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The retail power-performance conundrum: What have we learned?

Kusum L. Ailawadi*

*Associate Professor of Business Administration, Tuck School, Dartmouth College, 100 Tuck Hall,
Hanover, NH 03755, USA*

Abstract

The conventional wisdom that retailers have grown more powerful relative to packaged goods manufacturers in the packaged goods industry has not been supported by empirical analyses of the relative profitability of retailers and manufacturers. This is despite increases in trade and consumer promotion, and the prevalence of store brands, all of which were viewed as indicators of growing retail power. In recent years, researchers have developed a much better understanding of the role that these purported “indicators” play in manufacturer-retailer interaction. The objective of this article is to synthesize what this new research teaches us about the impact of promotions and store brands on the relative performance of manufacturers and retailers. It concludes that promotions are just as beneficial for manufacturers as for retailers, if not more so. Store brands do provide leverage to retailers and allow them to improve margins, but a competitive national brand assortment is still necessary for retail profitability. This helps explain why manufacturer profitability has not worsened relative to retailers even as trade and consumer promotion spending have grown and store brands have become strong in many product categories. © 2001 by New York University. All rights reserved.

1. Introduction

It has been a decade since Farris and Ailawadi (1992) first questioned the conventional wisdom that the balance of power in interactions between packaged goods manufacturers and retailers has shifted towards the latter. Their analysis of trends in retailer and manufacturer profits did not support the purported power shift. They found that, if anything, manufacturer profitability has improved relative to retailers. Subsequently, other researchers studied

* Tel: +1-603-646-2845; fax: +1-603-646-1308.

E-mail address: Kusum.L.Ailawadi@Dartmouth.edu (K.L. Ailawadi).

different measures of performance and came to the same conclusion (e.g., Messinger & Narasimhan, 1995; Ailawadi, Borin & Farris 1995). Although specific retailers may have power in specific markets (Ailawadi, Borin, & Farris, 1995; Kadiyali, Chintagunta, & Vilcassim, 2000), even manufacturers who sell to these powerful retailers may not necessarily have lower profitability than those who do not (Bloom & Perry, 2001). In any event, there is certainly no empirical evidence for an overall shift in market power towards the trade.

To recognize that conventional wisdom was mistaken on this issue was an important step. But, there is valuable learning to be obtained in understanding why conventional wisdom was mistaken. What assumptions or theories led to this conventional wisdom? Which of these are correct, and which ones need to be revised? Farris and Ailawadi (1992) and Messinger and Narasimhan (1995) noted some trends/phenomena in the packaged goods industry during the eighties and nineties that were widely viewed as indicators of the purported shift in power towards retailers. Three of these phenomena are listed below along with an outline of the conventional arguments about their relationship to retail power:

Increase in trade promotion: The trade forces manufacturers to provide promotional allowances if they want retail space and merchandising support for their brands. These allowances go to the trade's bottom line and do not benefit manufacturers.

Increase in consumer promotion: Consumer promotion makes people more price sensitive and simply encourages brand switching, hurting brand equity and sales in the long term.

Increase in share of store brands: The increasing prevalence of store brands helps retailers. They use store brands to compete with national brands for value conscious consumers on one hand and as leverage to negotiate better allowances from manufacturers on the other.

Farris and Ailawadi (1992) and Messinger and Narasimhan (1995) speculated on the validity of these arguments but called for further research on the impact of these phenomena to get a better understanding of why conventional wisdom was not in agreement with the reality of manufacturer and retailer profitability. In the past decade, researchers have investigated these phenomena in some detail and built up a large body of research (e.g., see Neslin's 2001 review of sales promotion).

The purpose of this article is to select, from this large literature, the new articles that are directly relevant to understanding the impact of trade promotion, consumer promotion, and store brands on channel interaction, and determine what they teach us about the relative performance of manufacturers and retailers. In the next three sections I synthesize the lessons from relevant new research in trade promotions, consumer promotions, and store brands respectively, and conclude with directions for further research in the last section.

2. Trade promotions and manufacturer-retailer interaction

In the late eighties and nineties, trade promotion in the packaged goods industry steadily increased its share of the total marketing budget, from less than 35% in 1983 to 53% in 1999 (Donnelley Marketing, 1997; Cannondale Associates, 2000). It was widely believed that

retailers “extract” allowances and therefore channel surplus from manufacturers, who do not benefit from these trade allowances. Rather, marketers felt that the retailer forward buying encouraged by some trade promotions creates huge crests and troughs in the manufacturing, inventory, and distribution cycles, and, as a result, manufacturer costs increase significantly. Consequently, many marketers suggested that “Every-Day-Low-Prices” to the trade are preferable to strategies that involve trade allowances (Bishop, 1988; Buzzell, Quelch, & Salmon, 1990; Kristofferson & Lal, 1996a,b; Advertising Age, 1997; Hau, Padmanabhan, & Whang, 1997). However, it was difficult to reconcile this “retail extortion” view with the fact that, as trade promotion spending grew, manufacturer profits improved relative to retailers. Since 1992, researchers have developed models to examine whether and how trade promotions may actually benefit manufacturers.

