Assessing the Impact of Manufacturer Power on Private Label Success in an Equilibrium Framework.

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Introduction

- Private labels have grown rapidly over the past decade.
- 2004 - 2014 annual sales rose by over 40% in supermarkets and by 96% in drug chains.
- Market share is 43% in the UK, 40% in Germany, 54% in Switzerland, and 18% in the US.
- Private label growth is not uniform globally.
- In Africa, Asia and South America market share average about 3%.
- In 2012, market shares were 5.3% in Egypt, 4.5% in India, 3.5% in Brazil, 2.3% in China and 9.5% in South Africa's market.
- Why do Private labels market share vary between "developed" and "emerging" economies?

Model Specification

- I estimate a structural model of the South African bread market wherein retail prices are determined both by consumer demand, and equilibrium responses by manufacturers.

Consumer Demand

\[ U_{jt} = X_j p_{jt} - \alpha_j p_{jt} + \xi_j + \epsilon_{jt} \]

- \( x_j \) is a vector of characteristics for product \( j \), \( p_{jt} \) represents the price of product \( j \) during period \( t \)

Retailer Pricing

\[ \prod_{j}^{r} = \Sigma_{j}^{M} (p_j - w_j) \cdot S_j (p) \]

- \( w_j \) is the manufacturer price paid by the retailer for product \( j \)
- \( S_j \) is the quantity demanded of product \( j \)

Manufacturer Pricing

\[ \prod_{j}^{m} = \Sigma_{j}^{m} (w_j - c_j) \cdot S_j (p) \]

- \( c_j \) is the marginal cost of producing product \( j \) incurred by the manufacturer
- \( S_j \) is the set of products sold by manufacturer \( m \)

The implied price-cost margins for the whole channel are obtained by substituting for retail and manufacturer prices.

\[ p - c = -(T_m \cdot \Delta_m)^{-1} S(p) + \Delta_r^{-1} \cdot S(p) \]

Measuring Market Power

\[ p = c + \phi m^R + \theta m^M \]

- \( m^M = -(T_m \cdot \Delta_m)^{-1} S(p) \) is the manufacturer margin
- \( m^R = \Delta_s^{-1} \cdot S(p) \) which is the retailer margin
- Deviation of the manufacturer margin \( \phi \) and the retail margin \( \theta \)
- \( \theta \) estimates market power where \( \theta = 0 \) implies no market power.
- \( \phi > 0 \) and \( \theta > 0 \) implies market power.

Counterfactual Simulations

- Market where retailers either produce their own private labels or acquire them from independent manufacturers.
- Market without private labels.

Research Objectives

- To explain the relatively low private label penetration rates observed in emerging markets.
- To examine conditions in which Private labels fail.

Hypotheses

- In most emerging economies, national brand manufacturers produce private labels.
- National brand manufacturers in this supply arrangement possess market power.
- NB manufacturers prevent retailers from entering the market.
- NB manufacturers offer retailers high margins on private labels and lower margins on national brands, so the two margins are in equilibrium.
- This discourages retailers from pursuing aggressive private label programs resulting in low private label market share.

Conclusion

- Manufacturers generally price in excess of purely competitive levels implying that they have inherent market power.
- National brand manufactures market power is highest when they are the sole producers of private labels.
- Retailers’ private label retail margins increase with manufacturer market power meaning that NB manufacturers offer retailers relatively high margins on private labels.
- Thus, retailers forego private production as they still earn the same margins as on national brands and have no incentives to promote or push private labels across their stores, resulting in low private label market shares.