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Price and quality competition between brands and own brands

A value systems perspective

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Abstract *The selling prices to consumers of similar products vary considerably within the same retail outlet and between different types of retail outlet. Applying a value systems framework, the cost structures behind the selling prices of products in five product categories are identified using primary and secondary data. The quality of the competing products is also compared using conjoint analysis of the ratings given by consumers for the edible products and available chemical analysis in the case of detergents. The main explanation for the differences observed in selling prices and cost structures of competing value systems lay not in the interface costs between value chains such as logistics, as expected, nor only in advertising costs, but in the internal costs of individual value system members. In particular, the internal costs of brand manufactures are shown to be the main source of their cost disadvantage against own brands. Only in one product category was there a quality justification for the higher prices charged by the leading manufacturer brand.*

Consumers buying grocery and other everyday products can select from different brands and own brands within the same product type and choose to shop for the same products in different types of retail outlet. Similar products often sell at very different prices across the market. Our main aim in this paper is to explain why. Potential answers may be found in real differences in product quality, in differences in the cost structures of the companies in the different value systems, or in their interface costs, or that the customer is willing to pay a premium for brand imagery.

Retail strategic groups

Products branded by suppliers to the retail grocery sector have faced increasing competition from products branded by the retail sector itself (Dunne and Narasimhan, 1999). By the 1990s "own brands" accounted for one-quarter of retail sales in Britain, Germany and Switzerland and over 15 per cent in the USA, France, Denmark, Belgium and Holland (*The Economist*, 1995). The annual rate of increase in product lines sold as own brands in Europe has been

estimated at 11 per cent (Corstjens and Corstjens, 1995). Retailers now exist that sell few and sometimes no supplier-branded products. The dominant strategic group of grocery retailers in European markets is still that of the large store selling a range of both supplier brands and own brands. The term "superstore" is used to label the large grocery outlets operated by the likes of Sainsbury and Tesco in Britain. Their stores are 3-4,000 square metres in size. The term "hypermarket" is used to label the dominant group of similar, but even larger, outlets trading with a wider range of non-food items in France, Spain and much of Scandinavia (Tordjman, 1994). Sales of own brands in the retailers operating such large stores account for between 15 and 50 per cent of their turnover.

A second strategic group in Europe has very different features; a limited product range, low labour costs, small premises, minimal customer service and a dominance of own-branded products. Chains known as "hard discounters" such as Aldi, Netto and Lidl are almost identical in their trading format. Their selling prices are considerably below those in the larger, more up-market superstores and hypermarkets. Discount stores tend to be located in down market areas, but not exclusively. In the affluent market of Western Germany, for example, discounters hold a dominant market share and are patronized by most of society.

Own-branded products

Historically, it was believed that own-brand products appealed differentially to the poor. However, in a review of 13 earlier studies, McEnally and Harris (1984) found only one study reporting a higher purchase rate for own brands among low-income customers. Own brands are treated by customers much the same as supplier brands (Uncles and Ellis, 1989). Their purchase can be linked to specific behavioural (Baltus, 1997) as well as demographic factors (Hoch, 1996) and to perceived risk (Batra and Indrajit, 2000) but this is true of any product within any market.

There have been issues with the quality of own-brand products. Retailers have responded by investing in their own internal quality control departments to improve actual quality (Senker, 1987). They have developed premium priced own brands positioned on quality close to supplier brands (Quelch and Harding, 1996) to improve the perception of quality. Retailers can benefit from having their own brands in a number of ways; higher gross margins (Dhar and Hoch, 1997), an improved image with their own customers (PLMA, 1984), increased loyalty (Corstjens and Rajiv, 2000) and differentiation from other retailers.

Own-brand manufacturing has been seen as a marginally costed activity undertaken mainly by suppliers of brands or by small companies who lack the power to establish a brand franchise. Another feature of this market has, however, been the growth in substantial companies who specialise in the manufacture of own brands (Davies, 1990). (Suppliers of brands made few of

the own brands considered in this study.) The cost of establishing a brand image in more than one country has led some substantial companies, who offer only branded products in their home market, to provide own brand to retailers in other countries.

