

The Sourcing Strategy Decision for Private Brands in Grocery Retailing

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Abstract

Since grocery retailers strategically use their private brands, they place importance on the quality of the products. Accordingly, the importance of the sourcing strategy decision for grocery private brands has increased. However, to date, there is a lack of research. For this reason, this study examines a number of factors influencing the sourcing strategy decision for private brands in grocery retailing. The main purpose of this study is to develop a model conceptualizing how transaction cost factors and organizational factors moderate the path from ideal sourcing strategy based on competitive positioning to actual sourcing strategy. The proposed model offers some managerial guidance to grocery retailers by presenting factors that should be considered in evaluating and determining the sourcing strategy for private brands.

Keywords: Sourcing strategy decision, private brands, grocery retailing, in-house production, outsourcing

JEL classification code: M11

Introduction

As one of the emerging trends, retailers will continue to place importance on their private brands (Griffith & Krampf, 1997). Evolving from lower quality and me-too products into value-driven products, private brands have increasingly penetrated the market during the past decade. According to ACNielsen (2003), private brands represent 15 % of the market share in grocery retailing across 36 countries, with their growth rates being slightly higher than those of manufacturer brands. In the United States, private brands are now generating one-fifth of all grocery sales (Dunne & Narasimhan, 1999). As the differences among products, prices, and retail services are indiscernible, retailers want to differentiate their retail chains and products from their competitors by introducing and developing private brands (Bell, Davies, & Howard, 1997). Because private brands are exclusively offered in certain grocery retail chains, consumers consider them as extensions of the store image, which contributes to store differentiation and store patronage (Steenkamp & Dekimpe, 1997). A greater contribution comes from premium private brands with quality better than or the same as national brands (Corstjeans & Lal, 2000). Thus, grocery retailers pay more attention to quality of private

brands and control of the supply chain (Erdem, Zhao, & Valenzuela, 2004). Integration of the supply chain is critical because it largely influences private brand development, which allows retailers to increase added value (Laaksonen & Reynolds, 1994).

Some retailers manufacture their own private brands while others source from outside suppliers (Fitzell, 1998). Private brands in grocery retailing have been usually sourced from outside manufacturers (Fitzell, 1992). However, the impressive growth of private brands in the past few decades has placed retailers in a dual position as both manufacturers' clients and competitors in production (Tarziján, 2004). According to Kroger Fact Book (2004), Kroger has manufacturing plants and produces 55% of the corporate brand products, such as breads, dairy products, meat, and grocery items. For superior quality, Kroger's in-house quality assurance group monitors the quality of private brands. When producing private brand products internally, retailers are becoming "manufacturers" in terms of participating in product design, product development, and quality control of private brands (Burt, 2000).

The make-or-buy (i.e., in-house production vs. outsourcing) decision has been recognized as the key strategic decision within the company (Cox, 1999; McIvor, Humphreys, & McAleer, 1997). However, many companies have no solid guideline for determining whether to choose in-house production or outsourcing (Ford, Cotton, Farmer, Gross, & Wilkinson, 1993). Likewise, in retailing, the academic literature has neglected the sourcing strategy decision for private grocery brands despite retailers' more active roles in production due to private brand development. In addition, there is a limitation of directly applying previous studies on the sourcing strategy developed for the manufacturing industry to grocery retailing. For example, some retailers produce products internally. However, this is not their core business area (Fitzell, 1992). Being involved in in-house production means that grocery retailers expand their business scope into a new area, which may require grocery retailers to possess financial resources and production skill.

In grocery retailing, some products (e.g., sugar) have commodity characteristics which tend to be broad and undifferentiated (Smith, 1979). Those products are purchased largely on a price basis. On the other hand, some premium products (e.g., gourmet ice cream) have characteristics that are unusual and generate subjective values determined largely by the mind-set, the social and economic standards of the buyers (Smith, 1979). Depending on whether the product has commodity or premium characteristics, a different approach on the sourcing strategy decision should be implemented. For example, in the case of basic and low-price private label products, it is often that retailers rely on the manufacturers' product development and buy a finished product at the lowest possible price thus using a cost-driven strategy (KPMG, 1999). In premium markets, on the other hand, unique and highly subjective values beyond functional benefits are keys for success (Smith, 1979). Thus, the sourcing strategy decision needs to assure differentiation of products for providing unique values to a certain consumer segment.

