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Multimarket contact, differentiation, and prices of chain hotels

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HIGHLIGHTS

- This study analyzes how two types of differentiation moderate the effect of multimarket contact on prices of chain hotels.
- Hotels that belong to a chain can increase prices when they have more multimarket contact and are more differentiated.
- Multimarket contact is a most effective mechanism to increase prices for hotels that do not follow a branding strategy.
- Multimarket contact is a most effective mechanism to increase prices for hotels less differentiated in services.
- Multimarket contact is a most effective mechanism to increase prices for 3-star chain hotels.

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ABSTRACT

This study seeks to analyze the joint effect of multimarket contact and product differentiation on the intensity of price competition between chain hotels. The theory predicts that both variables reduce price rivalry, but little is known about their interaction effect. Multimarket literature establishes that when two firms meet one another in more than one market, the mutual recognition of their interdependencies will reduce the intensity of competition, leading to mutual forbearance. This article argues that differentiation moderates negatively the effect of multimarket contact on price because differentiation decreases the recognition of interdependence and thus, it makes difficult mutual forbearance. Using data from 1147 Spanish hotels that belong to a chain, this study shows that chain hotels with higher multimarket contact and higher differentiation (i.e. more stars, the Q certificate, common umbrella brand and a unique combination of services) charge higher prices. The evidence confirms the negative interaction but only for horizontal differentiation (i.e. different services and common brand).

1. Introduction

When two firms have multimarket contact, that is they meet one another in more than one market, the mutual recognition of their interdependencies will reduce the intensity of competition, leading to mutual forbearance (Bernheim & Whiston, 1990). The reason for such an effect is that if one firm is attacked in one market, it will have the ability to retaliate not only in the market in which the rival has initiated an aggressive action but also in all other markets in which it coincides with that rival. Therefore, as the markets of firms overlap, the rivalry intensity will diminish because of the risk of retaliatory actions in all of the markets in which they coincide (Gimeno & Woo, 1996). Given the relevance of multimarket contact to understand the firm behavior and performance, there has been a proliferation of studies on multimarket competition research in the management literature in the last years (Yu & Cannella, 2013). As a result, there is strong evidence to support that multimarket contact affects the intensity of rivalry and firm performance in a variety of sectors, such as airlines (Gimeno & Woo, 1999), cement (Jans & Rosenbaum, 1997), personal computers (Kang, Bayus, & Balasubramanian, 2010), or hotels (Fernández & Marín, 1998).

A stream of research within the multimarket literature has focused on the contingencies that moderate the effects of multimarket contact on mutual forbearance as for instance, firm size, internal coordination or strategic similarity respect to multimarket competitors (Yu & Cannella, 2013). However, the degree of product differentiation has received less attention.

Economists distinguish between two types of differentiation: vertical and horizontal (Cremer & Thisse, 1991). Vertical differentiation makes the firm's product more attractive to all

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customers of the market, whereas horizontal differentiation makes the firm's product more attractive to some customers and less attractive to others (Makadok, 2010). Yet it remains unclear whether product differentiation decreases the recognition of interdependence with multimarket rivals and thus it inhibits mutual forbearance.

This study expands the literature on multimarket contact by analyzing how these two types of differentiation may influence the effectiveness of multimarket contact as a mechanism to restrict price rivalry: do vertical and horizontal differentiation strengthen (positive interaction) or weaken (negative interaction) the effect of multimarket contact on prices? Understanding the effects of the interaction between multimarket contact and differentiation on the intensity of rivalry experienced by hotel chains can be useful in predicting which particular competitive interactions will be more intense, thereby helping hotel chain managers to develop strategies to cope with situations of high rivalry.

The setting of hotel chains is particularly relevant to test this research question. Hotel chains compete with each other in multiple geographical markets. Hotel chains may also vary in their degree of vertical and horizontal differentiation of each one of their hotels. For instance, a hotel chain may differentiate their hotels by their level of quality, by their brand or by their unique services. This paper proposes that differentiation weakens the effect of multimarket contact on prices because differentiation decreases the recognition of interdependence and consequently, it makes difficult mutual forbearance. This moderation effect is tested using hand-coded data of 1147 hotels that belong to a chain. The database comprises detailed information about the characteristics of each one of the hotels, which allows including in the analysis several differentiation variables.

