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Offering value and capturing surplus: A strategy for private label sales in a new customer loyalty building scenario

Jake D. Hoskins

Department of Marketing, David Eccles School of Business, University of Utah, 1655 East Campus Center Drive, Salt Lake City, UT 84112, United States

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ABSTRACT

The competition between private label brand and national brands in the diaper category is investigated from the view of the private label brand manager. In this category, new customers routinely enter the category buying entry-level diaper sizes (for infants) and then progress to buy larger diaper sizes over time (as their child grows older). Thus, consumer comparisons between the private label brand and national brands are focused on single diaper sizes during any single purchase scenario. Because private label brands are known to suffer from low quality perceptions that often understate the true quality levels of private label brands, this paper advances a pricing strategy to optimize private label performance in the category. The private label brand should price significantly low for small diaper sizes (maintaining a sizeable price gap from national brand competitors). Then, in most cases, the private label brand should shrink the size of this price gap for large diaper size offerings. This strategy will successfully offer initial value to new customers, build private label brand quality perceptions and loyalty, and then capitalize on these gains through higher dollar sales in the late stages of the customer relationship. The price gap shrinking strategy is found to be generally effective, but high national brand competition and too high of an initial price gap diminish the effectiveness of the strategy.

1. Introduction

Private label brands have traditionally acted as a low cost alternative to national brands. While national brand managers invest significant marketing resources to develop brand equity advantages (Steenkamp et al., 2010), private label brands rely on lowered investment costs to provide goods at lower final prices. So, the goal of many retailers has been to keep costs of production, packaging, and manufacturing low to maintain a significant price gap between the private label and national brand offerings. Such a strategy allows retailers to offer value to customers through the private label product offerings and to simultaneously capture significant profit margins, due to the reduced marketing costs of managing the private label brand in comparison to a national brand.

More recently, however, private label strategy has transformed from simply selling on a cost advantage to actually establishing the private label as a brand itself (Kumar and Steenkamp, 2007). Many retailers have determined that simply positioning the private label brand as cheap may be a suboptimal strategy that sells short the true potential of the private label brand for overall retail business.

Academic research has revealed several factors that positively influence the quality perceptions of the private label brand and can therefore be of strategic importance to retailers. Store atmosphere and store quality have positive impacts on the quality perception of the private label brand (Dhar and Hoch, 1997; Vahie and Paswan, 2006). Adding a name brand ingredient to a private label brand can also boost the perceived quality of the private label (Vaidyanathan and Aggarwal, 2000). So, by investing in the private label brand, whether through partnerships with national brands or through developing the retail outlet itself (such as service quality and store appearance), the private label can close the gap in perceived quality from the national brand offerings. Of course, the clear tradeoff in developing the perceived quality level of the private label brand is that the savings typically afforded by the private label choice for consumers is likely to shrink.

So, private label brands face a clear dilemma. There is industry wide pressure to shrink the price gap between the private label brand and the national brand in order to signal quality and build the private label brand, yet many retailers are still afraid to abandon the core offering of the private label brand to most consumers: economic value. This paper identifies a category situation in which a private label can utilize in its natural low priced, or value based, positioning to gain initial trial of the brand. Then, the private label brand can capitalize on the benefits of initial trial and capture surplus from the gained customers over the duration of their customer relationship with the private label brand. Hence,

E-mail address: jake.hoskins@utah.edu

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this paper establishes that a private label brand may benefit from strategically shrinking the price gap between the private label and the national brands over the duration of the customer relationship. Lastly, this paper considers some important conditions under which this price gap shrinking strategy may be less effective.

2. Theoretical framework and hypotheses

2.1. Offering value: the advantages of a private label-national brand price gap

Despite the trend towards developing the private label brand as a strong brand in its own right, the private label still persists as the value alternative in the minds of most consumers. In general, private label brand attitudes are positively aligned with value consciousness, deal proneness, and perceiving oneself as a smart-shopper (Garretson et al., 2002; Lichtenstein et al., 1993). By contrast, positive private label brand attitudes conflict with levels of national brand loyalty and with a tendency to expect a price–quality relationship (Burton et al., 1998).

So, typical private label shoppers are generally looking for a good deal and are more likely to forgo high-priced national brand offerings. Lichtenstein et al. (1993) identified that price oriented consumers may focus on value consciousness: the difference between the price paid and the perceived quality attained, while other consumers may assume a price–quality relationship: that high priced brands must be of higher quality to warrant the high price charged (Batra and Sinha, 2000; Kirmani and Rao, 2000). These price–quality relationship buyers are likely to prefer national brands, while price conscious consumers are likely to prefer private label brands, on average.