This study examines factors influencing the sourcing strategy decision for private brands in grocery retailing. The main purpose of this study is to develop a model conceptualizing how transaction cost factors and organizational factors moderate the path from ideal sourcing strategy based on competitive positioning to actual sourcing strategy. This study only considers the sourcing strategy decision in grocery retailing. For the actual sourcing strategy, two possible sourcing strategies, outsourcing and in-house production, are considered.

Conceptual Framework

As shown in Figure 1, the model illustrates that competitive positioning of a private grocery brand influences a retailer's ideal sourcing strategy. The ideal sourcing strategy is moderated by transaction cost and organizational factors, resulting in the actual sourcing strategy.

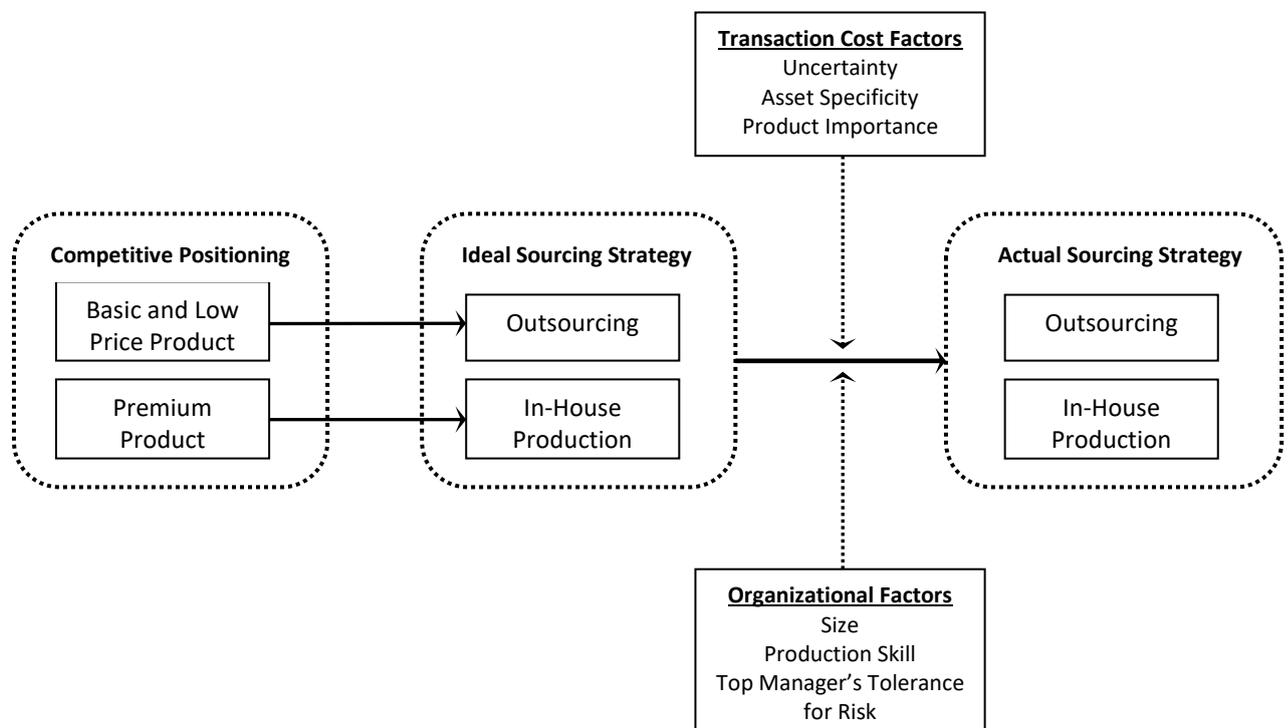


Figure 1. A model of sourcing strategy decision for private brands in grocery retailing

Effects of competitive positioning on ideal sourcing strategy

Private brands are positioned differently based on the image of the store and quality of the products (Davies, 1998). For example, the Aldi name represents a low-price image so that Aldi has positioned its private brands as basic and no-frills products and has pursued a low-cost strategy (Davies, 1998). On the other hand, private brands of Albert Heijn, the largest grocery retailer in the Netherlands, have been positioned as premium products due to the attractive design of its store and quality products (Semeijn, van Riel, & Ambrosini, 2004).

