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Why Do Manufacturers of Leading National Brands Produce Private Labels for Food Retailers?

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Introduction

1. One important change in food retailing is the increasing use of private labels, or store brands, by retailers.

   - The sales of private labels grew at 4.5% annually while the sales of national brands declined during the 2003-2008 period (the Food Institute 2009).
   - Various reasons for food retailers to adopt private labels:
     - Offering private labels allows a retailer to have more leverage with manufacturers of national brands (Richards, Hamilton, and Patterson 2010).
     - Private labels are an instrument for food retailers to differentiate themselves from other stores so that they can increase the margin of not only the category with private labels but also all other product categories.

2. Food retailers' private label products are produced by manufacturers.

   - According to the Private Label Manufacturers Association, there are about 1,500 manufacturers in the United States produce private labels for retailers. A significant portion of these manufacturers also produce their own branded products.
   - It is understandable that manufacturers of fringe brands have an incentive to produce private labels for large supermarkets because those supermarkets usually do not carry the specific fringe brands so the produced private labels do not directly compete with the manufacturers' own brands.

<u>One puzzle</u>: Why do manufacturers of some leading national brands (e.g. Gruma) also produce private labels for food retailers?

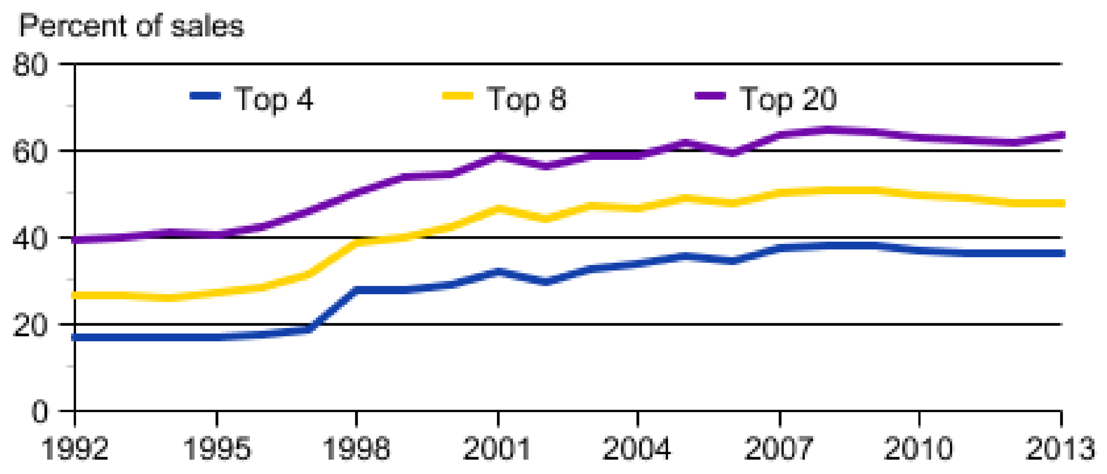
Objectives

- Develop a simple conceptual framework to analyze the incentives of manufacturers of leading national brands to produce private labels.
  - If a large retailer develops its own private label product, it becomes a horizontal competitor for the manufacturers of leading national brands in the retailer's stores.
  - Offering a private label also forces those manufacturers to lower the wholesale prices of leading national brands paid by the retailer.

  Then, why do manufacturers of leading national brands produce private labels?

- Examine how factors affect the incentives of manufacturers of leading brands and the implications for consumer and social welfare.

Top 4, 8, and 20 firms' share of U.S. grocery store sales, 1992-2013
In 2013, the share of sales in the top 20 U.S. grocery retailers rose for the first time since the 2007-09 recession



Source: USDA, ERS calculations using data from U.S. Census Bureau, Monthly Retail Trade Survey, company annual reports, and industry sources. Sales based on North American Industry Classification System (NAICS).

The Model

- There are two manufacturers of leading national brands and many manufacturers of fringe brands.
- Several (N>0) large food retailers carry two leading national brands and their own private labels in their stores. Each large retailer offers one private label. Many small food retailers sell both leading national brands and fringe brands to consumers.
- Both vertical and horizontal differentiation of products are included in the model:
  - Two leading national brands are perceived by consumers to have the highest level of quality.
  - The qualities of private labels are lower than those of leading national brands but higher than those of fringe brands.
  - The two leading national brands are horizontally differentiated and so do the private labels.
- Consumers are symmetrically distributed in the quality space and a consumer will purchase one unit of the product from a store or not buy at all.
- There are three stages of market chain:
  - In the first stage, each large retailer offers the production contract, (p, q), of its private label to the manufacturers.
  - In the second stage, retailers purchase leading national brands and/or fringe brands from manufacturers.
  - In the third stage, retailers decide the optimal prices of their private labels and carried manufacturers' brands and each consumer makes her purchasing decision.

Results

- Manufacturers of leading national brands are willing to produce private labels for food retailers when the vertical quality difference between leading national brands and fringe brands is small.
- Private labels produced by the manufacturer of a leading national brand can be used to squeeze the market shares of other competing manufacturers. This market share effect also gives manufacturers of leading national brands an incentive to produce private labels for food retailers.
- consumer and social welfare are usually lower when manufacturers of leading national brands instead of manufacturers of fringe brands produce private labels for food retailers.

Conclusions

- Private labels are widely used in many food categories and the competition between private labels and national brands have profound implications for consumers, farmers, and food manufacturers and marketers.
- Why manufacturers of leading national brands are willing to produce private labels for food retailers is an important competition issue.
- Our analysis on the incentives of manufacturers of leading brands to produce private labels and the corresponding welfare implications can improve the profession's understanding on this issue.