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Being better vs. being different: Differentiation, competition, and pricing strategies in the Spanish hotel industry

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ABSTRACT

We study the effects of vertical and horizontal differentiation on pricing policy in a large sample of hotels in Spain. We show that hotels with more stars (i.e., vertically differentiated) offer smaller discounts over listed prices, in addition to charging higher prices. Similarly, hotels that belong to a branded chain (i.e., horizontal differentiation) also charge higher prices and provide smaller discounts. We show how the degree of local competition moderates the effect of differentiation on pricing policy, but only for vertical differentiation. Differentiation indeed protects hotels from the pressure to reduce prices as competition increases, but being better seems to be more effective than just being different.

1. Introduction

Product differentiation has been widely regarded as one way for firms to isolate themselves from the pressure of competitors and thus obtain superior performance (Bain, 1956; Dickson & Ginter, 1987; Porter, 1980). Defining long ago this critical concept in firm strategy, prominent economist Edward Chamberlin noted that "A general class of product is differentiated if any significant basis exists for distinguishing the goods of one seller from those of another and leads to a preference for one variety of the product over another" (Chamberlin, 1933: 56). However, despite its importance, there is only scarce empirical research that investigates which types of product differentiation isolate firms more effectively from competitive forces (Porter, 1980). In this paper we try to fill this gap by analyzing the effect of two distinct differentiation strategies, vertical and horizontal, on pricing policies in the hotel industry.

Several empirical studies in the hotel industry have documented the benefits of differentiation (Baum & Mezias, 1992; Garrigós-Simón & Palacios Marqués, 2004), which can be viewed as a barrier to entry or, more generally, a generic source of competitive advantage in sharp contrast to cost leadership. Some authors believe that all competitive strategies, including cost leadership, involve a certain differentiation of the firm's products and services versus its competitors in some way (Mintzberg, 1988). Extant research has focused primarily on the contrast between cost leadership and differentiation, usually exploring whether they do exist as alternative choices for firm strategy and their implications for performance (Campbell-Hunt, 2000). The positive effects of differentiation in protecting firms from competition have been widely accepted since Porter (1980), but the conditions under which they do so have not been investigated empirically yet.

We study the isolating effect of differentiation strategies from competitive pressures in the context of the Spanish hotel industry. According to the World Tourism Organization, Spain was one of the main destinations in the world in 2010 in terms of arrivals and the second in international tourism receipts after the US (World Tourism Organization, 2011). Tourism's contribution to Spanish gross domestic product (GDP) is estimated at 10%, whereas worldwide is around 5%. Similarly, tourism's contribution to Spanish employment represents 10.8% of the overall number of jobs, while worldwide is estimated in order of 6–7% (Instituto de Estudios Turísticos, 2011; World Tourism Organization, 2011). The Spanish hotel industry is a particularly appropriate context to conduct this study because it provides a rich setting across a large number of geographical locations with varying levels of competitive rivalry for which there are publicly available statistics of listed prices, discounts, and features for hotel differentiation.

Looking at the extant literature, our knowledge is still limited with regard to how much the options for differentiation can isolate hotels from the negative effects of competition on prices. Though the effect of specific hotel features on room prices has been the subject of abundant empirical research (Bull, 1994; Espinet, Saez, Coenders, & Fluvià, 2003; Haroutunian, Mitsis, & Pashardes, 2005; Rigall-I-Torrent & Fluvià, 2011; Thrane, 2005), we do not know the extent to which alternative types of differentiation can protect hotels from the pressure to reduce prices when competition in their

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geographical area increases. Based on the differentiation literature in IO (Beath & Katsoulacos, 1991), we investigate how vertical differentiation (i.e., competing along one product dimension valued similarly by all customers, such as overall hotel quality) and horizontal differentiation (i.e., offering a unique combination of product features that satisfies the needs of a specific customer segment) can both be used to insulate hotels from an increase in the degree of competition in its location. In addition to finding support for the effects of both vertical and horizontal differentiation on room prices and discounts, our empirical results show that "being better" (i.e., vertically differentiated) allows hotels to resort less to room price discounts from their listed prices as competition increases than merely "being different" (horizontally differentiated).

In the rest of the paper we develop several hypotheses about the effects of vertical and horizontal differentiation on hotel room prices and how competitive rivalry moderates these effects. We use a sample of 1490 hotels in 67 locations in Spain to test the hypotheses, which are generally supported.

2. Differentiation strategies

2.1. Literature review

The concept of differentiation goes back to the seminal work on monopolistic competition of Chamberlin (1933), who highlighted that customers may have different preferences among available products within the same industry. Along this line, Porter (1980) later popularized the generic strategy of differentiation when a firm creates something tangible or intangible that is perceived as "being unique" by at least one set of customers. Thus, it is the customers' perceptions what determines the extent of product differentiation.