Some, but not all, own brands are derivatives of supplier brands and can therefore be far cheaper to develop. The protection given to suppliers who find their brands being imitated by own brands varies. Under British law, mimicking the presentation of another brand using similar packaging is an issue under consumer law. "Passing off", the wrong committed by presenting goods as if they were those of another, exists if the consumer is deemed to be confused by the similarity (Howard, 1994). Under German law the matter is dealt with under fair competition legislation, which tends to offer suppliers and their brands greater protection. In 1998 legislation allowing the registration of packaging designs was introduced into British law. This has strengthened the supplier's position, at least in theory, in markets governed by British law. In practice, and in any market, if a retailer does launch an own-branded copy of one of its products, the supplier is still left in the unenviable position of deciding whether to take legal action against a large customer.

Thus far, competition between own brands and brands has been seen mainly within the context of the retail outlet itself and from the point of view of the supplier of nationally branded products (Hoch, 1996). Using such analyses, a number of strategies have been identified for suppliers to counter the penetration of own brands. In the context of this paper the strategy of narrowing the price differential between supplier and own brands is important. Such moves can benefit the supplier brand, due to the different price elasticities typical of both types of product (Hoch, 1996; Quelch and Harding, 1996). High service retailers have their own price problems and are equally concerned to reduce the price differential between themselves and "hard discounters". To achieve what has now become a shared goal of lowering prices, suppliers and high service retailers have collaborated in initiatives that require viewing the supply chain more as a singly entity; in other words, as a value system. The empirical work reported here takes the same approach in assessing the competition between brands and own brands, the latter selling in both full service and discount retailers.

The value systems perspective

An individual company gains competitive advantage not only from its own value chain, but also from how it fits within the various value systems it joins (Porter, 1985, p. 34). In our context there are a number of different types of competing value system. The individual firms within each can include growers, raw material and packaging suppliers, manufacturers, wholesalers, retailers and logistics companies. We focus on the British market and its three main value system configurations, typified by manufacturers providing products

they brand themselves and sell via large, full service retailers; manufacturers of own-brand products and larger retailers; manufacturers of own-brand products and discount retailers. Together with their suppliers and logistics providers these three systems dominate the supply of grocery and other everyday products in most European markets.

Despite the view that the unit of strategic analysis should be the value system rather than the individual value chain (Normann and Ramirez, 1993), prior research in the field has been limited to specific issues within the value system, such as the need to manage inter-firm relationships in a less transactional way (Ring and Van de Ven, 1992; Lorange, 1988; Nielsen, 1988); and the benefits from coordinating functions such as purchasing (McIvor *et al.*, 1997), information technology (Lockett *et al.*, 1992) and logistics (Bowersox, 1990) across two or more companies within the same value system.

A value system's perspective involves viewing all individual value chains as part of a single entity and endeavouring to coordinate them as such (Porter, 1996). A number of practical initiatives with this in mind began in the 1990s, sponsored by leading brand manufacturers and large retailers under the banner of efficient consumer response (ECR) (Kurt Salmon, 1993) and category management (Dhar and Hoch, 2001). The primary motive was to reduce the total costs in such value systems and so become more price competitive with the system of own brands sold via discounters. ECR USA began in 1992, ECR Italia in 1993 and ECR Europe in 1994. The essence of ECR is for the manufacturer to make what the retailer has sold rather than for both to sell what the manufacturer has made. It involves the integration of logistics throughout the value system (Bowersox, 1990; McKinnon, 1990; GEA, 1994), such that data flows from the point of sale right back to suppliers of raw materials. Greater coordination between manufacturer and retailer is needed, together with a sense of partnership. Greater flexibility is needed in product manufacture (Womack and Jones, 1996).

It was claimed that very large sums were at stake if ECR was successfully implemented (Lee *et al.*, 1997). Kurt Salmon (1993) calculated that the consumer price of dry groceries in the USA could be reduced by an average of 10.8 per cent. GEA (1994) provided an estimate in Europe of 2.3 to 3.4 per cent of retail sales value. Coopers and Lybrand (1995) estimated 5.7 per cent of sales value in Europe, and higher figures in American and Australian markets.

