choosing a product $x \in S$ and the probability of choosing $y \in S$ does not depend on the set S. In practice, however, the IIA property is often violated. More complex choice models have been proposed in the literature such as the Nested Logit model (Williams, 1977), the latent class MNL (Greene and Hensher, 2003), the Markov Chain model (Blanchet, Gallego, and Goyal, 2013), and the exponomial model (Daganzo, 1979; Alptekinoğlu and Semple, 2016). All these models satisfy the following property: The probability of choosing an alternative does not increase if the offer set is enlarged. Despite the fact that this property (known as regularity) appears natural, it is well-known that it is sometimes violated by individuals (Tversky, 1972a,b; Tversky and Simonson, 1993). Recently, there have been efforts to develop discrete choice models that can explain complex choice behaviours such as the violation of regularity, one of the most prominent examples is the perception adjusted Luce's model (PALM) (Echenique, Saito, and Tserenjigmid, 2013).

1.1 Our Contributions

In this paper, we study the assortment optimisation problem for a two-stage discrete choice model model that generalizes the classical Multinomial Logit model. This model, which we call the *Sequential Multinomial Logit* (SML) for brevity, is a special case of the recently proposed model known as the perception-adjusted Luce model proposed by Echenique, Saito, and Tserenjigmid (2013). In the SML model, products are partitioned *a priori* into two sets, which we call levels. These product segmentation into two levels can capture different degree of attractiveness, consumer brand awareness, and product visibilities in the market. Our main contribution is to provide a polynomial-time algorithm for the assortment problem under the SML and to give a complete characterization of the resulting optimal assortments.

A key feature of the SML model is its ability to capture several effects that cannot be explained by any choice model based in random utility (such as for example the MNL, the mixed MNL, the markov chain model, and the stochastic preference models). Examples of such effects include attraction, (Doyle et al., 1999), compromise (Simonson and Tversky, 1992), similarity (Debreu, 1960; Tversky, 1972b), and the paradox of choice (Schwartz, 2004). These effects are discussed in the next section. In particular, the SML model allows for violations to the regularity condition, i.e., the fact that the probability of purchasing a product may increase in a larger assortment. There are very few analyses of assortment problems under a choice model that does not satisfy the regularity condition.

Our algorithm is based on an in-depth analysis of the structure of the SML: It exploits the concept of revenue-ordered assortments that underlies the optimal algorithm for the assortment problem under the MNL. The key idea in our algorithm is to consider an assortment built from the union of two sets of products: A revenue-ordered assortment from the first level and another revenue-ordered assortment from the second level. Several structural properties of optimal assortments under the SML are also presented.

1.2 Relevant Literature

The heuristic of revenue-ordered assortments, consists in evaluating the expected revenue of all the assortments that can be constructed as follows: fix threshold revenue ρ and then select all the products with revenue of at least ρ. This strategy is appealing because it can be applied to assortment problems for any discrete choice model. In addition, it only needs to evaluate as many assortments as there are different revenues among products. In a seminal result, Talluri and Van Ryzin (2004) showed that, under the MNL model, the optimal assortment is revenue-ordered. This result does not hold for all assortment problems however. For example, revenue-ordered assortments are not necessarily optimal under the MNL model with capacity constraints (Rusmevichientong, Shen, and Shmoys, 2010). Nevertheless, in another seminal result, Rusmevichientong, Shen, and Shmoys (2010) showed that the assortment problem can still be solved optimally in polynomial time under such setting.

Rusmevichientong and Topaloglu (2012) considered a model where customers make choices following a MNL model, but the parameters of this model belong to a compact uncertainty set, i.e., they are not fully determined. The firm wants to be protected against the worst-case scenario and the problem is to find an optimal assortment under these uncertainty conditions. Surprisingly, when there is no capacity constraint, the revenue-ordered strategy is optimal in this setting as well.

There are also studies on how to solve the assortment problem when customers follow a mixed multinomial logit model. Bront, Méndez-Díaz, and Vulcano (2009) showed that this problem is NP-hard in the strong sense using a reduction from the *minimum vertex cover problem* (Garey and Johnson, 1979). Méndez-Díaz et al. (2014) proposed a branch-and-cut algorithm to solve the optimal assortment under the Mixed-Logit Model. An algorithm to obtain an upper bound of the revenue of an optimal assortment solution under this choice model was proposed by Feldman and Topaloglu (2015). Rusmevichientong et al. (2014) showed that the problem remains NP-hard even when there are only two customers classes.

Another model that attracted researchers attention is the *nested logit model*. Under the nested logit model, products are partitioned into nests, and the selection process for a customer goes by first selecting a nest, and then a product within the selected nest. It also has a dissimilarity parameter associated with each nest that serves the purpose of magnifying or dampening the total preference weight of the nest. For the two-level nested logit model, Davis, Gallego, and Topaloglu (2014) studied the assortment problem and showed that, when the dissimilarity parameters are bounded by 1 and the no-purchase option is contained on a nest of its own, an optimal assortment can be found in polynomial time; If any of this two conditions is relaxed, the resulting problem becomes NP-hard, using a reduction from the *partition problem* (Garey and Johnson, 1979). The polynomial-time solution was further extended by Gallego and Topaloglu (2014), who showed that, even if there is a capacity constraint per nest, the problem remains polynomial-time solvable. Li et al. (2015) extended this result to a d-level nested logit model (both results under the same assumptions over the dissimilarity parameters and the no-purchase option). Jagabathula (2014) proposed a local-search heuristic for the assortment problem under an arbitrary discrete choice model. This heuristic is optimal in the case of the MNL, even with a capacity constraint. Wang and Sahin (2017) has studied the assortment optimization in a context in which consumer search costs are non-negligible.

Recently, Berbeglia and Joret (2016) studied how well revenue-ordered assortments approximate the optimal revenue. They provide three types of revenue guarantees that are tight for RUMs and, in general, incomparable. These guarantees are valid for all choice models that satisfy the following property: The probability of selecting a product from an assortment cannot increase if the assortment is enlarged [*].

In the last few years, there has been progress in studying the assortment problem in choice models that incorporate visibility biases. In these models, the likelihood of selecting an alternative not only depends on the offer set, but also in the specific configurations the offer set is displayed (Abeliuk et al., 2016; Aouad and Segev, 2015; Davis, Gallego, and Topaloglu, 2013; Gallego et al., 2016).

The perception adjusted Luce's model proposed by Echenique, Saito, and Tserenjigmid (2013) is based on MNL model (Luce, 1959). One of its key features is the possibility to violate the axiom of independence from irrelevant alternatives (IIA) and more importantly, the regularity axiom. These violations were identified as perception priorities. The model can then explain and reproduce many behavioral phenomena such as attraction, compromise, and similarity effects. See Rieskamp, Busemeyer, and Mellers (2006) for a survey.

The attraction effect stipulates that, under certain conditions, adding a product to an existing assortment can increase the probability of choosing a product in the original assortment. We briefly describe two experiments of this effect. Simonson and Tversky (1992) considered a choice among three microwaves x, y, and z. Microwave y is a Panasonic oven, perceived as a good quality product, and z is a more expensive version of y. Product x is an Emerson microwave oven, perceived as a lower quality product. The authors asked a set of 60 individuals ($N = 60$) to choose between x and y; they also asked another set of 60 participants ($N = 60$) to choose among x, y, and z. They found out that the probability of choosing y increases when product z is shown. This is a direct violation of regularity, which states that the probability of choosing a product does not increase when the choice set is enlarged, as described by McCausland and Marley (2013). Another demonstration of the attraction effect was carried by Doyle et al. (1999) who analyzed the choice behaviour of two sets of participants ($N = 70$ and $N = 82$) inside a grocery store in the UK varying the choice set of baked beans. To the first group, they showed two types of baked beans: Heinz baked beans and a local (and cheaper) brand called Spar. Under this setting, the Spar beans was chosen 19% of the time. To the second group, the authors introduced a third option: a more expensive version of the local brand Spar. After adding this new option, the cheap Spar baked beans was chosen 33% of the time. It is worth highlighting that the choice behaviour in these two experiments cannot be explained by a Multinomial Logit Model, nor can it be explained by any choice model based on random utility.