2.1. Trade promotions and manufacturer profit

Kim and Staelin (1999) develop an analytic model of two manufacturers and two retailers to explain why increased trade promotions have not translated into higher profits for retailers. When both manufacturers and retailers face competition, they show that it is in the manufacturers’ best interest to offer trade allowances and it is in the retailers’ best interest to pass through at least some portion of the allowances to consumers. This is because the in-store merchandising funded by trade promotion allowances induces both brand switching within the store and store switching. The in-store brand switching, which reflects manufacturer competition, induces manufacturers to offer trade promotion allowances. The cross-store shopping, which reflects retailer competition, induces retailers to pass on at least some portion of the allowance to the consumer. Further, when retail competition increases, as it did with the growth of mass-merchandisers during the eighties and nineties, retailer profits decrease despite higher trade allowances.

Silva-Risso, Bucklin, and Morrison (1999) also show that trade promotions are optimal for manufacturers even when retailer pass through is low. Thus, manufacturers offer trade promotions, not because powerful retailers extract them, but because they are optimal, and retailers compete them away as inter-retailer competition heats up.

Gerstner and Hess (1995) show that promotion helps to alleviate the familiar “double marginalization” problem and coordinate the channel. Double marginalization occurs when the manufacturer and retailer each set their prices to maximize their own individual profit instead of the total channel profit. The result is that manufacturer and retailer prices are set too high and total sales, total channel profit, and the manufacturer profit, are all below optimal levels (Jeuland & Shugan, 1983). Gerstner and Hess (1995) argue that a combination of trade and consumer promotion increases total channel profit and manufacturer profit beyond the level that would be attained without either type of promotion or with one type alone.

Ailawadi, Farris, and Shames (1999) distinguish between different kinds of trade promotion and show that certain pay-for-performance trade promotions are more effective at coordinating the channel than others. The most effective trade promotions link the manufacturer’s selling price, not to the amount purchased (which encourages forward buying) but to the amount sold by the retailer, or, better still, to the price featured by the retailer.

Promotional allowances may be linked to the units sold by the retailer through “scan-backs” which give a discount to retailers for the number of units sold to consumers during a promotion period. The link to retailer price may be a direct “reward” to the retailer in the form of a deeper discount for lower feature prices. Or, it could be indirect, such as when the manufacturer subsidizes retail advertising, knowing that retailers are unlikely to advertise a noncompetitive price (see also Jorgenson, Sigue, and Zaccour, 2000).

Some articles have also examined the effect of retailer forward buying on manufacturer profit. Neslin, Powell, and Stone (1995) show that retailer forward buying “holds back” trade promotion expenditure because it makes trade deals less profitable for the manufacturer. They predict that both trade promotion spending and manufacturer profits should increase as pass-through of trade discounts increases and forward buying decreases. Lal, Little, and Villas-Boas (1996) argue that forward buying softens manufacturer competition, but, they define softened competition as a reduced probability of trade deals, so, in essence, they too conclude that forward buying decreases trade promotion spending.

In a new paper, Drèze and Bell (2000) show that, compared to off-invoice allowances, scan-backs reduce forward buying, have higher pass-through and higher sales during the promotion period, and are more profitable for the manufacturer. Most interestingly, they also show that manufacturers can design scan-backs such that they would be better off and retailers would be indifferent between off-invoice allowances and the scan-backs. This is possible because manufacturers can convert the inventory costs incurred by retailers who forward buy under off-invoice allowances into additional profit for themselves.

Trends in industry are in line with these lessons. Trade promotions continue to be offered, even by manufacturers like P&G who implemented a value pricing strategy in the nineties. However, the composition of trade promotions has moved away from off-invoice allowances towards more pay-for-performance deals like scan-backs, cooperative advertising allowances and other discretionary funds (Progressive Grocer, 1993; Neslin, 2001). According to Cannondale Associates (2000), off-invoice allowances were down from 50% of the trade promotion budget in 1995 to 33% in 1999, while scan-backs and discretionary funds together were up to 58%. As forward buying and pass-through problems are alleviated with better-designed trade deals, we can expect both trade promotion expenditures and manufacturer profit to further increase.

2.2. Competitive and anticompetitive roles of slotting allowances

Another series of articles has looked at the role of a specific kind of trade allowance that grew during the eighties - the slotting allowance. Slotting allowances are lump sum payments paid by a manufacturer to a retailer in return for obtaining (temporary) shelf space for a new product. Conventional wisdom had concluded that these allowances were anticompetitive and a vivid example of how retailers could use their power to extract profit from manufacturers (Fitch, 1988; Gibson, 1988; Weinstein, 1988). Consistent with this conventional wisdom, Shaffer (1991) developed a theoretical model of how slotting allowances lead to lower retail competition, higher retail prices, and higher retail margins. Chu (1992) showed that retailers demand slotting allowances from manufacturers to separate successful new products from failures, and to extract channel surplus.