One explanation for the higher estimates for American markets is the wider range of products normally on sale in large food stores within a product category (Kahn and McAlister, 1997). Another explanation is the greater role there of wholesalers. In Europe, most transactions are made directly between large retailers and their suppliers. The Italian market is an exception and the projected cost savings from ECR there are relatively high, at 13.4 per cent of grocery sales value (ECR Italia, 1997). The sources of cost savings by adopting an ECR philosophy include eliminating any wholesalers by direct dealing

between manufacturers and retailers; rationalising and simplifying product ranges; better coordination of marketing and particularly promotional activity and product introduction; and savings in stock holding. The potential savings will therefore vary depending upon the starting point of individual value systems, but many savings were expected to come from logistics costs of one type or another (Lee *et al.*, 1997). In practice, significant savings have been difficult to realise. One pilot study in Italy achieved actual cost savings of only 1 to 2 per cent of retail sales value, compared to the projected possible savings of ten times that level (ECR Italia, 1997), thus raising the question of whether large savings in cost can be attained.

The difference in final selling price between branded goods and own brands varies by retailer and product type, but they are higher than the savings implied even by the most optimistic projections for ECR. In one study, the price advantage for own brands ranged from 24 to 44 per cent (Dhar and Hoch, 1997). Thus, even if the most optimistic of cost savings projected for ECR are achieved, a significant price difference will still remain between manufacturer brands and own brands. Some other sources of cost saving will be needed to narrow the price gap or, failing that, a different strategy, one that is not based on cost and price reduction. To date there has been no study to explain why price differences exist that can guide any discussion as to how such differences can be narrowed and to allow a judgment as to whether existing initiatives are capable of closing such gaps.

Research issues and design
Our overall aim was to understand why competing value systems result in very different prices to the end customer. To achieve this aim we selected a number of product categories. We obtained data on the transfer prices of goods and services from one value chain member to another and on the costs added within each value chain by different elements such as production, marketing and logistics. In a second stage we used market research to assess how important product quality and brand image were in explaining price differences. The cost and price data we present here are only from the products for which we also have data on product quality.

The five product categories that were selected for analysis – detergents, breakfast cereals, yellow fats, sauces and biscuits – collectively account for over 10 per cent of total UK grocery sales. Within these we selected five product types:

(1) washing up liquids;

(2) cornflakes;

(3) margarine;

(4) mayonnaise; and

(5) cream crackers.

We were concerned to examine products with a range of manufacturing and product technologies, factors that could influence both product acceptability and the management of a value system. The simplest product to make is polyunsaturated margarine where hydrogenated food oils are purchased from the supplier, blended and votated into tubs. Cream crackers require significant capital investment in plant but are also relatively easy to make. Mayonnaise is an emulsion, liable to be unstable and to oxidation and therefore more difficult to manufacture. Cornflakes can be made by one of two processes, the traditional process of cooking, flaking and baking pieces of maize or by extruding a maize flour gel and shaping the gel into flakes prior to baking. All the food products are subject to both technical and craft based differences in organoleptic qualities. One product may taste or eat better than another because it is made from superior raw materials or because it is better made. Washing up liquid is not an edible product, but different ingredients and concentrations do produce very different qualities that are detectable both in use and in scientific tests. The products selected for detailed analysis are listed in Table I. In each market there is a leading supplier brand with a high market share and a significant penetration of own brands. This is typical of many product sectors in Britain.

Financial analysis

To analyse the cost structure of the various supply chains, information was gathered on different aspects of each market. As the various retailers,

Product category	Manufacturer	Brand	Percentage of market share by value
Washing-up liquid	Procter & Gamble	Fairy	46.0
	Lever	Persil	18.0
	Various	Own brand	20.0
Cornflakes	Kellogg	Kellogg	75.9
	Various	Own brand	15.6
Polyunsaturated margarine	Van-den Bergh (Unilever)	Flora	49.0
	Kraft	Vitalite	12.5
	Various	Own brand	18.0
Mayonnaise	CPC	Hellmann's	56.0
	HJ Heinz	Heinz	5.0
	Various	Own brand	31.0
Cream crackers	Jacobs/BSN	Jacobs	43.0
	United Biscuits	Various	23.0
	Various	Own brand	28.0

Sources: Euromonitor, AC Nielsen, Datamonitor, Market Intelligence

Table I.
Market shares of leading products and own brands for five product types

packaging and raw material suppliers, manufacturers and logistics companies all used different methods for allocating costs, we devised our own protocol. Our starting point was to obtain data on the selling prices at each stage in the value system. Retail selling prices to customers for individual retailers and products were obtained from the market research companies AC Nielsen and Taylor Nelson AGB for a full calendar year and an average taken.