The compromise effect (Simonson and Tversky, 1992) captures the fact that individuals are averse to extremes, which helps products that represent a "compromise" over more extreme options (either in price, familiarity, quality, ...). As a result, adding extreme options sometimes leads to a positive effect for compromise products, whose probabilities of being selected increase in relative

[*] these choice models include the standard random utility model.

terms compared to other products. This phenomenon violates again the IIA axiom of Luce's model and the regularity axiom satisfied by all random utility models (Berbeglia and Joret, 2016). Again, the compromise effect can be captured with the perception-adjusted Luce model.

Finally, the similarity effect is discussed in Tversky (1972b), elaborating on an example presented in Debreu (1960): Consider x and z to represent two recordings of the same Beethoven symphony and y to be a suite by Debussy. The intuition behind the effect is that x and z jointly compete against y, rather than being separate individual alternatives. As a result, the ratio between the probability of choosing x and the probability of choosing y when the customer is shown the set $\{x, y\}$ is larger than the same ratio when the customer is shown the set $\{x, y, z\}$. Intuitively, z takes a market share of product x, rather than a market share of product y.

2 Problem Formulation

This section presents the sequential multinomial logit model considered in this paper and its associated assortment optimization problem. Let X be the set of all products and x_0 be the no-choice option ($x_0 \notin X$). Following Echenique, Saito, and Tserenjigmid (2013), each product $x \in X$ is associated with an intrinsic utility $u(i) > 0$ and a perception priority level $l(x) \in \{1, 2\}$. The idea is that customers perceive products sequentially, first those with priority 1 and then those with priority 2. This perception priority order could represent differences in familiarity or salience of the different products, or even in the way the products are presented. Let $X_i = \{x \in X : l(x) = i\}$ be the set of all products belonging to level $i = 1, 2$. Given an assortment $S \subseteq X$, we write $S = S_1 \uplus S_2$ with $S_1 \subseteq X_1$ and $S_2 \subseteq X_2$ to denote the fact that S is a partition consisting of two subsets S_1 and S_2.

The *Sequential Multinomial Logit Model* (**SML**) is a discrete choice model where the probability $\rho(x, S)$ of choosing a product x in an assortment S is given by:

$$\rho(x, S) = \begin{cases} \frac{u(x)}{\sum_{y \in S} u(y) + u_0} & \text{if } x \in S_1, \\ \left[1 - \frac{\sum_{z \in S_1} u(z)}{\sum_{y \in S} u(y) + u_0}\right] \cdot \frac{u(x)}{\sum_{y \in S} u(y) + u_0} & \text{if } x \in S_2. \end{cases}$$

where u_0 denotes the intrinsic utility of the no-choice option, which has a probability

$$\rho(x_0, S) = 1 - \sum_{i \in S} \rho(i, S)$$

of being chosen[†]. Observe that the probability of choosing a product $x \in S_1$ (which implies that $l(x) = 1$ and $x \in S$) is given by the standard MNL formula, whereas the probability of choosing a product y that belongs to the second level is given by the probability of not choosing any product belonging to the level 1 multiplied by the probability of selecting product y according the MNL again. Note that, if all the offered products belong to the same level, this model is equivalent to the classical MNL model.

Let $r : X \cup \{x_0\} \to \mathbb{R}^+$ be the revenue function which assigns a per-unit revenue to each product and let $r(x_0) = 0$. We use $R(S)$ to denote the *expected revenue* of an assortment S, i.e.,

$$R(S) = \sum_{x \in S} \rho(x, S) \cdot r(x). \tag{1}$$

[†]The *Perception Adjusted Model* makes the outside option value u_0 to be dependent upon the assortment shown S. In the SML, we kept the outside option value to a constant as in the standard MNL model.

The assortment optimization problem under the SML consists in finding an assortment S^* that maximizes R, i.e.,

$$S^* = \underset{S \subseteq X}{\operatorname{argmax}}\, R(S). \tag{2}$$

We use R^* to denote the maximum expected revenue, i.e.,

$$R^* = \max_{S \subseteq X} R(S). \tag{3}$$

Without loss of generality, we assume that $u(i) > 0$ in the rest of this paper. We use x_{ij} to denote the j^{th} product of the i^{th} level ($i = 1, 2$), and m_i to denote the number of products in level i. It is always possible to add products with zero utility to satisfy this assumption. Also, we assume that the products in each level are indexed in a decreasing order by revenue (breaking ties arbitrarily), i.e.,

$$\forall i \in \{1, 2\}\,, r(x_{i1}) \geq r(x_{i2}) \geq \ldots \geq r(x_{im_i}).$$

It is useful to illustrate how the SML allows for violations of the regularity condition, a property first observed by Echenique, Saito, and Tserenjigmid (2013). Our first example captures the attraction effect presented earlier.

Example 1 (Attraction Effect in the SML)**.** Consider a retail store that offers different brands of chocolate. Suppose that there is a well-known brand A and the brand B owned by the retail store. There is one chocolate bar a_1 from brand A and there are two chocolate bars b_1 and b_2 from Brand B, with b_2 being a more expensive version of b_1. When shown the assortment $\{a_1, b_1\}$, 71% of the clients purchase a_1 and 8.2% buy b_1. When shown the assortment $\{a_1, b_1, b_2\}$, customers select a_1 49.8% of the time and, surprisingly, bar b_1 increases its market share to about 10%, while bar b_2 accounts for 15% of the market. The introduction of b_2 to the assortment increases the purchasing probability of b_1, violating regularity. The numerical example can be explained with the SML as follows: Consider $A = \{a_1\}$, $B = \{b_1, b_2\}$ and $X = A \uplus B$. With $u(a_1) = 100, u(b_1) = 40, u(b_2) = 60$, and $u_0 = 1$ as the utility of the outside option, we have:

$$\rho(b_1, \{a_1, b_1\}) = \frac{40}{141} \cdot \left[1 - \frac{100}{141}\right] = \frac{1}{18} \approx 8.2\%.$$

and

$$\rho(b_1, \{a_1, b_1, b_2\}) = \frac{40}{201} \cdot \left[1 - \frac{100}{201}\right] = \frac{1}{16} \approx 10\%.$$

Hence $\rho(b_1, \{a_1, b_1\}) < \rho(b_1, \{a_1, b_1, b_2\})$ which contradicts regularity.

Our second example shows that the SML can capture the so-called *paradox of choice* (e.g., Schwartz (2004)): The overall purchasing probability may decrease when the assortment is enlarged. Once again, this effect cannot be explained by any random utility model and it is sometimes called the effect of "too much choice".

Example 2 (Paradox of Choice in the SML)**.** Let $X_1 = \{x_{11}\}$, $X_2 = \{x_{21}, x_{22}\}$, $X = X_1 \uplus X_2$, $u(x_{11}) = 10$,$u(x_{21}) = 1$,$u(x_{22}) = 10$, and $u_0 = 1$. We have

$$\begin{aligned}\rho(x_0, \{x_{11}, x_{21}\}) &= 1 - \rho(x_{11}, \{x_{11}, x_{21}\}) - \rho(x_{21}, \{x_{11}, x_{21}\}) \\ &= 1 - \frac{10}{12} - \left(1 - \frac{10}{12}\right) \cdot \frac{1}{12} = 0.152\overline{7},\end{aligned}$$

and

$$\begin{aligned}\rho(x_0, \{x_{11}, x_{21}, x_{22}\}) &= 1 - \rho(x_{11}, \{x_{11}, x_{21}, x_{22}\}) - \rho(x_{21}, \{x_{11}, x_{21}, x_{22}\}) - \rho(x_{22}, \{x_{11}, x_{21}, x_{22}\}) \\ &= 1 - \frac{10}{22} - \left(1 - \frac{10}{22}\right) \cdot \frac{1}{22} - \left(1 - \frac{10}{22}\right) \cdot \frac{10}{22} = 0.\overline{27}.\end{aligned}$$

Hence $\rho(x_0, \{x_{11}, x_{21}\}) < \rho(x_0, \{x_{11}, x_{21}, x_{22}\})$.