As private brands have become upscale in today's retail market (Dunne and Narasimhan, 1999), many grocery retailers have become focused more on premium private brands (Kumar, 1997). One of the newest trends in private brands is that grocery private brands have been divided into different tiers: the premium product, first quality product (i.e., the equivalent of national brands at a lowest cost) and economy product (Large, 2005). Many retailers introduced their premium products, such as "Private Selection" (Kroger), "Sam's American Choice" (Wal-Mart), and "Essensia" (Albertsons). Kroger's "FMV" and Albertsons' "Good Day" are examples of economy products. This model examines two different tiers of private brands categorized by competitive positioning: basic and low-price product and premium product. In the model, *basic and low-price product* refers to a basic commodity product with low price (e.g., milk, frozen green beans). *Premium product* is defined as the product of high price and high perceived quality, is exclusive to a certain retail store (e.g., Essensia's organic blueberry juice).

The model assumes that a retailer's ideal sourcing strategy depends on the competitive positioning of a private brand. According to Hooley, Greenley, Fahy, and Cadogan (2001), competitive positioning is formed by combining choice of target market with competitive advantage. For example, in order for price positioning to be successful, companies target a price-sensitive customer segment with a cost advantage (Hooley & Broderick, 1998). Accordingly, previous research (Harrigan, 1985; Jennings, 2001) pointed out the importance of consistency between an organization's sourcing strategy and competitive advantage. Thus, the firm's sourcing decision needs to support the business strategy and to be modified as competitive conditions change (Jennings, 2001).

Many companies develop outsourcing for cost efficiency or cost reduction (Anderson & Weitz, 1983; Fill & Visser, 2000), while some companies employ in-house production for product or store differentiation (Anderson and Weitz, 1983; Jennings, 2001). When outsourcing a product from a manufacturer, the product may not be distinguishable in the eyes of the customers because the manufacturer supplies the product to other retailers (Venkatesan, 1992). Hence, the model suggests that a retailer will pursue outsourcing for its basic and low-price product because outsourcing strategy can boost cost advantage and efficiency. On the other hand, a retailer will pursue in-house production utilizing production know-how, such as a unique product recipe, for its premium brands that is expected to contribute to store differentiation. Because high quality premium products create enough appeal for consumers, quality control of premium brands is increasingly emphasized. In-house production can permit powerful quality control of premium brands for grocery retailers by allowing more involvement in the production process (Bell et al., 1997). Thus, the following propositions are developed.

Proposition 1a: If a grocery private brand is positioned as a basic and low-price product, a retailer is more likely to pursue outsourcing.

Proposition 1b: If a grocery private brand is positioned as a premium product, a retailer is more likely to pursue in-house production.

Factors moderating the path from ideal sourcing strategy to actual sourcing strategy

Transaction cost factors

Transaction costs are generated in any exchange (Williamson, 1981), associated with identification of appropriate partners, contract development, and monitoring of partners' execution (Pache, 1998).

Uncertainty. A certain degree of inherent uncertainty exists in all transactions (Spekman and Strauss 1986). In an uncertain environment, opportunistic behaviors (e.g., self-interest seeking behaviors in a deceitful way) by other parties easily arise and they might be undetected. Information asymmetry is also expected to occur because a buyer and a supplier might not have equal access to relevant market information (Spekman & Strauss, 1986). Uncertainty causes contracts to be revised frequently because exact predictions are difficult (Anderson & Weitz, 1983), which forces retailers to adopt in-house production (Hobbs, 1996). Thus, uncertainty makes transaction costs high through outsourcing, which suggests that in-house production would become a more viable option. Similar to other industries, uncertainty resulting from market competition, dynamic consumer trends, technological innovation, and economic recession will be a deterrent for grocery retailers trying to outsource their private brands due to the difficulties associated with writing contracts with suppliers. Thus, under high uncertainty, our initial proposition that outsourcing will be considered as the ideal

sourcing strategy for basic and low-price products may be less likely to occur. However, when pursuing in-house production, there is no concern for opportunistic behaviors by other parties and information asymmetry between two parties. Hence, our initial path will not be moderated by uncertainty. Thus,

Proposition 2a: For basic and low-price grocery private brands, the higher the level of uncertainty, the less the likelihood of pursuing outsourcing.