Our main data came from personal interviews with managers working for firms who were at different stages in each value system. Typically 20 to 30 such interviews were needed for each product. The purchase prices of retailers from manufacturers were obtained from both retailers and their suppliers. Our convention was to exclude any indirect financial support given by manufacturers to retailers such as rebates or promotional allowances in determining the transfer price. Any such allowances are treated as part of the supplier's marketing costs.

Product formulations were obtained from manufacturers, from retailers in the case of certain own brands, from independent analysts, from competitors of manufacturers and from the declared list of ingredients. The costs of raw materials and packaging were obtained from manufacturers and their suppliers. Details about manufacturing processes were obtained from manufacturers and university departments. These were needed so that we could understand the manufacturing technologies involved so as to obtain estimates (for wastage and figures such as the water content of raw materials and finished product) to improve our calculations of the raw material costs per tonne of finished product. All analyses presented here are based on the dominant package size for each product. All costs are expressed in terms of tonnes of finished product. Advertising costs for manufacturers were taken from published sources (MEAL) to ensure that they were assessed in a similar way for each case.

Certain costs were estimated from companies' annual accounts. These costs included depreciation and the cost of working capital. The last was calculated using current bank interest rates. Other costs were derived from data obtained during personal interviews and visits. In particular we were interested in logistics costs, a major interface cost area. During visits, data on organisation structures and other background information were also gathered.

Our data were verified by confirming each statistic with at least one other source. This was essential in cases where a company or individual manager was unable to provide internal data. Once detailed analyses had been made, the results and our interpretation of them were discussed with industry members, to ensure that the cost structures we had calculated had face validity. We concentrated on identifying the direct costs to produce the final product inside the manufacturer, that is raw materials, manufacturing and advertising. Any difference between these and the transfer price to the retailer, less the company's declared pretax profit, represent "other costs" such as overheads,

research and development, price promotions to retailers, and contributions to (loss making) activities elsewhere in the manufacturer. It was these "other costs" that were to be significant in explaining the differences between the cost structures of competing value systems.

Results

One example is discussed first in detail to illustrate our approach. Table II contains data on the UK polyunsaturated margarine market, three different products selling via the same superstore retailer. All our cost data are presented as a percentage of the consumer selling price.

Taking the example of Flora, the UK's leading brand, we estimate that the cost of the main raw materials (hydrogenated food oils) represents 24.2 per cent of the price paid in the store by the shopper. Minor ingredients, mainly additives, represent 1.0 per cent. Packaging represents 18 per cent. Thus, in total, the manufacturer's purchases from suppliers represent 43.2 per cent of the final selling price. The retailer's gross margin is 8 per cent of the consumer price. What remains, 48.8 per cent of the final price, represents the manufacturer's internal costs and profit. Employee costs represent the highest individual element of this, at 10.4 per cent of the consumer selling price. They include only the labour costs to manufacture. The figure for "other costs" is calculated from the difference between the manufacturer's total added value and the sum of the costs we identify individually.

The average gross margin achieved by large British food retailers is 23 per cent (Business Monitor, 1996). We found that gross margins varied across product categories and between individual lines within any category. Fresh produce, for example, had a higher gross margin than packaged groceries. The