However, recent research suggests that slotting allowances may be consistent with competitive behavior on the part of retailers and manufacturers. Lariviere and Padmanabhan (1997) show that manufacturers are not forced by retailers to give slotting allowances; rather, they willingly offer slotting allowances in situations where they have more information than retailers do about the demand for a new product and retailers incur a fixed cost in stocking the new product. Further, these allowances do not represent a windfall for retailers who may only breakeven on the product when the slotting allowance is paid. This is consistent with Kelly (1991) who argues that slotting allowances may be a form of risk sharing between manufacturers and retailers that became necessary as the number of new product failures, and therefore retailers' costs of stocking new products, increased.

Sullivan (1997) develops a demand-supply model where retailers and manufacturers both operate in a competitive environment and retailers stock multiple products to reduce consumer search costs but they incur a cost to stock new products. Her model shows that when the supply of new products increases but total retail sales are constant, as in the case of many mature packaged goods, then higher slotting allowances are necessary to compensate retailers for their costs and induce them to stock the new products. The argument in these models that slotting allowances simply cover rising retailer costs is consistent with the fact that retailer profit has not increased with slotting allowances.

Bloom, Gundlach, and Cannon (2000) survey both manufacturers and retailers and find significant differences in their perceptions of slotting allowances. Not surprisingly, manufacturers are more critical than retailers of slotting allowances. However, there is convergence between the two groups on certain issues. First, neither group believes that the amount of slotting allowance is a particularly good indicator of a new product's potential. Second, both groups agree that slotting allowances (a) have come about due to an increased supply of new products; (b) increase the manufacturers' risk in new product introductions; (c) reflect greater influence of retailers, especially large retailers; and (d) facilitate higher retail prices.

Thus, practitioners perceive that slotting allowances are competitive in terms of risk sharing and adjusting demand and supply of new products (Kelly, 1991; Sullivan, 1997), but anticompetitive in terms of greater retail influence and higher retail prices (Shaffer, 1991).

However, there is very little empirical validation of these perceptions since slotting allowances are usually negotiated in private. Messinger and Narsimhan (1995) show that retail food prices actually rose slower than the rate of inflation during the eighties when slotting allowances were growing at a very fast pace. Further, although retail gross margins increased, manufacturer gross margins increased faster. Lariviere and Padmanabhan (1997) provide some evidence that slotting allowances are more likely in categories where retailers have higher opportunity costs. Sullivan (1997) shows that new product introductions by manufacturers and number of items stocked by retailers increased significantly during the eighties while total retail sales did not keep pace with these increases - conditions that are consistent with her hypothesis of supply-demand adjustment. These aggregate trends are somewhat more consistent with the competitive rather than the anticompetitive argument, but they are far from conclusive.

2.3. Summary

In summary, a substantial amount of new research has been done on the role that trade promotions play in manufacturer-retailer interaction. This research shows why retail profits have not improved relative to those of manufacturers, even as trade promotion spending has increased.

- Trade promotions exist not because powerful retailers extract them from manufacturers, but because it is optimal for manufacturers to offer them in a competitive market. Growing retail competition induces retailers to compete away these allowances.
- Some trade promotions like off-invoice allowances are tied not to what the retailer sells to consumers but to what she buys from the manufacturer. This encourages forward buying by retailers and lowers manufacturer profitability. However, that does not mean all trade promotions are bad for the manufacturer.
- Certain trade promotions, especially those that are linked either directly or indirectly to the retail price featured by the retailer, coordinate the channel. Others, such as scan-backs, alleviate the forward buying problem and they can be designed such that manufacturers are better off and retailers are no worse off. These “pay-for-performance” trade promotions are just as beneficial for the manufacturer as they are for the retailer, if not more so.
- Slotting allowances do reflect greater retailer influence on new product introductions, and large retailers may receive higher allowances than small ones. But, they are also an efficient risk sharing and demand-supply equalizing mechanism in a competitive environment where supply of new products has increased tremendously and opportunity costs of shelf space are very high.

3. Consumer promotion & manufacturer-retailer interaction

As the budget allocation of packaged goods companies moved away from media advertising and towards promotion (Donnelley Marketing, 1997), the business press claimed that this shift in spending was hurting brand loyalty by encouraging brand switching and increasing consumer price sensitivity (Sloan, 1992). Academic research buttressed this view by showing that the biggest component of the sales bump during a consumer promotion is due to brand switching (Neslin, Henderson, and Quelch, 1985; Gupta, 1988; Blattberg & Neslin, 1990, p117). The effect of promotion on sales can be decomposed into brand switching, stockpiling, and increased consumption and the relative size of each component has important implications for the profit of manufacturers and retailers. For instance, brand switching benefits manufacturers only in the short term and does not benefit retailers at all while increased consumption benefits manufacturers as well as retailers (van Heerde, Leeflang, and Wittink, 1996). In the last few years, researchers have provided new insights into the switching, stockpiling, and consumption effects of promotion, both in the short and long term. In addition, P&G’s value pricing strategy (Shapiro, 1992) has afforded an unusual opportunity to examine the effect of a major change in promotion policy.