Proposition 2b: There is no effect of uncertainty on the initial path for premium grocery private brands (premium grocery private brands → in-house production).

Asset specificity. Asset specificity refers to specialized investments for a particular transaction (Williamson, 1981). After specific investments have been made, a termination of the contract between a buyer and a supplier can cause several problems. Possibly, a buyer cannot easily find alternative sources of supply and thus cannot make a contract in an advantageous position (Williamson, 1981). In this circumstance, a buyer becomes locked into a certain supplier and placed in a vulnerable position (Anderson & Weitz, 1983). As asset specificity increases, grocery retailers should make special efforts (e.g., fully described contract development and deliberate selection of partners) for continuing successful exchanges with suppliers, accordingly leading to high transaction costs.

In grocery retailing, asset specificity might increase when a private brand is narrowly focused on a specific market segment. For example, some retailers launch new private brands supporting emerging customer values, such as healthy eating, animal welfare, and environmental concern (Burt, 2000). Another case is the private brand specialized for a certain ethnic market. In both cases, private brands are not standardized products and thus production specifications cannot be easily transferred between suppliers. Moreover, specialized equipment and knowledge might be required for producing those products. As a result, asset specificity will increase, which in turn will increase transaction costs in sourcing the products from outside suppliers. Thus, asset specificity will negatively influence grocery retailers to pursue outsourcing for basic and low-price products. However, when pursuing in-house production, there is no concern for a termination of the contract with a manufacturer so that asset specificity does not have an impact on grocery retailers' selection of in-house production of premium products. Thus,

Proposition 3a: For basic and low-price grocery private brands, the greater asset specificity, the less the likelihood of pursuing outsourcing.

Proposition 3b: There is no effect of asset specificity on the initial path for premium grocery private brands (premium grocery private brands → in-house production).

Product importance. Product importance has been determined in various ways, including the product's purchase cost to total purchase, product's impact on the company's image (Spekman & Strauss, 1986), and product's contribution to total company sales (Jolly & Branson, 1991). The market penetration level of grocery private brands differs by product category (Dhar & Hoch, 1997). Higher market share was gained in categories with high perceived quality, low quality variability, high gross margins, less-promotion by national brands, and a small number of national brands (Hoch & Banerji, 1993). According to ACNielsen (2003), the largest shares of private brands were obtained in paper and food products, while the personal care, cosmetics, and baby food products had significantly lower shares of private

brands. Thus, products with higher market share may be considered more important to the retailer than products with lower market share.

Product importance affects the sourcing decision (Speckman & Strauss, 1986). If a certain private brand category is considered important to a grocery retailer due to its high contribution to company sales, it is critical to find an appropriate supplier with a certain level of production capability. In addition, if grocery retailers have to find a new supplier after terminating a contract with an existing supplier, they should make more efforts in finding a supplier for its private brands with high product importance than for those with low product importance because maintaining consistent quality of the product will substantially affect total sales of the retailer. This aspect will make grocery retailers hesitant in pursuing an outsourcing strategy for private brands which are considered very important to them. As product importance increases, our initial proposition that outsourcing will be considered as the ideal sourcing strategy for basic and low-price products will be less likely to occur. However, when pursuing in-house production, there is no concern for inconsistent quality of products due to change of a manufacturer. Hence, the initial path for premium products will not be moderated by product importance.

Proposition 4a: For basic and low-price grocery private brands, the greater product importance, the less the likelihood of pursuing outsourcing.

Proposition 4b: There is no effect of product importance on the initial path for premium grocery private brands (premium grocery private brands → in-house production).

Organizational factors

Previous studies indicated that in-house production requires much significant investment and production sophistication from the retailer compared to outsourcing (Campbell, 1995; Gilley, McGee, & Rasheed, 2004). Thus, some factors (e.g., financial resource and production skill) will be required for pursuing in-house production, which forces organizational factors included in the proposed model.

Size of retailer. The size of retailer influences the sourcing strategy decision. The effectiveness of in-house production can be achieved by controlling the internal costs arising from monitoring employees and conveying information, which are influenced by company size (Levy, 1985). Smaller companies seem to have a preference for outsourcing for quickly achieving economies of scale and scope (Sarkar, Butler, & Steinfield, 1998). Thus, for small retailers, our initial proposition that in-house production will be considered as the ideal sourcing strategy for premium products will be less likely to occur. However, there is no problem for small retailers to pursue outsourcing. Therefore,

Proposition 5a: For premium grocery private brands, the smaller the size of retailer, the less the likelihood of pursuing in-house production.