	Flora (£/tonne)	%	Vitalite (£/tonne)	%	Superstore retailer own label (£/tonne)	%
Main raw materials	382.2	24.2	390.6	21.9	390.6	39.9
Other ingredients	15.0	1.0	15.0	0.8	15.0	1.5
Packaging	284.0	18.0	245.0	13.8	206.0	21.0
Employee costs	164.2	10.4	167.8	9.4	42.1	4.3
Transportation	25.0	1.6	25.0	1.4	15.0	1.5
Warehousing	42.1	2.7	43.8	2.5	23.9	2.4
Variable manufacturing costs	8.0	0.5	8.0	0.5	8.0	0.8
Cost of working capital	2.9	0.2	18.1	1.0	5.8	0.6
Depreciation	33.4	2.1	34.8	2.0	10.7	1.1
Advertising	103.6	6.6	167.0	9.4	0.0	0.0
Other costs	378.8	24.0	225.8	12.7	87.3	8.9
Manufacturer pre-tax profit	14.5	0.9	170.8	9.6	20.6	2.1
Retailer gross margin	126.6	8.0	268.3	15.1	155.0	15.8
Consumer price	1,580.0	100.0	1,780.0	100.0	980.0	100.0

Table II.
Cost data for margarine

gross margin for the three examples of margarine varied from 8.0 per cent on Flora to 15.8 per cent for the own brand. Vitalite, at the time of the study the number two brand, had a higher selling price due almost entirely to a higher retail gross margin. The gross margin for the leading brand, Flora, was low compared with other, similar products on sale in the same retailer and low compared with the average for the retail business as a whole.

Figure 1 shows part of the data in Table II in graphical form to illustrate some of the main issues. The superstore retailer's own brand sells at a much lower price than either manufacturer brand. The explanation lies not in cheaper raw materials, but in the differences in added value at the manufacturing stage. Raw material and packaging costs differ only slightly (something that was found generally in the markets we appraised). There is a difference in the retailer's added value for each margarine line, which is in their gross margin, but this is not a dominant issue.

The two brand manufacturers both incur higher transportation and warehousing costs than the own brand supplier, who can concentrate its efforts on a limited number of accounts, but the differences between these costs could not explain much of the difference in final selling price. One notable difference is that between employee costs. Labour efficiency was higher in the own label manufacturer. There are two explanations here, higher wage rates in the manufacturer and the benefit to the own brand supplier of a smaller and less complex range of products.

To the left of the leading brand's cost structure in Figure 1 is an indication of where its costs lie. Direct costs (defined as the essential costs to produce the product) and advertising together account for half of all costs. The rest are "other" costs and profit, where profit is the manufacturer's book profit. The contribution from the supplier brand was higher than this, but it is spent elsewhere in the firm. The book per cent profit for the own brand supplier in Table II was almost the same as the profit for the product itself.
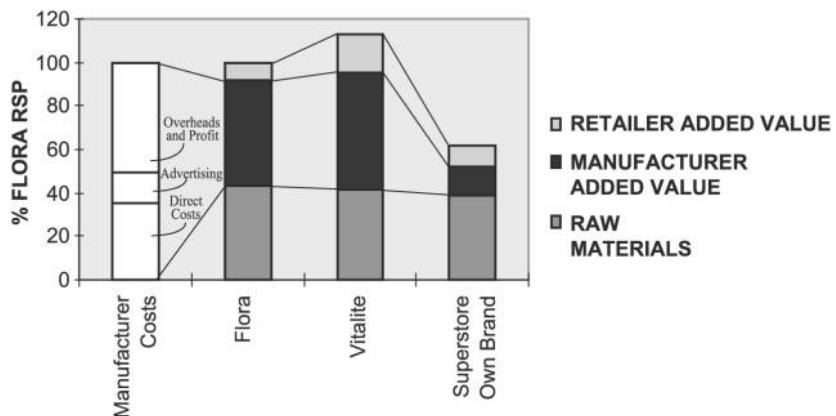

Figure 1.
Margarine

British superstore retailers regularly check on the selling prices of supplier brands in competitor outlets in order to match any price promotions. It is unusual, therefore, for a leading brand to be sold for a period of time at a relatively low price in just one of the major retail chains. The average price of each product line over the year varied little from one large retailer to another. Prices charged for own brands tended to vary more between retailers, but the price differences between premium own brands and supplier brands were of a similar order. The pattern in Table II and Figure 1 is then typical of that in all major superstores at the time.