3 Properties of Optimal Assortments

This section derives properties of optimal solutions to the assortment problem under the SML. We assume a set of products $X = X_1 \uplus X_2$ and use the following notations

$$U(S) = \sum_{x \in S} u(x), \quad \alpha(S) = \frac{\sum_{x \in S} u(x)r(x)}{\sum_{x \in S} u(x)} = \frac{\sum_{x \in S} u(x)r(x)}{U(S)} \quad \text{and} \quad \lambda(Z, S) = \frac{U(Z)}{U(S) + u_0} \tag{4}$$

where $Z \subseteq S$ and $Z, S \subseteq X$. Note that $\alpha(S)$ is the usual MNL formula for the revenue and, when $S = \{x\}$ for some $x \in X$, $\alpha(S) = r(x)$. With these notations, the revenue of an assortment $S = S_1 \uplus S_2$ is

$$\begin{aligned}R(S) &= \frac{\alpha(S_1)U(S_1)}{U(S_1) + U(S_2) + u_0} + \frac{\alpha(S_2)U(S_2)}{U(S_1) + U(S_2) + u_0} \cdot \left(1 - \frac{U(S_1)}{U(S_1) + U(S_2) + u_0}\right) \\ &= \frac{\alpha(S_1)U(S_1)}{U(S) + u_0} + \frac{\alpha(S_2)U(S_2)}{U(S) + u_0} \cdot \left(1 - \frac{U(S_1)}{U(S) + u_0}\right).\end{aligned} \tag{5}$$

The following proposition is useful to divide a set into disjoint sets, which can then be analyzed separately.

Proposition 1. *Let $S \subseteq X$ and $S = H \cup T$ with $H \cap T = \emptyset$. We have*

$$\alpha(S) = \frac{\alpha(H)U(H) + \alpha(T)U(T)}{U(S)}. \tag{6}$$

Proof.

$$\begin{aligned}\frac{\alpha(H)U(H) + \alpha(T)U(T)}{U(S)} &= \frac{\frac{\sum_{x \in H} r(x)u(x)}{U(H)} \cdot U(H) + \frac{\sum_{x \in T} r(x)u(x)}{U(T)} \cdot U(T)}{U(S)} && \text{/using definition of } \alpha(\cdot) \\ &= \frac{\sum_{x \in H} r(x)u(x) + \sum_{x \in T} r(x)u(x)}{U(S)} && \text{/cancelling } U(H) \text{ and } U(T) \\ &= \frac{\sum_{x \in S} r(x)u(x)}{U(S)} && \text{/using that } H \cup T = S \\ &= \alpha(S). && \text{/definition of } \alpha(S)\end{aligned}$$

□

The next proposition is useful to bound expected revenues.

Proposition 2. *Let $S_1, S_2 \subseteq X$. If $\forall x \in S_1, \forall y \in S_2, r(x) \geq r(y)$, then $\alpha(S_1) \geq \alpha(S_2)$.*

Proof. If $\forall x \in S_1, \forall y \in S_2 : r(x) \geq r(y)$, then $\min_{x \in S_1} r(x) \geq \max_{y \in S_2} r(y)$. We have

$$\alpha(S_1) = \frac{\sum_{x \in S_1} u(x) r(x)}{\sum_{x \in S_1} u(x)} \geq \min_{x \in S_1} r(x) \cdot \underbrace{\frac{\sum_{x \in S_1} u(x)}{\sum_{x \in S_1} u(x)}}_{1} \geq \max_{y \in S_2} r(y) \underbrace{\frac{\sum_{y \in S_2} u(y)}{\sum_{y \in S_2} u(y)}}_{1} \geq \alpha(S_2).$$

□

The following proposition bounds the MNL revenue of the products in the first level. We use $S_i^* = S^* \cap X_i$ to denote the products in level i in the optimal assortment, i.e., $S^* = S_1^* \uplus S_2^*$.

Proposition 3 (Bounding Level 1)**.** $\alpha(S_1^*) \geq R^*$.

Proof. The proof shows that the optimal revenue is a convex combination of $\alpha(S_1^*)$ and another term by using Equation (5) and multiplying/dividing the revenue associated with the second level by $\frac{U(S_2^*)+u_0}{U(S_2^*)+u_0}$. We have

$$\begin{aligned}
R^* =& \frac{\alpha(S_1^*)U(S_1^*)}{U(S^*)+u_0} + \frac{\alpha(S_2^*)U(S_2^*)}{U(S^*)+u_0} \cdot \left(1 - \frac{U(S_1^*)}{U(S^*)+u_0}\right) \\
=& \frac{\alpha(S_1^*)U(S_1^*)}{U(S^*)+u_0} + \frac{\alpha(S_2^*)U(S_2^*)}{U(S_2^*)+u_0} \cdot \underbrace{\frac{U(S_2^*)+u_0}{U(S^*)+u_0}}_{\left(1-\lambda(S_1^*,S^*)\right) \in (0,1)} \cdot \left(1 - \frac{U(S_1^*)}{U(S^*)+u_0}\right) \\
=& \alpha(S_1^*)\lambda(S_1^*, S^*) + R(S_2^*)\left(1 - \lambda(S_1^*, S^*)\right)^2.
\end{aligned}$$

R^* is a convex combination of $\alpha(S_1^*)$ and $R(S_2^*)(1 - \lambda(S_1^*, S^*))$. By optimality of R^*, $R(S_2^*) \leq R^*$ and hence $\alpha(S_1^*) \geq R^*$. □

We now prove a stronger lower bound for the value $\alpha(S_2^*)$ of the second level.

Proposition 4. *(Bounding Level 2) $\alpha(S_2^*) \geq \frac{R^*}{1-\lambda(S_1^*,S^*)}$.*

Proof. The proof is similar to the one in Proposition 3.

$$\begin{aligned}
R^* =& \frac{\alpha(S_1^*)U(S_1^*)}{U(S^*)+u_0} + \frac{\alpha(S_2^*)U(S_2^*)}{U(S^*)+u_0} \cdot \left(1 - \frac{U(S_1^*)}{U(S^*)+u_0}\right) \\
=& \frac{\alpha(S_1^*)U(S_1^*)}{U(S_1^*)+u_0} \cdot \underbrace{\frac{U(S_1^*)+u_0}{U(S^*)+u_0}}_{1-\lambda(S_2^*,S^*)} + \alpha(S_2^*) \cdot \underbrace{\frac{U(S_2^*)}{U(S^*)+u_0}}_{\lambda(S_2^*,S^*)} \cdot \underbrace{\left(1 - \frac{U(S_1^*)}{U(S^*)+u_0}\right)}_{1-\lambda(S_1^*,S^*)} \\
=& R(S_1^*) \cdot (1 - \lambda(S_2^*, S^*)) + (\alpha(S_2^*)(1 - \lambda(S_1^*, S^*))) \cdot \lambda(S_2^*, S^*).
\end{aligned}$$

R^* is a convex combination of and $R(S_1^*)$ and $\alpha(S_2^*)(1-\lambda(S_1^*, S^*))$. By optimality of R^*, $R(S_1^*) \leq R^*$ and $\alpha(S_2^*) \geq \frac{R^*}{(1-\lambda(S_1^*,S^*))}$. □

Note that it is not the case that $r(x) \geq \frac{R^*}{1-\lambda(S_1^*,S^*)}$ for all $x \in S_2^*$. See Example 3 in Appendix A. However, the weaker bound holds for every product. The proof relies on the following technical lemma whose proof is straightforward but long and given in Appendix B.