Proposition 5b: There is no effect of size of the retailer on the initial path for basic and low-price grocery private brands (basic and low-price grocery private brands → outsourcing).

Production skill. Production skill is an important condition necessary for the success of in-house production (Campbell, 1995). Because production is not a core business activity for retailers, production skill should be attained for pursuing in-house production. Due to supplier's production expertise and sophistication, many companies choose outsourcing instead of in-house production (Ford et al., 1993). High quality private brands lead to store

differentiation, store loyalty, and profitability (Corstjeans & Lal, 2000). Pursuing in-house production with limited production skill will result in providing low quality products. With such limited production skill, grocery retailers will be less likely to pursue in-house production for premium products. On the other hand, when adopting outsourcing for basic and low-price products, a grocery retailer depends on a supplier's production skill. Thus, the initial path for basic and low-price products will not be moderated by production skill.

Proposition 6a: For premium grocery private brands, the less production skill, the less the likelihood of pursuing in-house production.

Proposition 6b: There is no effect of production skill on the initial path for basic and low-price grocery private brands (basic and low-price grocery private brands → outsourcing).

Top manager's tolerance for risk. Gilley et al. (2004) argued that outsourcing needs a lower level of capital assets and investment in manufacturing capacity and thus has a low level of risk. This argument was approved by their finding that risk-averse executives prefer to engage in outsourcing rather than in-house production. Thus, when a top manager does not want to take a risk, our initial proposition that in-house production will be considered as the ideal sourcing strategy for premium products will be less likely to occur. In other words, grocery retailers associated with risk-averse top managers will be less likely to pursue in-house production for premium products. On the other hand, outsourcing does not incur higher risks than in-house production. The initial path for basic and low-price products will not be moderated by top manager's tolerance for risk. Thus,

Proposition 7a: For premium grocery private brands, the lower top manager's tolerance for risk, the less the likelihood of pursuing in-house production.

Proposition 7b: There is no effect of top manager's tolerance for risk on the initial path for basic and low-price grocery private brands (basic and low-price grocery private brands → outsourcing).

Conclusion

This paper has presented a conceptual model of how the sourcing strategy decision for grocery private brands might be achieved, starting from the ideal sourcing strategy based on competitive positioning of a private brand to the actual sourcing strategy moderated by transaction cost and organizational factors. Since grocery retailers strategically use their private brands, the importance of the sourcing strategy decision for their private brands has increased. Thus, this study addresses those research needs. The proposed model also offers some managerial guidance to grocery retailers by presenting factors that should be considered in evaluating and determining the sourcing strategy for private brands. Suppose a grocery retail manager needs to choose a sourcing strategy for its private brand which is narrowly focused on the Hispanic market. Based on the proposed model, the retail manager should determine the best sourcing strategy by analyzing the level of asset specificity, whether the retailer owns a certain level of production skill, or how the private brand will contribute to total company sales.

This model also suggests that grocery retailers should re-analyze the best sourcing strategy whenever competitive positioning of a private brand, transaction cost factors, and organizational factors change. For example, as product category shares of a private brand increase, a grocery retailer will not consider outsourcing as the best sourcing strategy for that

product any more. Therefore, decision makers must understand that an initially determined actual sourcing strategy at a certain point may not be optimal in the long term. Because there is a lack of research in this area, this paper can provide guidelines for future research. The proposed model must be empirically tested in future studies. To begin, a means to measure transaction cost and organizational factors should be identified. Secondly, this paper examined only two sourcing strategies. Therefore, other forms of sourcing strategies (e.g., developing product specifications by a retailer and having products made by a manufacturer) should be examined in future studies. As greater emphasis is being placed on quality control of private brands, grocery retailers must be more proactively involved in a series of activities within the supply chain. Thus, long-term and cooperative relationships between retailers and manufacturers will be more prevalent in the future. Therefore, there is a research need for various forms of sourcing strategies. Finally, future research should consider additional factors influencing the sourcing strategy decision in grocery retailing. One of them relates to perishable characteristics of grocery products. It may be a distinct aspect regarding grocery retailing and thus should be considered for sourcing strategy decisions in grocery retailing.

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