In our analysis of the cornflakes market some similarities emerged, Table III, Figure 2. This time our data is presented for the leading brand on sale in a superstore retailer, the retailer's own brand and a similar own brand product on sale in a discount retailer. The data illustrate the additional price benefit to the shopper of having a low cost retailer selling a product made by a low cost supplier. The leading supplier brand, Kellogg, was on sale in a full service retailer at a premium of one third over the price of the discounter's own brand. In selling the Kellogg brand the superstore retailer made only a tiny gross margin on the product. The retail gross margin for the discounter own brand is lower than that for the full service retailer's own brand, who will need to recover higher overheads.

Figure 3 and Table IV contain data on washing up liquids sold via a superstore in Britain. Yet again the difference in retail selling price is explained largely within the manufacturer's proportion of the value system. (The diagram is shown with value added tax (VAT) removed). Unusually in our experience, the retail gross margin is much the same across the three products. The

	Kellogg (£/tonne)	%	Superstore retailer own label (£/tonne)	%	Discounter own label (£/tonne)	%
Main raw materials	352.5	17.3	244.4	13.7	244.4	15.5
Other ingredients	70.6	3.5	70.6	4.0	70.6	4.5
Packaging	270.5	13.3	270.5	15.2	270.5	17.1
Employee costs	225.6	11.1	186.7	10.5	186.7	11.8
Transportation	90.0	4.4	60.0	3.4	60.0	3.8
Warehousing	58.9	2.9	36.0	2.0	36.0	2.3
Variable manufacturing costs	51.4	2.5	51.4	2.9	51.4	3.3
Cost of working capital	10.2	0.5	6.2	0.4	6.2	0.4
Depreciation	101.6	5.0	39.7	2.2	39.7	2.5
Advertising	191.0	9.4	0.0	0.0	0.0	0.0
Other costs	286.6	14.1	199.9	11.2	199.9	12.7
Manufacturer pre-tax profit	323.1	15.8	76.6	4.3	76.6	4.9
Retailer gross margin	8.0	0.4	538.0	30.2	338.0	21.4
Consumer price	2,040.0	100.0	1,780.0	100.0	1,580.0	100.0

Table III.
Cost data for cornflakes

Figure 2.
Cornflakes
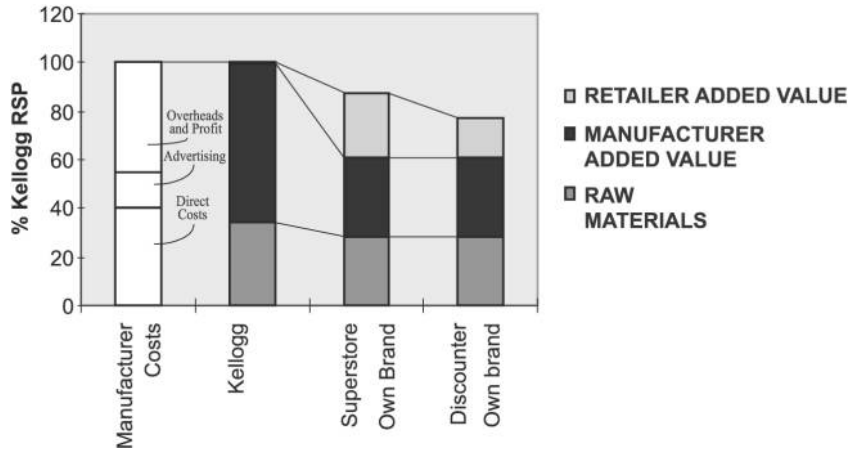
Figure 3.
Washing up liquid
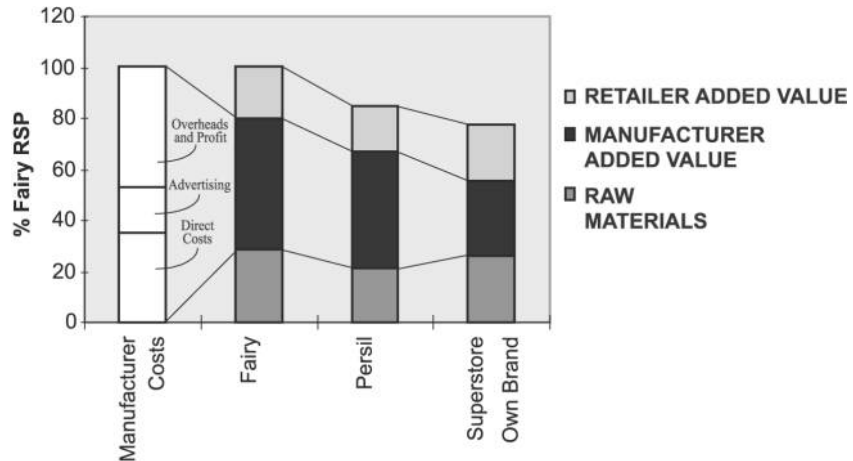
formulation costs of the number two supplier brand are lower than for both the own brand and the leading supplier brand.