3.1. *The effect of promotion on consumption*

Most promotion research has been conducted using scanner data, which provide information on consumer purchases but not on consumption. In the past, researchers assumed that consumption rate was unaffected by promotion, and attributed the bump in brand sales during a promotion to either brand switching or consumer stockpiling. However, researchers have now shown that promotion induces not just a cross-sectional and temporal shifting of demand, but also an increase in category consumption, and, consequently, it is more beneficial to manufacturers than previously thought. Assunção and Meyer (1993) and Ho, Tang, and Bell (1998) show analytically that increased consumption is a rational response to promotion induced stockpiling and the higher price variance caused by price promotions, respectively. Wansink and Deshpandé (1994) show experimentally that the increased inventory generated by promotion increases usage rate for products that are perishable, have multiple/flexible usage occasions, or occupy a prominent place in the pantry, and Chandon and Wansink (2000) show that the effect depends upon the category's consumption convenience. Stockpiling increases the number of consumption occasions for high convenience products like granola bars but only increases consumption quantity per consumption occasion for low convenience products like noodles.

Ailawadi and Neslin (1998) measure the effect of promotion on consumption using scanner data, by estimating a flexible function that relates household inventory to usage rate. They find that increased consumption accounts for a significant portion of the sales promotion bump for yogurt, but not for ketchup. These findings are supported by Bell, Chiang, and Padamanabhan (1999) and Nijs et al. (2000). The former study finds that consumption is highly flexible for impulse categories such as bacon, potato chips, soft drinks, and yogurt, that consumers can easily “switch” in and out of, but not for staples like bathroom tissue, detergent, coffee, and paper towels. The latter study covers 560 different product categories and finds that promotion significantly increases category demand in 58% of them. Thus, promotion is not just a demand shifter; it significantly increases consumption in “switchable” and perishable product categories.

3.2. *Decomposing the sales promotion bump*

A related area that researchers have revisited concerns the decomposition of the promotional sales “bump.” As noted earlier, conventional wisdom has been that the primary effect of promotion is on brand switching. This is exemplified by Gupta's (1988) finding that 84% of the immediate sales promotion bump is due to brand choice. However, recent research shows that while brand switching is indeed the major part of the short-term promotion effect, it may not be as large as was previously thought.

For instance, using different econometric models, Bucklin, Gupta, and Siddarth (1998) find that only 58% of the sales bump is due to brand switching in the yogurt category, and Pauwels, Hanssens, and Siddarth (2000) find that the percentage is 75% for yogurt and 48% for soup. Bell, Chiang, and Padmanabhan (2000) find that the brand switching component averages 75% across 13 different product categories, ranging from a high of 94% to a low of 49%. In addition, recent methodological work by Sun, Neslin, and Srinivasan (2000)

shows that the switching effect may be significantly smaller than that estimated by logit models if consumers are rational and adjust their purchase timing to the timing of promotions. If the smaller switching component is attributable to increased consumption, then, it is good news for both manufacturers and retailers. However, if it simply means more stockpiling, then it is a cause for concern for manufacturers. As I noted above, at least for some product categories, it may be the former.

3.3. Long-term effects of promotion

New research has also studied the long-term effect of promotion on price sensitivity, brand equity, and sales. Mela, Gupta, and Lehmann (1997) and Jedidi, Mela, and Gupta (1999) estimate a varying parameter model of consumer purchase behavior using eight years of data for an undisclosed nonfood category. They, as well as Kopalle, Mela, and Marsh (1999), show that, consistent with conventional wisdom, price promotion increases price sensitivity in the long term.

However, the findings on long term effects of promotion on brand equity and sales are mixed. Brand equity is often measured as the intrinsic brand preference or the constant term in a choice or sales model. Jedidi, Mela, and Gupta (1999) and Kopalle, Mela, and Marsh (1999) find that price promotion has a negative effect on brand preference in the long term. However, this has to be weighed against the fact, now established by researchers like Keane (1997), that purchase of a brand in one period increases its intrinsic preference in subsequent periods. This is called state dependence or purchase event feedback. Although the feedback from promotional purchases may be less than that from regular purchases, it is still positive (Papatla & Krishnamurthi, 1996; Gedenk & Neslin, 1999). In order to estimate the net long-term effect of promotions on brand preference, researchers need to model both varying parameters and purchase event feedback together.

As far as the long-term sales effect is concerned, Mela, Jedidi, and Bowman (1998) estimate a purchase incidence and quantity model. They find that promotion has a positive effect on purchase quantity but a negative effect on purchase incidence, that is, consumers learn to “lie in wait” for promotions and stockpile on deal without increasing consumption. Jedidi, Mela, and Gupta (1999) estimate a choice and quantity model and find that promotion elasticities are positive in the short term but negative in the long term, especially for promotion depth. This, together with their finding that promotion reduces brand preference, implies that promotion decreases sales in the long term.