Lemma 1. *Consider an assortment $S = S_1 \uplus S_2$ and $Z \subseteq S_i$ for some $i = 1, 2$. $R(S)$ can be expressed in terms of the following convex combinations:*

- *If $Z \subseteq S_1$,*

$$R(S) = R(S \setminus Z) \cdot (1 - \lambda(Z, S)) \\ + \left[\alpha(Z) - \frac{\alpha(S_2)U(S_2)(U(S_2) + u_0)(1 - \lambda(Z, S)}{(U(S) - U(Z) + u_0)^2}\right] \cdot \lambda(Z, S). \tag{7}$$

- *if $Z \subseteq S_2$,*

$$R(S) = R(S \setminus Z) \cdot (1 - \lambda(Z, S)) \\ + \left[\frac{\alpha(Z)(U(S_2) + u_0)}{U(S) + u_0} + \frac{\alpha(S_2 \setminus Z)(U(S_2) - U(Z))}{U(S) - U(Z) + u_0} \cdot \frac{U(S_1)}{U(S) + u_0}\right] \cdot \lambda(Z, S). \tag{8}$$

Proposition 5. *In every optimal assortment S^*, if $Z \subseteq S_i^*$ ($i = 1, 2$), then $\alpha(Z) \geq R^*$.*

Proof. Let $Z \subseteq S_i^*$ for some $i = 1, 2$. Consider first the case in which the optimal solution S^* contains only products from level i ($i \in \{1, 2\}$). Then,

$$\begin{aligned} R^* &= \frac{\sum_{y \in S^*} r(y)u(y)}{\sum_{y \in S^*} u(y) + u_0} \\ &= \frac{\sum_{y \in S^* \setminus Z} r(y)u(y)}{\sum_{y \in S^* \setminus Z} u(y) + u_0} \cdot \frac{\sum_{y \in S^*} u(y) - U(Z) + u_0}{\sum_{y \in S^*} u(y) + u_0} + \frac{\alpha(Z)U(Z)}{\sum_{y \in S^*} u(y) + u_0} \\ &= \underbrace{\frac{\sum_{y \in S^* \setminus Z} r(y)u(y)}{\sum_{y \in S^* \setminus Z} u(y) + u_0}}_{R(S^* \setminus Z)} \cdot (1 - \lambda(Z, S^*)) + \alpha(Z)\lambda(Z, S^*) \\ &= R(S^* \setminus Z) \cdot (1 - \lambda(Z, S^*)) + \alpha(Z)\lambda(Z, S^*). \end{aligned}$$

The optimal solution is a convex combination of $R(S^* \setminus Z)$ and $\alpha(Z)$. By optimality of R^*, $R(S^* \setminus Z) \leq R^*$ and hence $\alpha(Z) \geq R^*$.

Consider the case in which the solution is non-empty in both levels, and suppose that $\alpha(Z) < R^*$. We now show that this is not possible. The proof considers two independent cases, depending on the level that contains Z.

If $Z \subseteq S_1^*$, by Lemma 1, the revenue of S^* can be expressed as

$$R(S^*) = R(S^* \setminus Z) \cdot (1 - \lambda(Z, S^*)) + \underbrace{\left[\alpha(Z) - \frac{\alpha(S_2^*)U(S_2)(U(S_2^*) + u_0)(1 - \lambda(Z, S^*)}{(U(S^*) - U(Z) + u_0)^2}\right]}_{\Gamma_Z} \cdot \lambda(Z, S^*). \tag{9}$$

R^* is a convex combination of $R(S^* \setminus Z)$ and Γ_Z. We show that $\Gamma_Z < R^*$.

$$
\begin{aligned}
\Gamma_Z &= \alpha(Z) - \frac{\alpha(S_2^*)U(S_2^*)(U(S_2^*)+u_0)\,(1-\lambda(Z,S^*))}{(U(S^*)-U(Z)+u_0)^2} \\
&= \alpha(Z) - \frac{\alpha(S_2^*)U(S_2^*)(U(S_2^*)+u_0)}{(U(S^*)-U(Z)+u_0)(U(S^*)+u_0)} && \text{/using definition of } \lambda(Z,S^*) \\
&= \alpha(Z) - \frac{\alpha(S_2^*)U(S_2^*)(1-\lambda(S_1^*,S^*))}{(U(S^*)-U(Z)+u_0)} && \text{/by definition of } \lambda(S_1^*,S^*) \\
&\leq \alpha(Z) - \frac{R^*U(S_2^*)}{U(S^*)-U(Z)+u_0} && \text{/Using proposition 4} \\
&< R^*\left(1-\frac{U(S_2^*)}{U(S^*)-U(Z)+u_0}\right) && \text{/using the assumption } \alpha(Z)<R^* \\
&< R^*.
\end{aligned}
$$

Since $R(S^*/Z) \leq R^*$, we have that $R^* < R^*$ and hence it must be the case that $\alpha(Z) \geq R^*$. Now, if $Z \subseteq S_2^*$, by Lemma 1, the revenue of S^* can be expressed as

$$
\begin{aligned}
R(S^*) = {} & R(S^* \setminus Z)\,(1-\lambda(Z,S^*)) \\
& + \underbrace{\left[\frac{\alpha(Z)(U(S_2^*)+u_0)}{U(S^*)+u_0} + \frac{\alpha(S_2^*\setminus Z)(U(S_2^*)-U(Z))}{U(S^*)-U(Z)+u_0}\cdot\frac{U(S_1^*)}{U(S^*)+u_0}\right]}_{\Gamma_Z}\cdot\lambda(Z,S^*).
\end{aligned} \tag{10}
$$

R^* is thus a convex combination of $R(S^* \setminus Z)$ and Γ_Z. Again, we show that $\Gamma_Z < R^*$:

$$
\begin{aligned}
\Gamma_Z &= \frac{\alpha(Z)(U(S_2^*)+u_0)}{U(S^*)+u_0} + \frac{\alpha(S_2^*\setminus Z)(U(S_2^*)-U(Z))}{U(S^*)-U(Z)+u_0}\cdot\frac{U(S_1^*)}{U(S^*)+u_0} \\
&= \alpha(Z)(1-\lambda(S_1^*,S^*)) + \frac{\alpha(S_2^*\setminus Z)(U(S_2^*)-U(Z))}{U(S^*)-U(Z)+u_0}\cdot\lambda(S_1^*,S^*) && \text{/by definition of } \lambda(S_1^*,S^*) \\
&< \alpha(Z)(1-\lambda(S_1^*,S^*)) + \underbrace{\frac{\alpha(S_2^*\setminus Z)(U(S_2^*)-U(Z))}{U(S_2^*)-U(Z)+u_0}}_{R(S_2^*\setminus Z)}\cdot\lambda(S_1^*,S^*) && \text{/replacing } U(S^*) \text{ by } U(S_2^*) \\
&< R^*(1-\lambda(S_1^*,S^*)) + R(S_2^*\setminus Z)\cdot\lambda(S_1^*,S^*) && \text{/using that } \alpha(Z)<R^* \\
&< R^*(1-\lambda(S_1^*,S^*)) + R(S_2^*\setminus Z)\lambda(S_1^*,S^*) && \text{/Using the optimality of } R^* \\
&< R^*.
\end{aligned}
$$

Hence, it must be the case that $\alpha(Z) \geq R^*$, completing the proof. □

The converse of Proposition 5 does not hold: Example 4 in Appendix A presents an instance where the optimal solution does not contain all the products with a revenue higher than R^*. The following corollary, whose proof is in Appendix B, is a direct consequence of Proposition 5.

Corollary 1. *For any non-empty subset $S_0 \subseteq S^*$, where S^* is an optimal solution, we have $\alpha(S_0) \geq R^*$.*

The corollary above implies that $\alpha(\{x\}) = r(x) \geq R^*$ for all $x \in S^*$. Thus, every product in an optimal assortment has a revenue greater than or equal to R^*.

4 Optimality of Revenue-Ordered Assortments by level

This section proves that optimal assortments under the SML are revenue-ordered by level, generalizing the traditional results for the MNL (Talluri and Van Ryzin, 2004). As a corollary, the optimal assortment problem under the SML is polynomial-time solvable.

Definition 1 (Revenue-Ordered Assortment by Level)**.** Denote by N_{ij} the set of all products in level i with a revenue of at least r_{ij} ($1 \leq j \leq m_i$) and fix $N_{i0} = \emptyset$ by convention. A revenue-ordered assortment by level is a set $S = N_{1j_1} \uplus N_{2j_2} \subseteq X$ for some $0 \leq j_1 \leq m_1$ and $0 \leq j_2 \leq m_2$. We use $\mathcal{A}$ to denote the set of revenue-ordered assortments by level.

When an assortment $S = S_1 \uplus S_2$ is not revenue-ordered by level, it follows that

$$\exists k \in \{1, 2\}, z \in X_k \setminus S_k, y \in S_k : \quad r(z) \geq r(y).$$

We say that S has a gap, the gap is at level k, and z belongs to the gap. We now define the concept of *first gap*, which is heavily used in the proof.