However, strategic firm actions by either the national brand or the private label brand may be able to convince otherwise unlikely consumers to buy certain products. For example, Garretson et al. (2002) argue that price oriented customers generally choose one of two options: buy the private label brand that is always offered at a low price (thus providing the value proposition of regular, everyday savings) or buy the national brand that is on deal (price promotion). Interestingly, citing prior work (Ailawadi et al., 2001; Sethuraman, 1992), they go on to note that the average private label brand is priced at about 30% less than the national brand and that national brand promotions typically amount to 20–30%. So, often times, the national brand is available for a similar price as the private label brand. Thus, value conscious consumers that typically prefer private label brands may be enticed to buy the national brand when it is on promotion (Besenko et al., 2005).

A comparative group of consumers focus on the price–quality relationship, expecting that high priced brands are more likely to be high quality brands. Such consumers are unlikely to have positive attitudes towards the private label brand. However, such consumers can retain positive attitudes towards the national brand that places their products on deal. The deal can be seen as temporary and, as such, less likely to harm the overall quality perception of the national brand. By constantly pricing at a low price, the private label brand is likely to appear low-end to consumers that focus on the price–quality relationship.

So, for both value conscious and price–quality driven consumers, the reduced quality perception of the private label brand coupled with the ability of national brands to frequently promote products to close the price gap creates a clear dilemma for private label brand managers. Fighting very low quality perceptions in the marketplace becomes a difficult task for the private label brand. Thus, actions to develop the private label's brand perceived quality might be the key to influencing these consumers to switch from the national brand to the private label brand, either in the short term or even permanently (Geyskens et al., 2010).

Given the strong overlaps between price consciousness of consumers and the likeliness to buy the private label, the price gap between the national brand and the private label brand has an important impact on private label performance (Dhar and Hoch, 1997). And, despite the fact that consumers tend to perceive a high price as a quality signal for national brands, high price quality signaling is a generally less effective strategy for private label brands due to low initial quality perceptions (Boyle and Scott Lathrop, 2013). In general, a sizeable price gap between the private label brand and national offerings is an important component of driving private label sales. Fighting an uphill battle of negative perceptions about the quality level private label brands as a class, individual retailers must provide some value-based reason for consumers to try and buy their private label offerings.

2.2. Capitalizing on loyalty: shrinking the price gap across product stages

Yet, simply increasing share of private labels does not necessarily increase performance of the retailer (Olbrich and Grewe, 2013); like basic marketing theory suggests, retailers must strive to achieve profitable private label share. With rising costs of managing the private label due to supplier strategies (Braak et al., 2013), there is even more pressure to capture private label surplus whenever possible.

The discussion of two large consumer segments (value conscious and price–quality) leads to a scenario where the private label brand is typically able to capture the value conscious group by establishing a significant price gap from national brand offerings that can sustain national brand competitive promotional activity pressures. Yet, pricing too low is unlikely to gain many more value conscious consumers, is likely to shrink profit margins of the private label brand, and is likely to further deter trial by price–quality dependent consumers. Providing an appropriate private label-national brand price gap leads to substantial trial and purchase rates among the base of consumers. An appropriate price gap is likely to appeal to both value conscious and price–quality consumers.

The efforts of private label brands to improve quality of the private label brand and to also promote the quality image to consumers have worked to some degree. Although consumers have recently reported a lower perceived quality gap between national brand and private label brand products, consumers still report an expected price premium and a general willingness to pay a higher price for national brand offerings (Boyle and Scott Lathrop 2013). The true quality level of private label brands are increasing at faster rates than perceived quality; many retailers have utilized their market power to negotiate supply relationships with the national brand suppliers, which further closes the gap in true quality between private label and national brand product offerings (Chen et al., 2010; Kadiyali et al., 2000). So, pre-trial, the perceived quality gap between the private label brand and the national brand tends to be larger than the true quality gap.

A clear impediment to growing the private label brand for many retailers is to encourage trial among consumers that have overblown negative quality perceptions of private label offerings. Thus, in repeat purchase categories, a pricing strategy to promote product trial through providing an initial value (large price gap between the national brand and the private label brand) and then capitalize on the surprisingly high quality level of the private label brand to capture more surplus (by shrinking the price gap over time) is likely to be successful.

Such a strategy may promote private label brand trial, increase sales revenue for the private label brand, and increase quality perceptions of the private label brand. Lamey et al. (2012) find that

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