In contrast, Pauwels, Hanssens, and Siddarth (2000) use times series VAR models to study all three decisions together, that is, incidence, choice, and quantity, for two product categories, soup and yogurt, and report a positive long term effect of promotion on sales. They find that, in the vast majority of cases, the total effect of promotion on purchase incidence is positive, not negative. In fact, in their analysis, the largest part of the total sales bump is attributable to enhanced purchase incidence. These results are more in line with category expansion effects than with deal-to-deal buying and stockpiling. Sun’s (2000) dynamic structural model of canned tuna purchase behavior also shows that the long-term effect of promotion on sales is positive because it encourages not only brand switching and stockpiling but also increased consumption. Interestingly, she finds this positive promotion effect

even after allowing for consumers to optimally adjust their purchase timing and quantity to coincide with expected promotion schedules.

Clearly, the two sets of findings have very different implications for the long-term profitability of promotions to manufacturers and retailers. In cases where the former results hold, promotions may have a deleterious effect for manufacturers in the long term, whereas where the latter results apply, promotions may benefit both retailers and manufacturers. A positive long-term sales effect is consistent with Ailawadi, Lehmann, and Neslin (2001) whose analysis of P&G's value pricing strategy, using data for 24 categories over seven years, shows that promotion benefits market share. It increases the number of people who buy a brand, and does not hurt the share of their category requirements accounted for by the brand. Thus, even if promotion make consumers more price sensitive, its long-term effect on sales in a competitive environment may be positive because consumers are more likely to buy a brand when it is on promotion than when it is not.

3.4. *Summary*

Thus, the last decade of research has provided some important insights into the benefits of consumer promotions to manufacturers, but it has also revealed some issues that require resolution.

- Conventional wisdom is supported in that promotion increases price sensitivity in the long term, making deeper and more frequent price cuts necessary to achieve the same sales effect.
- However, it is refuted in that promotion not only causes temporal and cross-sectional shifts in demand, but it also increases primary demand, especially in product categories that are perishable, “switchable,” or convenient to consume. Thus, it is more beneficial to manufacturers than previously thought.
- The long-term effect of promotion on brand preference and sales is still unresolved. There is evidence of a negative effect on both from one nonfood product category. But, the well-established existence of purchase event feedback implies a positive effect on brand preference and there is evidence from some food categories of a positive long-term effect on sales.
- Irrespective of these long-term effects, packaged goods manufacturers need to be wary of making major changes in promotional policy. Big cuts in promotion hurt market share because they significantly decrease penetration and do not improve share of requirements.

4. **Store brands and manufacturer-retailer interaction**

Store brands have made significant inroads into the packaged goods market in the eighties and nineties. The average market share of store brands was up from 15.3% in 1988 to 20% in 1998 (Marketing News, 1995; Dunne & Narasimhan, 1999). It has been argued that the success of store brands has provided retailers increased leverage over manufacturers in

several ways. Store brands provide higher margins to retailers than national brands do and also allow them to negotiate better margins on national brands from manufacturers. They are a means for retailers to attract value conscious consumers away from national brands and build store loyalty and differentiation. Although these mechanisms have often been discussed in the business press, only recently have they been systematically investigated in theoretical and/or empirical research.

4.1. Higher margins on store brands

It is well accepted that retail gross margins are higher on store brands than on national brands. Connor and Peterson (1992) and Ailawadi and Harlam (2000) note that the primary reason for a margin differential is that, in contrast with national brands, private label suppliers have very little market power. They are much less concentrated than national brand manufacturers and operate in a competitive market with no product differentiation. As a result, they may sell to retailers at a price close to their marginal cost.

In terms of empirical evidence, early studies noted that average gross margins were greater for store brands than for national brands but they relied on data from the sixties and seventies (e.g., Food Marketing, 1965; Supermarket Business, 1992). Ailawadi and Harlam (2000) use recent data on a wide variety of product categories from two retail chains to examine not only gross but also net contribution margins (after accounting for direct product costs incurred by the retailer). They confirm that both gross and net margins are significantly higher for the store brand compared to national brands, although the difference is somewhat smaller for net contribution margins than for gross margins. All else equal, the significantly higher margins available from store brands are certainly tempting for retailers. In fact, they have been cited as the most important reason why retailers carry store brands (Discount Merchandiser, 1996).

4.2. Higher margins on national brands

In the last few years, the business press has also discussed the bargaining power that a successful store brand can confer on a retailer (e.g., Hoch, 1996; Harrison, 1999a,b). Several analytical models have now been developed to show that a credible store brand threat can allow retailers to negotiate higher margins on national brands from manufacturers. They differ, however, in their view of what constitutes a credible threat. Mills (1995) shows that having a high share store brand allows retailers to earn higher gross margins on national brands. According to his model, both wholesale and retail prices of national brands fall as store brand share increases, but wholesale prices fall more than retail prices, thus increasing retail margins. Narasimhan and Wilcox (1998) and Morton and Zettelmeyer (2000) also model the negotiating power of a credible store brand threat. However, they argue that the ability of a retailer to extract more channel profit lies in the market share that the store brand could attain, that is, an unexercised threat, not the actual market share attained by the store brand. Narasimhan and Wilcox (1998) predict a negative relationship between store brand market share and retail margin on national brands, noting that manufacturers may not find it worthwhile to reduce the wholesale price of their brands if the store brand share is very high.