Definition 2 (First Gap of an Assortment)**.** Let $S = S_1 \uplus S_2$ be an assortment with a gap and let k be the smallest level with a gap. Let $\hat{r} = \max_{y \in X_k \setminus S_k} r(y)$ be the maximum revenue of a product in level k not contained in S_k. The *first gap* of S is a set of products $G \subseteq X_k \setminus S$ defined as follows:

- If $\max_{x \in S_k} r(x) < \hat{r}$, then the gap G consists of all products with higher revenues than the products in assortment S, i.e.,

$$G = \{y \in X_k \setminus S_k \mid r(y) \geq \max_{x \in S_k} r(x)\}.$$

- Otherwise, when $\max_{x \in S_k} r(x) \geq \hat{r}$, define the following quantities:

$$r_M = \min_{\substack{x \in S_k \\ r(x) \geq \hat{r}}} r(x) \quad \text{and} \quad r_m = \max_{\substack{x \in S_k \\ r(x) \leq \hat{r}}} r(x). \tag{11}$$

  The set G contains products with revenues in $[r_m, r_M]$, i.e.,

$$G = \{y \in X_k \setminus S_k \mid r_m \leq r(y) \leq r_M\}.$$

We are now in a position to prove the main theorem of this paper.

Theorem 1. *Under the SML, any optimal assortment is revenue-ordered by level.*

Proof. Assume that S is an optimal solution with at least one gap, G is the first gap of S, and G occurs at level k. Define $S_k = H \cup T$ with $H, T \subseteq X_k$ and

$$H = \{x \in S_k \mid r(x) \geq \max_{g \in G} r(g)\}$$

and

$$T = \{x \in S_k \mid r(x) \leq \min_{g \in G} r(g)\}.$$

In the following, the set H is called the *head* and the set T is called the *tail*. We prove that is always possible to select an assortment that is revenue-ordered by level and has revenue greater

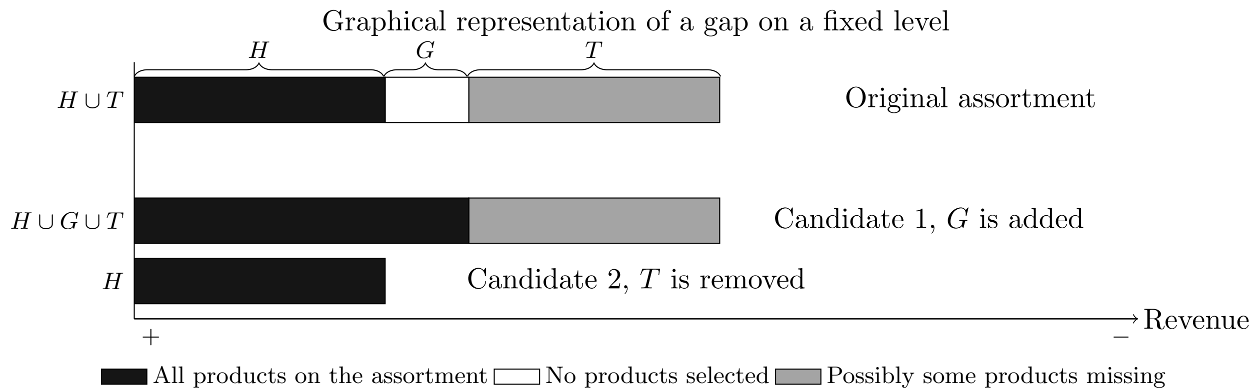

Figure 1: Representation of a level containing a gap G at the top, and the two proposed candidates fixing the gap by either adding G, or removing T.

than $R(S)$. The proof shows that such an assortment can be obtained either by including the gap G in S or by eliminating T from S. Figure 1 illustrates these concepts visually. The proof is by case analysis on the level of G.

Consider first the case where G is in the first level. We can define $S = S_1 \uplus S_2$, with $S_1 = H \cup T$ as defined above and $S_2 \subseteq X_2$. The revenue for S is

$$\begin{aligned} R(S_1 \cup S_2) &= \frac{\alpha(S_1)U(S_1)}{U(S)+u_0} + \left(1 - \frac{U(S_1)}{(U(S)+u_0)}\right) \cdot \frac{\alpha(S_2)U(S_2)}{U(S)+u_0} \\ &= \frac{\alpha(H)U(H)}{U(S)+u_0} + \frac{\alpha(T)U(T)}{U(S)+u_0} + \frac{U(S_2)+u_0}{(U(S)+u_0)^2} \cdot \alpha(S_2)U(S_2) \end{aligned}$$

where we used Proposition 1 on S_1 for deriving the second equality. We show that assortment $H \cup S_2$ or assortment $H \cup G \cup T \cup S_2$ provides a revenue greater than $R(S = H \cup T \cup S_2)$, contradicting our optimality assumption for S. The proof characterizes the differences between the revenues of S and the two considered assortments, adds those two differences, and shows that this value is strictly less than zero, implying that at least one of the differences is strictly negative and hence that one of these assortments has a revenue larger than $R(S)$. $R(H \cup S_2)$ can expressed as

$$\frac{\alpha(H)U(H)}{U(H)+U(S_2)+u_0} + \frac{U(S_2)+u_0}{(U(H)+U(S_2)+u_0)^2} \cdot \alpha(S_2)U(S_2). \tag{12}$$

Let $\theta = U(H) + U(T) + U(S_2) + u_0$ (or, equivalently, $\theta = U(S) + u_0$). The difference $R(H \cup T \cup S_2) - R(H \cup S_2)$ is

$$\frac{U(T)}{\theta(\theta - U(T))}\left[-\alpha(H)U(H) + \alpha(T)(\theta - U(T)) - \frac{\alpha(S_2)U(S_2)(U(S_2)+u_0)(2(\theta - U(T)) + U(T))}{\theta(\theta - U(T))}\right]. \tag{13}$$

$R(H \cup G \cup T \cup S_2)$ can be expressed as

$$\frac{1}{U(S)+U(G)+u_0} \cdot [\alpha(H)U(H) + \alpha(G)U(G) + \alpha(T)U(T)] + \frac{U(S_2)+u_0}{(U(S)+U(G)+u_0)^2} \cdot \alpha(S_2)U(S_2).$$

The difference $R(H \cup T \cup S_2) - R(H \cup G \cup T \cup S_2)$ is given by

$$\frac{U(G)}{\theta(\theta + U(G))} \cdot \left[\alpha(H)U(H) + \alpha(T)U(T) - \alpha(G)\theta + \frac{\alpha(S_2)U(S_2)(U(S_2) + u_0)(2\theta + U(G))}{\theta(\theta + U(G))}\right]. \tag{14}$$

By optimality of S, these two differences must be positive. However, their sum, dropping the positive multiplying term on each difference, which must also be positive, is given by

$$\begin{aligned}
(13) + (14) &= \alpha(T)\theta - \alpha(G)\theta + \frac{\alpha(S_2)U(S_2)(U(S_2) + u_0)}{\theta} \cdot \left[\frac{2\theta + U(G)}{\theta + U(G)} - \frac{2(\theta - U(T)) + U(T)}{(\theta - U(T))}\right] \\
&= (\alpha(T) - \alpha(G))\theta + \frac{\alpha(S_2)U(S_2)(U(S_2) + u_0)}{\theta} \cdot \left[1 + \frac{\theta}{\theta + U(G)} - 2 - \frac{U(T)}{(\theta - U(T))}\right] \\
&= \underbrace{(\alpha(T) - \alpha(G))\theta}_{\leq 0,\text{ by Proposition 2 and }\theta \geq 0} + \frac{\alpha(S_2)U(S_2)(U(S_2) + u_0)}{\theta} \cdot \left[\underbrace{\left(\frac{\theta}{\theta + U(G)} - 1\right)}_{<0} \underbrace{- \frac{U(T)}{(\theta - U(T))}}_{<0}\right] < 0
\end{aligned}$$

which contradicts the optimality of S.

