WHY DO LEADING BRAND MANUFACTURERS SUPPLY PRIVATE LABELS?

J. Tomas Gomez-Arias, St. Mary's College of California, United States
Laurentino Bello-Acebron, University of A Coruña, Spain

ABSTRACT

Private labels are gaining increasing importance in many industries. If some years ago they seemed to be confined to consumer packaged goods (CPG) sold through some large retailers, nowadays they command large and growing market shares in such diverse industries as investment funds, fixed-income securities, software, electronics, contact lenses, wine, pharmaceuticals, books and others. While there are obvious benefits for retailers to embrace private labels, the standard explanations for manufacturers' involvement (idle capacity, buffer against follower brands, retailer's conditions) do not explain it completely.

We try to explain the phenomenon of leading brand manufacturers supplying private labels using a model of vertical differentiation. It shows that, depending on the quality positioning chosen by the retailer, both manufacturers find situations where they are better off by not supplying the store brand and allowing the other manufacturer to produce the private label, and situations where they prefer to produce the private label, against Dunne and Narasimhan's (1999) contention that the threat of entry by another manufacturer is a sufficient condition for a branded good manufacturer to supply private labels.

We use a model of vertical differentiation inspired by Moorthy (1988) that departs from the existing analytical literature on private labels in two main aspects. On the demand side, we use an explicit consumer utility function where the main determinant of choice is the relative price-quality ratio for each brand. Unlike other authors (Narasimhan and Wilcox 1998; Scott Morton and Zettelmeyer 2001), we do not require the national brands to be preferred to the private brand under equal prices, thus offering a more realistic depiction of a market where premium private labels abound and are often preferred to national brands. On the supply side, while other authors use a third party who is not a strategic player as the supplier of the private label (Narasimhan and Wilcox 1998; Raju, Sethuraman and Dhar 1995; Scott Morton and Zettelmeyer 2001), or assume that one of the manufacturers necessarily manufactures only the private label (Cotterill, Putsis and Dhar 2000), we require the private label to be manufactured by one of the national brand manufacturers behaving strategically. This is in line with our purpose to study the supply of private labels by national brand manufacturers, but it can also accommodate the manufacture by an independent third party or a specialist, since the manufacturers in our model can choose to produce only the store brand, and the decision to become a private label specialist is endogenous. In fact, one of the results of our model is that when a retailer chooses to introduce a private label at a quality level between that of the existing brands in the market, and chooses the low-quality manufacturer to make the store brand, the low-quality manufacturer drops its own brand and becomes a private label manufacturing specialist. Also, we consider only differences in quality (vertical differentiation), but we do not model horizontal differentiation. Since the retailer appears both as a distributor and as a competitor, vertical strategic interaction and horizontal strategic interaction effects result (Sudhir 2001).

We show that, once the retailer has decided to introduce the private label, and depending on the quality positioning chosen by the retailer, both manufacturers find situations where they are better off by not supplying the store brand and allowing the other manufacturer to produce the private label, but also situations where they prefer to produce the private label. As a result, our model contributes to explaining why private label supply is becoming so pervasive among all kinds of manufacturers. Also, we show that retailers will choose the high-quality manufacturer for its premium store brand, and the low-quality manufacturer otherwise, and this decision is not based on the set of skills possessed by each manufacturing company.

References available upon request