Ailawadi and Harlam (2000) attempt to resolve this debate by developing a structural

model of national brand margins and estimating it with category level data from two very different retail chains. They find a significantly positive relationship between store brand share and national brand margin for both retail chains even after controlling for the fact that retailers are likely to put more effort behind the store brand in high margin categories. Having a high store brand share in a product category does enable retailers to obtain significantly higher profit margins on national brands in that category. It appears that national brand manufacturers decrease their prices to retailers in categories where the store brands narrow their share gap with the national brands.

4.3. The profitability of store brand users

During the nineties, retailers have viewed the store brand not just as an offering at the low price and low quality end of the spectrum but as a means for improving image, differentiating themselves from the competition, and engendering customer loyalty (e.g., Marketing News, 1987; Mogelonsky, 1995). Recent research suggests that store image and loyalty may improve as consumers become familiar with the store brand. Their shopping is also facilitated by the ability to buy a single brand across a wide range of product categories (e.g., Steenkamp & Dekimpe, 1997; Baltas & Doyle, 1998; Hoch & Lodish, 1998). The increased store loyalty is likely to increase retailer profit as consumers buy more of their requirements from the retailer. In fact, Corstjens and Lal (2000) show that the store loyalty engendered by a quality store brand can improve retailer profitability even when the store brand does not have a margin advantage over national brands. They obtain a positive correlation between store brand use and behavioral store loyalty using purchase data from a scanner panel. Ailawadi, Neslin, and Gedenk (2001) develop a structural model of store brand use and estimate it using self-reported measures of store brand use, store loyalty, and other psychographic characteristics. They too find that, after controlling for other psychographic correlates of store brand use, store loyalty has a positive relationship with store brand use.

However, the overall impact of this store brand driven loyalty depends upon how profitable store brand users are to the retailer. Ailawadi and Harlam (2001) compare the profitability of nonstore brand users, light/medium users, and heavy store brand users and find two pieces of “good news” for retailers. First, customers who buy a lot of store brands do not selectively buy other items that are significantly less profitable on a percentage basis. Second, customers who buy at least some store brand items contribute much more to the sales and profit of the retailer than those who do not buy any store brand items. However, they also find that heavy store brand buyers buy significantly fewer items in total and therefore contribute much less to the sales and dollar profit of the retailer than light store brand buyers. They conclude that retailers must retain a balance between store brands and national brands in order to attract and retain profitable customers who buy some store brands but not too many.

This supports the view of Farris and Ailawadi (1992) and Johnson (1994) that retailers cannot push store brands too much at the expense of national brands. The latter continue to be major traffic builders and reducing national brand choices may make the store less attractive to its most profitable shoppers. It is also consistent with Corstjens and Lal’s (2000) result that, for a quality store brand strategy to be profitable, there should be enough

customers who buy national brands. This balance is in the best interest of consumers since it ensures broad choice as well as low prices. The strength of store brands keeps manufacturers in line by inducing them to offer competitive wholesale prices on national brands. The strength of national brands keeps retailers in line by inducing them to compete with one another and offer competitive prices.

4.4. Competing with store brands

As low priced store brands have become more prevalent, manufacturers feel greater pressure to promote their national brands in order to retain value conscious customers. In fact, Lal (1990) and Quelch and Harding (1996) have argued that national brand promotions are an effective way to combat the growth of store brands. But this is true only if store brands and national brand promotions attract the same segments. Ailawadi, Neslin, and Gedenk (2001) find that national brand promotion usage and store brand usage are distinct behaviors, associated with different psychographics. Store brand users save money with everyday low prices on store brands, at the expense of quality, because their costs of time, thinking, storage space, and store switching are high. In contrast, users of promotions, especially “out-of-store” promotions like coupons, enjoy and plan their shopping, and their storage, thinking, and store switching costs are low, so they are willing to incur the effort involved in using promotions. These differences are strong enough to result in two separate segments, store brand users and national brand promotion users. However, there is also a sizeable segment that uses both, and one that uses neither.

The implication is that manufacturers and retailers can either avoid each other or compete head-to-head. If they want to reduce their tug-of-war, they can target promotion users and store brand users respectively. On the other hand, if manufacturers want to battle store brands, they can target the segment that uses both store brands and promotions. This will work only partially since there is still a substantial segment that exclusively buys store brands. The flip side is that retailers too, can only use store brands to attract customers away from national brand deals to a limited extent. Store brands do not provide the hedonic utility and quality that national brand promotions do.