Consider now the case where the gap is in the second level. Using the definition of the head and the tail discussed above, S can be written as $S = S_1 \uplus H \cup T$. The revenue $R(S)$ is given by

$$R(S_1 \cup H \cup T) = \frac{\alpha(S_1)U(S_1)}{\theta} + \frac{\alpha(H)U(H)}{\theta} + \frac{\alpha(T)U(T)}{\theta} - \frac{U(S_1)\alpha(H)U(H)}{\theta^2} - \frac{U(S_1)\alpha(T)U(T)}{\theta^2} \tag{15}$$

and the proof follows the same strategy as for the case of the first level. The revenue $R(S_1 \cup H)$ is given by

$$R(S_1 \cup H) = \frac{\alpha(S_1)U(S_1)}{\theta - U(T)} + \frac{\alpha(H)U(H)}{\theta - U(T)} - \frac{U(S_1)\alpha(H)U(H)}{(\theta - U(T))^2} \tag{16}$$

and the difference $R(S_1 \cup H \cup T) - R(S_1 \cup H)$ by

$$\begin{aligned}
&\frac{U(T)}{\theta(\theta - U(T))} \cdot \Bigg[-\alpha(S_1)U(S_1) - \alpha(H)U(H) + \alpha(T)(\theta - U(T)) \\
&+ \frac{\alpha(H)U(H)U(S_1)(2\theta - U(T))}{\theta(\theta - U(T))} - \frac{U(S_1)\alpha(T)(\theta - U(T))}{\theta}\Bigg]
\end{aligned} \tag{17}$$

The revenue $R(S_1 \cup H \cup G \cup T)$ is given by

$$\frac{\alpha(S_1)U(S_1)}{\theta + U(G)} + \frac{\alpha(H)U(H)}{\theta + U(G)} + \frac{\alpha(G)U(G)}{\theta + U(G)} + \frac{\alpha(T)U(T)}{\theta + U(G)} - \frac{U(S_1)}{(\theta + U(G))^2} \cdot [\alpha(H)U(H) + \alpha(G)U(G) + \alpha(T)U(T)] \tag{18}$$

and the difference $R(S_1 \cup H \cup T) - R(S_1 \cup H \cup G \cup T)$ by

$$\begin{aligned}
&\frac{U(G)}{\theta(\theta + U(G))} \cdot \Bigg[\alpha(S_1)U(S_1) + \alpha(H)U(H) - \alpha(G)\theta + \alpha(T)U(T) \\
&- \frac{\alpha(H)U(H)U(S_1)(2\theta + U(G))}{\theta(\theta + U(G))} - \frac{\alpha(T)U(T)U(S_1)(2\theta + U(G))}{\theta(\theta + U(G))} + \frac{U(S_1)\alpha(G)\theta}{\theta + U(G)}\Bigg]
\end{aligned} \tag{19}$$

Adding (17) and (19) and dropping the positive multiplying terms on each difference gives

$$
\begin{aligned}
&\theta\left(\alpha(T)-\alpha(G)\right)+U(S_1)\left(\alpha(G)-\alpha(T)\right)+U(S_1)\left[\frac{\alpha(T)U(T)}{\theta}-\frac{\alpha(G)U(G)}{\theta+U(G)}\right]\\
&+\frac{U(S_1)}{\theta}\left[\alpha(H)U(H)\left(1+\frac{\theta}{\theta-U(T)}\right)-\alpha(H)U(H)\left(1+\frac{\theta}{\theta+U(G)}\right)-\alpha(T)U(T)\left(1+\frac{\theta}{\theta+U(G)}\right)\right]\\
&=\left(\theta-U(S_1)\right)\left(\alpha(T)-\alpha(G)\right)+\frac{U(S_1)\alpha(H)U(H)}{\theta-U(T)}-\frac{U(S_1)}{\theta+U(G)}\cdot\left[\alpha(H)U(H)+\alpha(G)U(G)+\alpha(T)U(T)\right]\\
&=\underbrace{\left(\theta-U(S_1)\right)\left(\alpha(T)-\alpha(G)\right)}_{\leq 0,\text{ by Proposition 2 and }\theta\geq U(S_1)}+\underbrace{\frac{U(S_1)\alpha(H)U(H)(U(G)+U(T))}{(\theta-U(T))(\theta+U(G))}-\frac{U(S_1)}{\theta+U(G)}\cdot\left[\alpha(G)U(G)+\alpha(T)U(T)\right]}_{\Gamma}
\end{aligned}
\tag{20}
$$

Γ cannot be greater or equal than zero, since otherwise

$$
\begin{aligned}
&\frac{U(S_1)\alpha(H)U(H)(U(G)+U(T))}{(\theta-U(T))(\theta+U(G))}-\frac{U(S_1)}{\theta+U(G)}\cdot\left[\alpha(G)U(G)+\alpha(T)U(T)\right]\geq 0\\
&\frac{U(S_1)}{(\theta+U(G))}\cdot\left[\frac{\alpha(H)U(H)(U(G)+U(T))}{(\theta-U(T))}-\left(\alpha(G)U(G)+\alpha(T)U(T)\right)\right]\geq 0.
\end{aligned}
\tag{21}
$$

The factor on the left is always positive, so Inequality (21) implies that the term between brackets is greater than zero. We now show that this contradicts the optimality of S. We do this by manipulating Inequality (21) and showing that, if this inequality holds, then $R(H) > R(S)$.

$$
\begin{aligned}
&\frac{\alpha(H)U(H)(U(G)+U(T))}{(\theta-U(T))}-\left(\alpha(G)U(G)+\alpha(T)U(T)\right)\geq 0\\
&\frac{\alpha(H)U(H)}{(\theta-U(T))}\geq\frac{\alpha(G)U(G)+\alpha(T)U(T)}{(U(G)+U(T))}\\
&\frac{\alpha(H)U(H)}{(U(S_1)+U(H)+u_0)}\geq\frac{\alpha(G)U(G)+\alpha(T)U(T)}{(U(G)+U(T))}\\
&\underbrace{\frac{\alpha(H)U(H)}{(U(H)+u_0)}}_{R(H)}\cdot\left[1-\frac{U(S_1)}{U(S_1)+U(H)+u_0}\right]\geq\frac{\alpha(G)U(G)+\alpha(T)U(T)}{(U(G)+U(T))}\\
&R(H)\geq\underbrace{R(H)\cdot\frac{U(S_1)}{U(S_1)+U(H)+u_0}}_{>0}+\frac{\alpha(G)U(G)+\alpha(T)U(T)}{(U(G)+U(T))}>R(S)\cdot\frac{U(G)+U(T)}{U(G)+U(T)}>R(S).
\end{aligned}
\tag{22}
$$

Inequality (22) follows from Proposition 5 applied to $T \subset S_2$, which implies $\alpha(T) \geq R(S)$, and from Proposition 2, which implies $\alpha(G) \geq \alpha(T)$ and hence $\alpha(G) \geq R(S)$. $\square$

The following corollary follows directly from the fact that there are at most $\mathcal{O}(|X|^2)$ revenue-ordered assortments by level and the fact that the revenue obtained from a given assortment can be computed in polynomial time.

Corollary 2. *The assortment problem under the sequential multinomial logit is polynomial-time solvable.*

5 Conclusion and Future Work

This paper studied the assortment optimization problem under the *Sequential Multinomial Logit* (SML), a discrete choice model that generalizes the multinomial logit (MNL). Under the SML model, products are partitioned into two levels. When a consumer is presented with such an assortment, she first considers products in the first level and, if none of them is appropriate, products in the second level. The SML is a special case of the Perception Adjusted Luce Model (PALM) recently proposed by Echenique, Saito, and Tserenjigmid (2013). It can explain many behavioral phenomena such as the attraction, compromise, and similarity effects which cannot be explained by the MNL model or any discrete choice model based on random utility.

The paper showed that the seminal concept of revenue-ordered assortments can be generalized to the SML. In particular, the paper proved that all optimal assortments under the SML are revenue-ordered by level, a natural generalization of revenue-ordered assortments. As a corollary, assortment optimization under the SML is polynomial-time solvable. This result is particularly interesting given that the assortment optimization problem under the SML does not satisfy the regularity condition.

