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How emerging market investors' value competitors' customer equity: Brand crisis spillover in China

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ABSTRACT

Brand crisis not only damages customer equity of the affected brand, but also spill over to non-affected competitors when perceived as guilty by association. Therefore, understanding about the indirect financial costs of brand crisis spillover is critical, because customer equity puts much emphasis on the bottom-line financial value. However, little is understood about financial costs to competitors associated with the spillover effect. This study investigates the spillover effect of brand crisis on non-affected competing firms' financial values in emerging markets. The main research questions address: (1) whether and how brand crisis spillover influences non-affected competitors' financial market values in emerging markets, and (2) how marketing strategies by rival firms prior to the crisis influence spillover effects on their financial values in emerging markets. The paper conducts an event study to investigate whether and how the stock values of rival firms within the same product category—food brands—are affected by brand crisis released in China from 2001 to 2011. The results show that rival firms report negative abnormal returns at the time of the brand crisis and furthermore, the harm varies depending on three marketing strategies before crisis. Specifically, advertising expenditures of rival firms strengthens, but charity donation (as signal of corporate social responsibility) and the product diversity of rival firms weaken the spillover effect of a brand crisis in a financial market. Accordingly, the findings have provided managerial implications and recommendations regarding future directions.

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1. Introduction

Customer perception drives customer equity (Blattberg & Deighton, 1996; Rust, Lemon, & Zeithaml, 2004). Customer perception is fragile because the perception bases on beliefs and, due to customers' exposure to new information, can be prone to large and sudden incidents outside of management's control (Dawar & Pillutla, 2000). Unexpected incidents such as brand crisis are ubiquitous in the marketplace (Cleeren, van Heerde, & Dekimpe, 2013). A brand crisis may also spill over to non-affected competitors when perceived as guilty by association (Roehm & Tybout, 2006). These crises can pose severe damage to customers equity (e.g., Dahlen & Lange, 2006; Lei, Dawar, & Gurhan-Canli, 2012; Roehm & Tybout, 2006; van Heerde, Helsen, & Dekimpe, 2007; Zhao, Zhao, & Helsen, 2011).

Further, the spillover effect may cause competing firms to suffer indirect costs in the financial market. The increased product market and financial market relatedness may also expose competing firms to unintended risks caused by affected brands when negative incidents occur (Govindaraj, Jaggi, & Lin, 2004). A broader understanding of these indirect financial costs resulting from brand crisis spillover is critical as customer equity is affected (Rust et al., 2004). However, the limited empirical work investigating rivals' indirect costs in the stock market has been restricted to developed markets (e.g., U.S.) (Govindaraj et al., 2004). Little is understood regarding the indirect costs of competing firms associated with the spillover effect in financial markets of emerging economies.

In recent decades, emerging markets have become increasingly more important in the global economy and few brands ignore emerging markets. However, the characteristics of emerging markets differ distinctly from those of mature markets (Aiello et al., 2015; Ghemawat, 2001; Hofstede, 2001; Marchi, Martinelli, & Balboni, 2014). First, in many emerging markets, the public appears to have weak brand-consciousness (Sheth, 2011) and consequently, people are less aware of brand differentiation (McKinsey, 2012). Further, in many emerging markets, consumers rely more on social interaction and less on advertising than in Western countries (Money, Gilly, & Graham, 1988; Pauwels, Erguncu, & Yildirim, 2013). Second, firm self-discipline and consumer protection are key examples of an institutional void typically found in product markets of emerging countries due to the absence of rigorous regulatory systems (Khanna & Palepu, 2010; Kim & Schellhase, 2015). Finally, unlike mature stock markets in developed countries, individual investors are the majority in China (Chen, Li, & Shi, 2010). The Chinese markets are under-regulated and deficient in gathering and disseminating information to private or public organizations (Singh, 1998). As a result, information asymmetry is accentuated and imperfect signals

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released from firms highly impact investor decisions. Managers must understand how diverse stakeholders in emerging markets respond to negative brand publicity and firms must understand how to adjust their marketing mix to suit local markets (Sheth, 2011).

Furthermore, indirect costs associated with a brand crisis may vary greatly between firms due to marketing actions. To overcome a brand or category crisis, a number of studies have suggested post-crisis countermeasures such as denial, proactive recall policy, and advertising and communication strategies (Ahluwalia, Unnava, & Burnkrant, 2001; Chen, Ganesan, & Liu, 2009; Cleeren, Dekimpe, & Helsen, 2008; Cleeren et al., 2013; Roehm & Tybout, 2006; Dutta & Pullig, 2011). However, researchers have been unable to determine which factors prior to a crisis cause variations in indirect costs. Non-affected rivals need to proactively develop precautions in the event of a spillover effect from incidental brand crises.

This paper investigates the spillover effect of brand crises in emerging markets. The research questions address: (1) whether and how brand crisis spillover influences non-affected competitors' financial market values in emerging markets, and (2) what precautions non-affected competitors can take to protect their market values from the spillover effect.

The study empirically investigates these issues by examining financial market responses to brand crisis in a rapidly growing emerging market—China. The empirical analysis reveals some interesting findings. First, rival firms experienced negative abnormal returns during the brand crisis. Second, the spillover effect of the brand crisis on the financial market is strengthened by rival firms' investment in advertising prior to the crisis but weakened by charity donation and product diversity of rival firms prior to crisis.