Of course, if retailers are able to improve both the actual and perceived quality of store brands, manufacturers will have a tough time retaining their share of the market, witness retailers with a wide assortment of high quality store brands, like Trader Joe’s in the U.S. and Loblaws in Canada. Several researchers have found that quality is a critical factor that determines the success of store brands (e.g., Hoch & Banerji, 1993; Sethuraman & Cole, 1997; Dhar & Hoch, 1997; Steenkamp & Dekimpe, 1997). However, Sethuraman (2000) shows that national brands enjoy a level of equity and image, over and above quality, that is not offset by the lower price of store brands.

4.5. Summary

In summary, new research supports the conventional wisdom that store brands have the ability to improve the position of retailers versus manufacturers. However, it also shows that

national brands are essential to the success of retailers, so pushing store brands too far has its downside.

- Store brands do improve percentage category margins for retailers. Both gross and net retail margins are significantly higher for store brands than for national brands and retailers obtain higher margins on national brands in categories with a high store brand share.
- Retailers can build store loyalty through strong store brands, and store brand users are more profitable than consumers who do not buy store brands at all. However, the most profitable customers are those who buy some but not too many store brand items. In order to retain them, retailers must balance their national brand and store brand offerings.
- Manufacturers can combat store brands to some extent with promotions on national brands. However, there are significant segments that use either national brand promotions or store brands, but not both. This makes it harder for both manufacturers and retailers to capture the other's customers, and, in fact, may serve to reduce competition between the two parties.

5. Conclusions and implications for future research

The research I have reviewed in this article provides a better understanding of the impact of trade promotions, consumer promotions, and store brands on manufacturer and retailer performance. Many findings, such as the channel coordinating role of trade promotions, the impact of special kinds of pay-for-performance trade deals, and the ability of consumer promotions to increase category consumption and long term sales, show that promotions benefit manufacturers more than previously thought. Thus, trade and consumer promotions prevail not because powerful retailers force unwilling manufacturers to offer them, but because they are at least as beneficial to manufacturers as they are to retailers. Some other findings, such as a possible anticompetitive role of slotting allowances and the bargaining power of retailers with strong store brands, do support an improvement in the performance of retailers but this improvement is limited by market factors.

5.1. Trade promotion

The major contribution of new research in this area has been to provide economic theory based explanations for why it is in the interest of manufacturers in a competitive environment to offer trade promotions. It has also provided some guidelines for manufacturers to design "better" trade promotions that improve total channel profit as well as their own share of it. However, some important questions remain unanswered.

First, it is still not clear whether slotting allowances are competitive or anticompetitive. In fact, this question may soon be examined by the FTC (Thayer, 2000). Although theoretical models and the perceptions of managers suggest some aspects of both, there is a need for empirical work. This should address the magnitude of slotting allowances to variables such

as size of the manufacturer and retailer, nature of product category, advertising and “pull” promotion spending, and ultimate success of the new product.

This dearth of empirical evidence applies to other types of trade promotions as well. Our understanding of the impact of trade promotions on the profitability of manufacturers and retailers would be vastly improved with some empirical research.

The industry wide shift in the allocation of trade monies from off-invoice allowances towards more pay-for-performance deals like discretionary allowances and bill-backs provides a valuable opportunity for studying the effects of different types of deals on manufacturer and retailer profitability. Similarly, P&G’s value pricing strategy, which cut the levels of trade promotion while also shifting from off-invoice to pay-for-performance, is a natural experiment that can help us understand how retailers respond to a trade promotion policy change, and what the impact is on manufacturer and retailer profit. As Manning, O’Bearden, and Rose (1998) note, the impact of any change in policy by manufacturers depends upon the response that it receives from retailers. Although Ailawadi, Lehmann, and Neslin (2001) have studied the market share impact of P&G’s value pricing, they are unable to distinguish between manufacturer and retailer decisions given only retail level data.

5.2. *Consumer promotion*

That the short-term effect of consumer promotions on sales is positive and substantial is well established. New research shows that, in the short term, promotions may be even more desirable than previously thought since they can actually increase consumption of certain categories. It is not clear whether the long-term effect of promotions on sales is positive or negative, but it is clear that major cuts in promotion hurt the market share of a brand. In addition, consumer promotions allow the manufacturer to price discriminate (Narasimhan, 1984; Farris & Quelch, 1987) and retailers may provide better in-store placement, prices, displays and so forth to brands for which manufacturers generate consumer pull through promotions (Olver & Farris, 1989; Gerstner & Hess, 1995). All of this helps explain why manufacturers find it profitable to continue to promote despite the fact that promotions increase price sensitivity in the long term. However, some important questions deserve attention to further improve our understanding of how promotions influence manufacturer and retailer performance.

One issue in need of resolution is the decomposition of the promotion effect into switching, consumption increases, and stockpiling, since the relative importance of these three components has a direct bearing on how profitable promotions are for manufacturers versus retailers. As logit models may significantly overestimate the brand switching effect, and the consumption component may be substantial for certain types of product categories, researchers need to revisit and revise the conclusions of previous logit models.