A similar picture to that in margarine and cornflakes emerges from our data on mayonnaise and cream crackers, Tables V and VI. Hellmann's mayonnaise sold at twice the price of own brands and superstore retailers made little gross margin in selling it. The discounter's own brand sold at a price 20 per cent lower again than the full service retailer's own brand and at 44 per cent of the price of the market leader. The costs of raw materials were almost identical for the three products, although, as our estimates for the full service retailer's own brand indicate, more expensive ingredients were being used here. The major explanation for the difference in the consumer selling prices is in the difference in the manufacturer's overheads and profit on the product line that was being

	Fairy (£/tonne)	%	Persil (£/tonne)	%	Superstore retailer own label (£/tonne)	%
Main raw materials	320.1	20.5	193.2	14.5	279.6	23.0
Other ingredients	14.0	0.9	14.0	1.1	14.0	1.2
Packaging	112.0	7.2	120.0	9.0	112.0	9.2
Employee costs	85.4	5.5	73.7	5.5	121.2	10.0
Transportation	31.0	2.0	31.0	2.3	25.0	2.1
Warehousing	34.4	2.2	28.9	2.2	23.0	1.9
Variable manufacturing costs	10.7	0.7	− 2.0	− 0.2	7.1	0.6
Cost of working capital	23.7	1.5	22.9	1.7	21.4	1.8
Depreciation	98.8	6.3	193.8	14.6	0.0	0.0
Advertising	170.0	10.9	146.1	11.0	12.9	1.1
Other costs	78.3	5.0	0.0	0.0	37.2	3.1
Manufacturer pre-tax profit	273.6	17.5	233.0	17.5	212.4	17.5
Retailer gross margin	311.3	19.9	276.5	20.8	348.0	28.7
Consumer price	1,563.3	100.0	1,331.2	100.0	1,213.8	100.0

Table IV.
Cost data for
washing-up liquid

	Hellmann's (£/tonne)	%	Superstore retailer own label (£/tonne)	%	Discount retailer own label (£/tonne)	%
Main raw materials	387.6	13.3	417.6	27.7	396.1	30.8
Other ingredients	183.0	6.3	159.0	10.6	144.0	11.2
Packaging	361.0	11.5	349.0	23.2	347.0	27.0
Employee costs	336.5	11.5	177.8	11.8	172.6	13.4
Transportation	54.0	1.9	36.0	2.4	36.0	2.8
Warehousing	82.7	2.8	38.2	2.5	37.1	2.9
Variable manufacturing costs	11.0	1.3	11.0	0.7	11.0	0.9
Cost of working capital	34.2	1.2	13.2	0.9	12.8	1.0
Depreciation	88.4	3.0	50.0	3.3	48.6	3.8
Advertising	143.0	4.9	0.0	0.0	0.0	0.0
Other costs	1,079.4	37.0	36.2	2.4	45.2	3.5
Manufacturer pre-tax profit	91.3	3.1	29.0	1.9	28.1	2.2
Retailer gross margin	63.3	2.2	189.2	12.6	7.0	0.5
Consumer price	2,915.4	100.0	1,506.2	100.0	1,285.5	100.0

Table V.
Cost data for
mayonnaise

spent elsewhere in the firm. This represented just over one third of the
consumer selling price, Table V.