This study contributes to marketing literature on customer equity and crisis management in emerging markets and provides some managerial implications. As far as we know, this is the first study in marketing that deals with the spillover effect of brand crisis on competitors in the financial markets of emerging markets. In particular, the findings provide a comprehensive reference for managers on how to manage customer equity during periods of market turbulence in emerging markets.

1.1. Literature review

1.1.1. The spillover over of brand crisis and the impact on customer equity

A brand crisis occurs when (1) a key brand proposition is unsubstantiated or false, (2) a product is cited for failing to meet a mandatory safety standard, (3) a product defect is discovered that could cause substantial harm or an unreasonable risk of serious injury or death, or (4) failure to comply with a voluntary standard adopted by a specific industry (Dawar & Lei, 2009; Votolato & Rao, 2006). Brand crisis may not only be devastating for the affected brand, but also potentially impact related but non-affected brands through spillover effect. Spillover refers to the phenomenon in which information influences beliefs that are not addressed directly in a communication (Ahluwalia et al., 2001).

Researchers have found that a brand crisis can influence competitors' customer equity. For example, Roehm and Tybout (2006) have reported that a brand scandal negatively affects customers' attitudes and beliefs about the product category and competing brands. Dahlen and Lange (2006) have observed that customers reevaluate category attributes from associations with the brand in crisis; thus, the values attributed to competing brands differ depending on similarity to the affected brand. van Heerde et al. (2007) have noted an increase in a main competitor's sales after Kraft's crisis in Australia in 1996. Cleeren et al. (2013) have recorded changes in brands' market shares and category purchases following brand crises. For financial market reaction, Govindaraj et al. (2004) have found that the major competitors in the tire and auto industries experiences a significant gain in the market value of their stocks probably because their products substitute the products affected by recall. This result is inconsistent with those of Jarrell and Peltzman's (1985) that have shown a negative stock price reaction for competitors in the auto industry. However, both the findings are in developed country setting (U.S.) and not controlled by potential influence of marketing strategies.

Some studies have examined the influence of marketing variables on stock returns (Luo, 2009; Rust et al., 2004; Srinivasan & Hanssens, 2009). Several studies have explicated that a firm's advertising directly affects stock returns (Luo, 2008), and that advertising goes beyond the consumer to create spillover effects among other stakeholder such as investors (Luo & Bhattacharya, 2009). Corporate social responsibility (CSR) has a positive effect on global brand (Torres, Bijmolt, Tribó, & Verhoef, 2012). As a good sign of CSR, charitable donation is increasingly practiced by companies (Muller & Whiteman, 2009; Zhang, Zhu, Yue, & Zhu, 2010).

Horizontal Product Diversification (HPD) refers to a firm's having a single business (related products) or pursuing an unrelated business (products) (Rumelt, 1974). HPD can not only create new business growth and revenue but also reduce the risk of bankruptcy (Zhao & Luo, 2002). However, all these literatures are studies on mature markets. In immature emerging market, different theory and evidence about consumer and financial markets response may exist in regard to competing firms when a brand crisis occurs because of distinct environment of emerging markets.

1.2. Hypothesis development

1.2.1. Spillover effect of brand crises on financial values of competing firms in emerging markets

1.2.1.1. Customer reaction. First, the spillover of a brand crisis might have a negative impact on purchasing decisions of customers in emerging markets that could result in decreased sales and diminished financial performance of competing firms. When a brand receives negative publicity, the brand becomes more salient in customers' minds and may affect perceptions of the product category to a greater extent than previously (Lei, Dawar, & Lemmink, 2008). The affected brand may prime customers' evaluations of other brands in the same product category that are not fixed but are continually updated when customers encounter new information (Moreau, Page, Markman, & Lehmann, 2001). Therefore, with negative publicity priming product category perceptions, customers evaluate similar brands more critically and dissimilar brands more favorably (Dahlen & Lange, 2006).

Given the alternative evaluation processes, predicting which evaluation process (i.e., similarity evaluation or dissimilarity evaluation) a customer will pursue is crucial. In comparing a target with a given standard, judges engage in an initial holistic assessment of target-standard similarity; the outcome determines the nature of the hypothesis that is tested in the comparison. If the assessment indicates that the target is generally similar to the standard with respect to the judgmental dimension, judges engage in similarity testing. However, if the initial assessment indicates that the target is generally dissimilar from the standard, judges engage in dissimilarity testing. In emerging markets, unbranded products and services comprise as much as 60% of total consumption (Sheth, 2011). Consequently, customers in emerging markets are less aware of brand differentiation compared with customers elsewhere (McKinsey, 2012). For these reasons, customers are likely to judge non-affected competing brands to be in the same category of affected brands and do not discriminate from the affected brand by brand differentiation. Further, this holistic screening is sufficient to determine that similarity testing has been conducted. Therefore, emerging market customers are more likely to extend negative beliefs regarding affected brands to non-affected brands within a product category.

Negative publicity is likely the salient feature that lends itself to a holistic assessment during a brand crisis. For example, the 2008 crisis of contaminated Sanlu infant milk powder in China created a prolonged impact on customers' confidence in the Chinese dairy industry. In the

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