Second, it is important to reconcile the conflicting evidence about the long-term effect of promotions on sales. Researchers should determine whether the differences in results across studies can be explained by the type of product category studied, the econometric methodology used, the specification of the model, the time period studied, how a promotion is defined and so forth. The extent to which consumption of the category can be increased by promotion, and whether or not purchase event feedback is incorporated, may be particularly

important in resolving this issue. It is also important to examine how the long-term effect on sales may differ by type of promotion. There is some evidence that nonprice promotions are not damaging to price sensitivity in the long term (Mela, Gupta, & Lehmann, 1997) and they result in more positive purchase feedback than price promotions (Gedenk & Neslin, 1999). Thus, although the immediate effect of price promotions may be stronger than nonprice promotions, in the long term, this may well be reversed.

Finally, while there is a lot of research on the effects of promotion on sales, there is strikingly little new empirical evidence of the profit impact of promotions. Although some researchers like Jedidi, Mela, and Gupta (1999) and Ailawadi, Lehmann, and Neslin (2001) have done some useful profit calculations, these are based on assumptions about cost structure, margins and so forth that may or may not be valid. Especially for moves like P&G's value pricing, which were made at least partly to obtain cost savings, understanding the real impact on profit would be very useful. Of course, this is only possible if manufacturers and retailers are willing to share their data with researchers.

Such analyses also require that the costs of promotions be accounted for in a fair and uniform way. Farris and Quelch (1987) noted that the common practice of comparing the promoted price of a product to its highest list price in order to determine the cost of promotion unfairly exaggerates promotion costs. They recommended that the comparison should be made with the lower price that the manufacturer would charge under a no-promotion policy. If marketers want to understand the profit impact of promotions, they must first determine what the manufacturer and retail price would be and how much they would sell under a no-promotion policy.

The process of going through this far from trivial exercise is likely to prove enlightening as to the real cost and benefit of promotions. Ailawadi, Lehmann, and Neslin's (2001) finding that the net price paid by consumers for P&G products actually increased significantly as a result of value pricing, may pique readers' interest in this issue. The profit impact of the strategy depends critically on whether P&G raised its net manufacturer price or retailers did not pass along P&G's price reduction to consumers.

5.3. *Store brands*

The overarching conclusion here is that strong store brands benefit retailers through higher margins on store brands, the ability to negotiate lower wholesale prices on national brands, and higher store loyalty. Thus, conventional wisdom has been largely supported in this area. However, this research also shows that retailers' ability to exploit store brands is limited because consumer preferences for national brands are strong and a competitive national brand assortment is critical for retail profitability.

There are still many issues for future research to address, of course. First, wider validation of the ability of retailers to negotiate higher margins on national brands would be helpful. One possibility would be to compare retail margins before and after a store brand is introduced in a category and track both wholesale and retail price changes. Such an analysis would also allow researchers to test the predictions made by Raju, Sethuraman, and Dhar (1995) regarding the circumstances in which store brand introduction is profitable for a retailer.

Second, we need a better understanding of how profitable heavy store brand users are to a retailer and why. For instance, why do heavy users of store brands tend to buy less from a given retailer, and how can we reconcile this fact with other research that shows store brand use is associated with greater store loyalty. Addressing this question conclusively would require panel data from all the major stores in a market, covering not just a few product categories but the entire shopping basket of each panelist.

Third, what is the causal relationship between store loyalty and store brand use and how can retailers exploit the store loyalty of their customers? On one hand, store loyal consumers tend to be less price sensitive, which would suggest that retailers could charge them higher prices (e.g., Kim, Srinivasan, & Wilcox, 1999). On the other hand, store brand users are known to be very price sensitive so they would react very strongly to any price increases. How can these two seemingly divergent findings be explained?

In conclusion, I note that this review has concerned itself with three phenomena that were widely supposed to be related to retail power. There are others, such as increasing retail concentration and retailer access to scanner data, which also deserve attention. Messinger and Narasimhan (1995) provide evidence that retail concentration has increased, but they also note that manufacturer concentration has increased at a faster rate. Further, even as grocery retailers consolidate, they are facing increasing competition from warehouse clubs and discount merchandisers. It would be interesting to empirically examine what impact the entry of a mass merchandiser like Wal-Mart has on the pricing, sales, and profitability of traditional grocery retailers in the area.

Chu and Messinger (1997) show, through an analytical model that, if retailers are indeed able to acquire and use information, their profits should increase. However, there is no empirical evidence to confirm that retailers have acquired the expertise to actually use the scanner data that is generated in their stores. A recent review of the commercial use of scanner data by Bucklin and Gupta (1999) does an excellent job of surveying the state of the art from the perspective of manufacturers and market research companies but it does not include retailers. A similar comprehensive survey of retailers aimed at determining how much they use scanner data, and for what types of issues, would be a very helpful starting point. Similarly, a survey of the different types of loyalty programs used by retailers, what information they include, and how it is used to make merchandising decisions, would also be very insightful. Ultimately, all these variables must be included in a comprehensive structural model of the factors that influence retail profitability, to be estimated with longitudinal data from a wide variety of retailers.

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