The main open issue regarding this research is to generalize the results to the perception-adjusted Luce model, which has an arbitrary number of levels. In that model, the revenue-ordered by level algorithm would take $(O)(|X|^k)$ time where k is the number of levels. Based on preliminary computational experiments, we conjecture that our optimality result of revenue ordered assortments by level would still hold. A second interesting research avenue is to consider a new discrete choice models that allows decision makers to change the order in which the levels are presented to consumers. In the SML, the level ordering level is intrinsic to the products, but one may consider settings in which decision makers can choose, not only what to show, but also the priority associated with each of the displayed products. Finally, it is important to develop efficient procedures to estimate the parameters of the SML model based on historical data (e.g., van Ryzin and Vulcano (2017)).

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A Appendix: Examples

This section provides the examples not included in the main text.

Example 3. This example shows that the lower bound from Proposition 4 does not necessarily hold for each individual product in the second level. Let $X_1 = \{x_{11}\}$, $X_2 = \{x_{21}, x_{22}\}$, and $X = X_1 \uplus X_2$. Let the revenues be $r(x_{11}) = 10, r(x_{21}) = 9$, and $r(x_{22}) = 6$ and the utilities be $u(x_{11}) = u(x_{21}) = 1, u(x_{22}) = 3$, and $u_0 = 1$. The expected revenue for all possible subsets are given by

S	$R(S)$
$\{x_{11}\}$	5
$\{x_{21}\}$	4.5
$\{x_{22}\}$	4.5
$\{x_{11}, x_{21}\}$	$5.\overline{3}$
$\{x_{11}, x_{22}\}$	4.88
$\{x_{21}, x_{22}\}$	5.4
$\{x_{11}, x_{21}, x_{22}\}$	$5.41\overline{6}$

The optimal assortment is $S^* = \{x_{11}, x_{21}, x_{22}\}$ with an expected revenue of $R^* = 5.41\overline{6}$. By definition of $\lambda(\cdot)$, we have

$$\lambda(S_1^*, S^*) = \frac{U(S_1^*)}{U(S^*) + u_0} = \frac{1}{6} = 0.1\overline{6}.$$

It follows that $r(x_{22}) = 6 < \frac{R^*}{1-\lambda(S_1^*, S^*)} = \frac{5.41\overline{6}}{1-0.1\overline{6}} = 6.488$.

Example 4. We show that some products with revenue greater or equal than R^* may not be included in an optimal assortment. Let $X_1 = \{x_{11}\}$, $X_2 = \{x_{21}\}$, and $X = X_1 \uplus X_2$. Let the revenues be $r(x_{11}) = r(x_{21}) = 1$ and the utilities be $u(x_{11}) = 10, u(x_{21}) = 1$, and $u_0 = 1$. Consider the possible assortments and their expected revenues:

$$\begin{aligned}
R(\{x_{11}\}) &= \tfrac{u(x_{11})r(x_{11})}{u(x_{11})+u_0} = \tfrac{10\cdot 1}{10+1} = 0.9\overline{09} \\
R(\{x_{21}\}) &= \tfrac{u(x_{21})r(x_{21})}{u(x_{21})+u_0} = \tfrac{1\cdot 1}{1+1} = 0.5 \\
R(\{x_{11}, x_{21}\}) &= \tfrac{u(x_{11})r(x_{11})}{u(x_{11})+u(x_{21})+u_0} + \left(1 - \tfrac{u(x_{11})}{u(x_{11})+u(x_{21})+u_0}\right) \cdot \tfrac{u(x_{21})r(x_{21})}{u(x_{11})+u(x_{21})+u_0} \\
&= \tfrac{10\cdot 1}{10+1+1} + \left(1 - \tfrac{10}{10+1+1}\right) \cdot \tfrac{1\cdot 1}{10+1+1} \\
&= \tfrac{10}{12} + \left(1 - \tfrac{10}{12}\right) \cdot \tfrac{1}{10+1} \\
&= 0.847\overline{2}
\end{aligned}$$

The optimal assortment is $S^* = \{x_{11}\}$. However, we have that $r(x_{21}) = 1 > R^*$ but x_{21} is not part of the optimal assortment.

B Appendix: Proofs

In this section we provide the proofs missing from the main text.

Proof of Lemma 1. For $Z \subseteq X$ and $Z_0 \subseteq Z$, we have:

$$
\begin{aligned}
\alpha(Z \setminus Z_0) &= \frac{\sum_{x \in Z \setminus Z_0} r(x)u(x)}{U(Z \setminus Z_0)} \\
&= \frac{\sum_{x \in Z} r(x)u(x)}{U(Z \setminus Z_0)} - \frac{\alpha(Z_0)U(Z_0)}{U(Z \setminus Z_0)} \\
&= \frac{\sum_{x \in Z} r(x)u(x)}{U(Z \setminus Z_0)} \cdot \frac{U(Z)}{U(Z)} - \frac{\alpha(Z_0)U(Z_0)}{U(Z \setminus Z_0)} \\
&= \underbrace{\frac{\sum_{x \in Z} r(x)u(x)}{U(Z)}}_{\alpha(Z)} \cdot \frac{U(Z)}{U(Z) - U(Z_0)} - \frac{\alpha(Z_0)U(Z_0)}{U(Z) - U(Z_0)} \\
&= \frac{\alpha(Z)U(Z) - \alpha(Z_0)U(Z_0)}{U(Z) - U(Z_0)} \\
&= \frac{\alpha(Z)U(Z) - \alpha(Z_0)U(Z_0)}{U(Z) - U(Z_0)},
\end{aligned} \tag{23}
$$

which can be rewritten as

$$
\alpha(Z \setminus Z_0)(U(Z) - U(Z_0)) = \alpha(Z)U(Z) - \alpha(Z_0)U(Z_0). \tag{24}
$$

Note also that, when $Z_0 = Z$, $\alpha(Z \setminus Z_0) = \alpha(\emptyset) = 0$.

The rest of the proof is by case analysis on the level. If $Z \subseteq S_1$, $\lambda(Z, S) = \frac{U(Z)}{U(S)+u_0}$. We have:

$$
\begin{aligned}
R(S) =& \frac{\alpha(S_1)U(S_1)}{U(S) + u_0} + \frac{\alpha(S_2)U(S_2)}{U(S) + u_0} \cdot \left(1 - \frac{U(S_1)}{U(S) + u_0}\right) \\
=& \frac{\alpha(S_1)U(S_1) - \alpha(Z)U(Z)}{U(S) + u_0} + \frac{\alpha(Z)U(Z)}{U(S) + u_0} + \frac{\alpha(S_2)U(S_2)}{U(S) + u_0} \cdot \left(1 - \frac{U(S_1)}{U(S) + u_0}\right) \\
=& \frac{\alpha(S_1)U(S_1) - \alpha(Z)U(Z)}{U(S) + u_0} \cdot \frac{U(S) - U(Z) + u_0}{U(S) - U(Z) + u_0} + \frac{\alpha(Z)U(Z)}{U(S) + u_0} + \frac{\alpha(S_2)U(S_2)}{U(S) + u_0} \cdot \left(1 - \frac{U(S_1)}{U(S) + u_0}\right) \\
=& \frac{\alpha(S_1)U(S_1) - \alpha(Z)U(Z)}{U(S) - U(Z) + u_0} \cdot (1 - \lambda(Z, S)) + \alpha(Z)\lambda(Z, S) \\
&+ \frac{\alpha(S_2)U(S_2)(U(S_2) + u_0)}{(U(S) - U(Z) + u_0)^2} \cdot \left(\frac{U(S) - U(Z) + u_0}{U(S) + u_0}\right)^2,
\end{aligned}
$$

where we first add and subtract $\frac{\alpha(Z)U(Z)}{U(S)+u_0}$, and multiply and divide the first term by $(U(S) - U(Z) + u_0)$. The last step uses the definition of $\lambda(Z, S)$ and multiplies and divides the last term by $(U(S) - U(Z) + u_0)^2$. Now applying Equation (24) to S_1 and Z in the last equation, we obtain