The empirical evidence shows that multimarket contact and differentiation reduce price rivalry and that both mechanisms do not reinforce each other. Multimarket contact is an effective mechanism for reducing rivalry for chain hotels that are not horizontally differentiated (i.e. do not use a common brand and are similar in the level of services that they offer) as predicted. Additionally, the findings suggest that multimarket contact is more effective for three-star hotels than for hotels of higher or lower category.

This paper contributes to existing literature in several ways. First, this study is one of the first studies that examine the moderator role of differentiation on the effect of multimarket contact on price rivalry. Second, the study suggests the dissimilar roles of the two types of differentiation in moderating the effect of multimarket contact on prices. Third, the negative effect on prices of multimarket contact for hotels that offer a unique combination of services and for lowest-category hotels point out that there can be some circumstances under which increasing the level of multimarket contact can be harmful. Fourth, the results can contribute to a better understanding on variables that determine the room prices of hotels that belong to a chain.

The first section of this paper reviews the theoretical and empirical literature that analyzes the relationship among prices, multimarket contact, and the two types of differentiation. This review leads to the hypothesis section, which offers predictions regarding the interaction effects, followed by an empirical analysis. The final section discusses the main results and conclusions.

2. Literature review

2.1. The effect of multimarket contact on prices

Multimarket contact between two firms is defined as the number of contacts in geographic markets (Gimeno & Woo, 1996). The multimarket literature establishes that as the degree of multimarket contact between two firms increases, they are likely to become more interdependent, however this greater interdependence may not necessarily translate into higher intensity of competition (Jayachandran, Gimeno, & Varadarajan, 1999). On the contrary, the theory of multimarket competition suggests that the intensity of competition between firms with greater market overlap can be reduced due to “the mutual forbearance”. That is, firms that compete in many markets with other firms may be less motivated to compete vigorously against each other, because the gains in one market do not compensate for a general price war in all markets in which both firms coincide (Bernheim & Whinston, 1990).

Empirical research supports the notion that higher multimarket contact is associated to mutual forbearance and can lead to a reduction in the intensity of competition (see Yu & Cannella, 2013 for a recent literature review). This intensity of competition has been conceptualized in different ways as prices, profits or market entry. Evidence shows that higher multimarket contact can lead to higher prices (Evans & Kessides, 1994; Fernández & Marín, 1998; Gimeno & Woo, 1999; Jans & Rosenbaum, 1997; Kang et al., 2010; Parker & Röller, 1997); higher profits (Hughes & Oughton, 1993; Pilloff, 1999) and decreased rates of entry and exit (Baum & Korn, 1999; Fuentelsaz & Gómez, 2006).

The literature suggests that multimarket contact influences mutual forbearance because it enhances firms' interdependence trough increasing the familiarity with rivals' actions and increasing the ability of rival firms to deter each other (Jayachandran et al., 1999). In effect, multimarket contact facilitates mutual learning and increases the ability to prevent aggressive actions because a firm that is attacked in one market can counterattack in any other market in which both firms compete, creating serious financial loss for both sides.

Research in multimarket competition has identified an array of firm and market factors, such as spheres of influence, strategic similarity, organizational structure, or market concentration that moderate the effect of multimarket contact on the intensity of rivalry (Jayachandran et al., 1999). These factors can increase or decrease the degree of familiarity and deterrence of firms that compete in multiple markets and consequently the likelihood of mutual forbearance occurring (Jayachandran et al., 1999).

The literature on industrial organization recognizes that product homogeneity helps firms to reach collusive agreements, as they are thus able to acknowledge their interdependencies more easily (Chamberlin, 1929; Scherer & Ross, 1990; Stigler, 1987). A review of the empirical literature reveals that collusion occurs more frequently in homogeneous product markets than in differentiated product markets (Levenstein & Suslow, 2006). Just as product differentiation influences the likelihood of direct coordination or collusion, this article argues that product differentiation moderates the effect of multimarket contact and price, since mutual forbearance requires that firms recognize their interdependency.

2.2. The effect of vertical differentiation on prices

Vertical differentiation occurs when consumers agree on the ranking of all of the variants of a given product line. Thus, in a situation in which prices are identical, consumers would all buy the same (presumably the best) variant of the product (Cremer & Thisse, 1991, p. 383). One method by which firms can achieve a vertical differentiation advantage is by offering superior quality relative to that offered by their rivals (Gabszewicz & Thisse, 1986; Shaked & Sutton, 1987). In this type of differentiation, consumers are assumed to desire higher quality, although they may differ in their willingness to pay for quality improvements. Because a