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Do private labels always benefit the supply chain?

Private label products, or store brands, can bolster a store's market share and positively impact retail sales. But what effect do private label products have on the supply chain? Is introducing a store brand always a good idea, or can it have detrimental effects as well? Marc Sachon and Víctor Martínez de Albéniz propose a model that can help retailers determine whether introducing a private label product is a wise idea.

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Years ago, private label products, or store brands, were viewed as being of lesser quality than manufacturer's brands. They were cheaper, yes, but consumers were often wary that cheap meant poorly made.

Not so today. Over the past 10 years, the image of private labels has been transformed, and many products, such as Tesco's Finest range, actually surpass leading brands in quality.

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But introducing a private label is not always a good idea for supply chain efficiency. In Private Label Introduction: Does It Benefit the Supply Chain?, IESE professors Marc Sachon and Víctor Martínez de Albéniz propose a model that can help retailers determine whether a private label will be in their supply chain's best interest.

First, what is a private label? Private label products are specific to a retail chain, and the retailer retains its exclusive rights. Manufacturing takes place either by the retail chain or by a third-party manufacturer specializing in private labels or producing both private labels and manufacturer brands.

In today's challenging economic climate, discount retailers are among the few retailers to see consistent bottom-line performance and even growth, and many stores have opted to expand their private label selection. Indeed, private labels pose a true challenge to manufacturer brands.

Retailers secure many benefits from introducing private label products. Such products fill market niches, increase shopper loyalty and have a low cost structure. Most of all, private labels allow retail chains to increase their leverage against manufacturer brands, thereby reducing the effects of double marginalization. Double marginalization is when the manufacturer and the retailer both capture a profit margin independently, without coordination, resulting in suboptimal performance of the supply chain as a whole.

But is this true? Does introducing a private label always improve supply chain efficiency?

Not so, suggests new research. Existing literature has examined private labels? effect on retailers and manufacturers separately, without analyzing the effect of private labels on supply chain efficiency. This new model analyzes the competitive dynamics between one retailer and several manufacturers, when one of the manufacturer brands is replaced by a private label.

The model involves product demand as a function of its price, other products? price gap and equilibrium prices. The authors create a basic model with one retailer, two products and linear demand functions.

An applicable scenario is as follows: When a retailer sells two manufacturer products in one category, it must decide whether to replace one of them with a private label. This new product can be produced by brand manufacturers, private label manufacturers or vertically integrated retailers. The manufacturer product and private label product are similar in quality, which makes customer behavior a key factor in the analysis of competitive dynamics.

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The model incorporates demand as a standard price-dependent function.

The model yields three conclusions. First, a channel's pricing dynamics are changed by introducing a private label, thanks to the elimination of double marginalization and a reduction in wholesale price. Second, private label sales will increase, thanks to lower prices and a substitution of the manufacturer brand product. Finally, it's best for retailers' profits to cooperate with manufacturers when planning to introduce a private label.

But what about the supply chain? After all, the effect on the supply chain will determine both the retailer's and the manufacturer's long-term competitiveness.

To ensure that a retail chain remains competitive, its supply chain must benefit as a whole from the introduction of the private label. When looking at supply chain profits as a function of product substitutability (i.e., the level by which a private label product can substitute for a national brand product) a surprising result manifested itself: the model shows that the profits generated in the whole supply chain can suffer from the introduction of private labels! For products with high product substitutability the supply chain would generate more profits by selling national brand products only, i.e., by not introducing a private label. Furthermore, a private label may make the total supply-chain profit lower if too many sales are driven to the private label. The reduction in profit is particularly pronounced when competition in the retail category is strong.

Therefore the generally held wisdom that retailers always benefit from the introduction of a private label cannot be supported by this research. Retailers would do well to consider the effect of introducing private labels on both their own profits and their supply chain.

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