$$
\begin{aligned}
R(S) =& \frac{\alpha(S_1 \setminus Z)(U(S_1) - U(Z))}{U(S) - U(Z) + u_0} \cdot (1 - \lambda(Z,S)) + \alpha(Z)\lambda(Z,S) + \frac{\alpha(S_2)U(S_2)(U(S_2) + u_0)}{(U(S) - U(Z) + u_0)^2} \cdot (1 - \lambda(Z,S))^2 \\
=& \underbrace{\left[\frac{\alpha(S_1 \setminus Z)(U(S_1) - U(Z))}{U(S) - U(Z) + u_0} + \frac{\alpha(S_2)U(S_2)(U(S_2) + u_0)}{(U(S) - U(Z) + u_0)^2}\right]}_{R(S_1 \setminus Z \cup S_2)} \cdot (1 - \lambda(Z,S)) \\
&+ \left[\alpha(Z) - \frac{\alpha(S_2)U(S_2)(U(S_2) + u_0)\,(1 - \lambda(Z,S))}{(U(S) - U(Z) + u_0)^2}\right] \cdot \lambda(Z,S) \\
=& R(S_1 \setminus Z \cup S_2)\,(1 - \lambda(Z,S)) + \left[\alpha(Z) - \frac{\alpha(S_2)U(S_2)(U(S_2) + u_0)\,(1 - \lambda(Z,S))}{(U(S) - U(Z) + u_0)^2}\right] \cdot \lambda(Z,S) \\
=& R(S \setminus Z)\,(1 - \lambda(Z,S)) + \left[\alpha(Z) - \frac{\alpha(S_2)U(S_2)(U(S_2) + u_0)\,(1 - \lambda(Z,S))}{(U(S) - U(Z) + u_0)^2}\right] \cdot \lambda(Z,S).
\end{aligned}
$$

If $Z \subseteq S_2$, the proof is essentially similar. It also uses $\lambda(Z,S) = \frac{U(Z)}{U(S)+u_0}$ and apply Equation (24) to S_2 and Z to obtain

$$
\begin{aligned}
R(S) =& \frac{\alpha(S_1)U(S_1)}{U(S) + u_0} + \frac{\alpha(S_2)U(S_2)}{U(S) + u_0} \cdot \left(1 - \frac{U(S_1)}{U(S) + u_0}\right) \\
=& \frac{\alpha(S_1)U(S_1)}{U(S) - U(Z) + u_0} \cdot (1 - \lambda(Z,S)) + \frac{\alpha(Z)U(Z)(U(S_2) + u_0)}{(U(S) + u_0)^2} \\
&+ \frac{(\alpha(S_2)U(S_2) - \alpha(Z)U(Z))(U(S_2) + u_0)}{(U(S) + u_0)^2} \\
=& \frac{\alpha(S_1)U(S_1)}{U(S) - U(Z) + u_0} \cdot (1 - \lambda(Z,S)) + \frac{\alpha(S_2 \setminus Z)(U(S_2) - U(Z))(U(S_2) - U(Z) + u_0)}{(U(S) + u_0)^2} \\
&+ \frac{\alpha(S_2 \setminus Z)(U(S_2) - U(Z))U(Z)}{(U(S) + u_0)^2} + \frac{\alpha(Z)U(Z)(U(S_2) + u_0)}{(U(S) + u_0)^2},
\end{aligned}
$$

where we multiply and divide the first term by $(U(S) - U(Z) + u_0)$ and use the definition of $\lambda(Z,S)$ and then add and subtract $\frac{\alpha(Z)U(Z)(U(S_2)+u_0)}{(U(S)+u_0)^2}$. The last step uses Equation (24) and adds and subtracts $\frac{\alpha(S_2 \setminus Z)(U(S_2)-U(Z))U(Z)}{(U(S)+u_0)^2}$. The goal of this manipulation is to form $R(S \setminus Z)\,(1 - \lambda(Z,S))$. We then obtain

$$
\begin{aligned}
=&\frac{\alpha(S_1)U(S_1)}{U(S)-U(Z)+u_0}\cdot(1-\lambda(Z,S))+\frac{\alpha(S_2\setminus Z)(U(S_2)-U(Z))(U(S_2)-U(Z)+u_0)}{(U(S)+u_0)^2}\\
&+\frac{\alpha(S_2\setminus Z)(U(S_2)-U(Z))U(Z)}{(U(S)+u_0)^2}+\frac{\alpha(Z)U(Z)(U(S_2)+u_0)}{(U(S)+u_0)^2}\\
=&\frac{\alpha(S_1)U(S_1)}{U(S)-U(Z)+u_0}\cdot(1-\lambda(Z,S))+\frac{\alpha(S_2\setminus Z)(U(S_2)-U(Z))(U(S_2)-U(Z)+u_0)}{(U(S)-U(Z)+u_0)^2}\left(1-\lambda(Z,S)\right)^2\\
&+\frac{\alpha(S_2\setminus Z)(U(S_2)-U(Z))U(Z)}{(U(S)+u_0)^2}+\frac{\alpha(Z)U(Z)(U(S_2)+u_0)}{(U(S)+u_0)^2}\\
=&\underbrace{\left[\frac{\alpha(S_1)U(S_1)}{U(S)-U(Z)+u_0}+\frac{\alpha(S_2\setminus Z)(U(S_2)-U(Z))(U(S_2)-U(Z)+u_0)}{(U(S)-U(Z)+u_0)^2}\right]}_{R(S_1\cup S_2\setminus Z)}\cdot(1-\lambda(Z,S))\\
&+\frac{\alpha(Z)U(Z)(U(S_2)+u_0)}{(U(S)+u_0)^2}+\frac{\alpha(S_2\setminus Z)(U(S_2)-U(Z))U(Z)}{(U(S)+u_0)^2}\\
&-\frac{\lambda(Z,S)\left(1-\lambda(Z,S)\right)\alpha(S_2\setminus Z)(U(S_2)-U(Z))(U(S_2)-U(Z)+u_0)}{(U(S)-U(Z)+u_0)^2},
\end{aligned}
$$

where the second step multiplies and divides the second term by $(U(S)-U(Z)+u_0)$ and uses the definition of $\lambda(Z,S)$. The third step splits the second term by expressing $(1-\lambda(Z,S))^2$ as $(1-\lambda(Z,S))-\lambda(Z,S)(1-\lambda(Z,S))$ in order to identify the term $R(S_1\cup S_2\setminus Z)$. Now, putting together the remaining terms, we obtain:

$$
\begin{aligned}
R(S)=&R(S_1\cup S_2\setminus Z)\left(1-\lambda(Z,S)\right)\\
&+\lambda(Z,S)\left[\frac{\alpha(Z)(U(S_2)+u_0)}{U(S)+u_0}+\frac{\alpha(S_2\setminus Z)(U(S_2)-U(Z))}{U(S)+u_0}\right.\\
&\quad\left.-\frac{\left(1-\lambda(Z,S)\right)\alpha(S_2\setminus Z)(U(S_2)-U(Z))(U(S_2)-U(Z)+u_0)}{(U(S)-U(Z)+u_0)^2}\right]\\
=&R(S_1\cup S_2\setminus Z)\left(1-\lambda(Z,S)\right)\\
&+\lambda(Z,S)\cdot\left[\frac{\alpha(Z)(U(S_2)+u_0)}{U(S)+u_0}+\frac{\alpha(S_2\setminus Z)(U(S_2)-U(Z))}{U(S)+u_0}\left[1-\left(1-\frac{U(S_1)}{U(S)-U(Z)+u_0}\right)\right]\right]\\
=&R(S\setminus Z)\left(1-\lambda(Z,S)\right)+\left[\frac{\alpha(Z)(U(S_2)+u_0)}{U(S)+u_0}+\frac{\alpha(S_2\setminus Z)(U(S_2)-U(Z))}{U(S)-U(Z)+u_0}\cdot\frac{U(S_1)}{U(S)+u_0}\right]\cdot\lambda(Z,S).
\end{aligned}
$$

where the second line uses the definition of $\lambda(Z,S)$ to factorize the expression and the last step just simplifies the resulting expressions. □

Proof of Corollary 1. By Proposition 5, we have $\alpha(\{x\})=r(x)\geq R^*$ for all $x\in S^*$. For each set $S_0\subseteq S^*$, we have:

$$
\begin{aligned}
\alpha(S_0)=&\frac{\sum_{x\in S_0}u(x)r(x)}{\sum_{x\in S_0}u(x)}\\
\geq&R^*\frac{\sum_{x\in S_0}u(x)}{\sum_{x\in S_0}u(x)}\quad\text{/ by Proposition 5}\\
=&R^*.
\end{aligned}
$$

□