Differentiation has been regarded as an important generic strategy widely used across all industries (Beal & Yasai-Ardekani, 2000; Homburg, Krohner & Workman, 1999), but their performance consequences are not well understood yet (Campbell-Hunt, 2000). Furthermore, there seem to be many possible differentiation strategies. For instance, Miller (1986) argued in favor of two types of differentiation strategy: innovation and marketing, which was supported by Lee and Miller (1999). In a broader categorization of differentiation-based strategies, Mintzberg (1988) proposed six types: quality, design, support, image, price, and undifferentiated products, which obtained empirical support from Kotha and Vadlamani (1995). Recently, strategy researchers have explored the distinction between vertical and horizontal differentiation widely used in the IO literature (Ethiraj & Zhu, 2008; Makadok, 2010, 2011).

In the case of vertical differentiation all customers would agree in a preference ranking of available products, if they were offered at the same price. In this case, competition among firms takes place along only one dimension with the most differentiated firm providing the highest level of such a dimension. For instance, by offering the highest overall quality, a hotel may become more attractive to all customers. In this case, even though customers have the same ranking of perceived product quality, products sell at different prices because customers have different willingness to pay for quality improvements, driven primarily by their differences in wealth (Beath & Katsoulacos, 1991).

However, customers often have different preferences about the set of desirable features in a product or service, so that a single ranking along a quality index cannot be developed for the firms in the market for which all customers would agree. This is the case of horizontal differentiation in which, even if all products were sold at the same price, firms would obtain different market shares to the extent that their products have a unique combination of attributes that are preferred by one specific set of customers. For instance, through brand loyalty a firm becomes more attractive to a specific set of customers with similar needs, which limits the degree of substitutability among competing firms (Makadok, 2010).

Most of the IO literature on product differentiation is based on this distinction between vertical and horizontal differentiation (Beath & Katsoulacos, 1991). However, strategy research has ignored this distinction until recently (Makadok & Ross, 2009). In a sequence of theoretical papers, Makadok and Ross (2009), Makadok (2010, 2011) predicted the performance consequences of both types of differentiation as well as their interaction effects, though there is scarce empirical research in strategy about both types of differentiation. In one of the few empirical studies on differentiation strategies, Ethiraj and Zhu (2008) show that competition is primarily based on horizontal differentiation in the early stages of industry development, which makes incumbents' advantage relatively sustainable; however, as the industry matures, new entrants with greater vertical differentiation are more likely to beat incumbents.

In the next section we will explain how the two main alternatives for differentiation, vertical and horizontal strategies, can be used to help us understand competition among hotels and its effect on prices; more precisely, how hotels can cope with the pressure to reduce room prices as the intensity of competition increases.

2.2. Differentiation and prices in the hotel industry

Let us investigate now the connection between differentiation strategies and pricing policies in the specific framework of the hospitality sector. This topic is worthwhile studying because price planning is one of the most overlooked and poorly researched areas of marketing (Hoffman, Turley, & Kelley, 2002; Rowley, 1997). Furthermore, pricing decisions are particularly relevant in the hotel industry since hospitality prices are one of the main influences on accommodation selection decisions (Hung, Shang, & Wang, 2010; Lockyer, 2005).

The existing literature in the hotel industry indicates that there are many attributes that influence the customers' choice, such as location, room rate, service quality, reputation, security, and cleanliness (Chu & Choi, 2000). Similarly, hedonic pricing research has explored a large number of variables that determine room prices, such as location, hotel category and size, brand name, restaurant availability, distance to city center, room features, parking, and sport facilities (Bull, 1994; Carvell & Herrin, 1990; Espinet et al., 2003; Thrane, 2005; Wu, 1999). Any unique feature that is relevant for at least one set of customers is a potential source of differentiation (Dubé & Renaghan, 2000).

Certain hotel characteristics, such as service quality, are arguably important for all customers, but some customers value certain features more than others. From the many possible features on which hotels can build their differentiation, we have chosen two important elements of a hotel's strategy to conduct our study: hotel category (i.e., number of stars) and hotel chain (i.e., membership to a branded hotel chain), as critical choices for vertical and horizontal differentiation respectively.

In the hotel industry there is one overall ranking of quality with which we would expect all customers to substantially agree, i.e., hotel category (1 through 5 stars, which is actually assessed officially in Spain by the proper agency). In other words, most people would agree that a five-star hotel is usually better than a four-star hotel and so on. It is reasonable to believe that, if customers were given the same rates for hotels, they would choose a higher category hotel. Thus, hotel category is an option for hotels to differentiate vertically and, indeed, it is regarded as an excellent proxy for overall hotel quality (Fernández & Marín, 1998). Of course,