The same comparisons are made in the cream cracker biscuit market; the
leading brand, a full service retailer's own brand and a discounter's own brand.
The selling price of the first own brand was very close to that of the leading
brand but the discounter's own-brand was 40 per cent cheaper (Table VI). The
superstore retailer's own brand sold at a price only 8 per cent lower and the
retailer made a 33.6 per cent gross margin on the product. The full service
retailer made a large gross margin on its own brand and a small, negative gross

	Jacob's (£/tonne)	%	Superstore retailer own label (£/tonne)	%	Discount retailer own label (£/tonne)	%
Main raw materials	275.1	18.5	274.6	20.1	276.7	27.6
Other ingredients	10.5	0.7	12.4	0.9	7.4	0.7
Packaging	169.0	11.4	169.0	12.4	160.0	15.9
Employee costs	329.0	22.2	211.4	15.5	211.4	21.1
Transportation	53.0	3.6	44.0	3.2	44.0	4.4
Warehousing	44.8	3.0	26.3	1.9	26.3	2.6
Variable manufacturing costs	12.0	0.8	12.0	0.9	12.0	1.2
Cost of working capital	7.7	0.5	9.1	0.7	9.1	0.9
Depreciation	66.4	4.5	29.9	2.2	0.0	3.0
Advertising	69.5	4.7	0.0	0.0	29.9	0.0
Other costs	478.1	32.2	89.7	6.6	101.6	10.1
Manufacturer pre-tax profit	29.3	2.0	29.0	2.1	29.0	2.9
Retailer gross margin	− 58.8	− 4.0	459.3	33.6	97.0	9.7
Consumer price	1,485.6	100.0	1,366.7	100.0	1,004.4	100.0

Table VI.
Cost data for cream cracker biscuits

margin on the Jacob's brand. In other words, the retailer could only have been making a profit on selling the leading brand if it received some trade marketing monies from the supplier. The major difference in cost in the cream cracker examples came from the differences in manufacturer added value. The contribution from the brand was much higher than its average net profit margin. Labour costs were again higher in the leading brand company than in those making own brands.

Comparing value systems

Some of the differences between the total costs of competing value systems are relatively easy to explain. Own brands sold via a discount retailer have two inherent advantages over a manufacturer's brand sold via a superstore. The manufacturer's brand relies on advertising to appeal to the shopper over the head of the retailer. A discounter has inherently lower labour costs than a full service superstore. Many operate with as few as four full time equivalent staff per store compared with the 200 or more in a superstore. A superstore may offer 20,000 product lines, a discounter 1,500. Such cost differences are widely recognised (Gambino *et al.*, 1994) and can explain much of the differences in final selling price to the consumer between the own brands sold in full service stores and own brands sold in discount stores.

What is less easy to explain are the cost differences between the two value systems competing inside the full service retailer. Our expectation from the literature on ECR was that interface costs, and in particular logistics costs, would explain much of any such differences. The average logistics costs for all products considered here were 5.1 per cent of retail selling price (excluding VAT in the case of washing up liquid). These figures exclude any logistics

costs within the retailer's organisation. These would add about an additional 1 percentage point to the total and are unlikely to be capable of reduction. The logistics costs in the systems we examined could be reduced in the opinion of those we interviewed, but even if they could be halved in one system and not in another, the price difference to the shopper would not be noticeable. Substantial savings may be possible, but none that can close even the large price gap between the manufacturers' brands and retailers' own brands sold in the same store.

The estimates made in the various reports on ECR of the potential cost savings mentioned earlier ranged from 2.3 per cent to 13.4 per cent of sales value. At the top end of the range in such figures the selling price gap between an own brand selling in a discounter and a manufacturer's brand in a superstore would be narrowed but still not eliminated. In our study the selling price difference between competing supplier brands was small enough such that the level of cost savings projected for ECR could provide a cost advantage for one supplier's product over another, but not between a supplier brand and an own brand.

So where are the main explanations for the marked cost differences?

Tables VII and VIII contain an analysis of the aggregate costs for our data from the two main competing systems, supplier brands sold via full service stores and own brands sold via full service stores. Comparing the cost contribution from each provides an indication of the source of the final cost differences.

The cost structures were compared using the Mann Whitney test. Basic costs (raw materials, packaging) represent a significantly higher percentage of total cost for own-branded products, but such costs do not differ significantly

	Manufacturer brand via superstore	Retailer own brands
Basic costs	34.4	47.6
Other manufacturing costs	26.0	25.5
Advertising	8.6	0.0
Unexplained costs	20.9	7.1
Retailer gross margin	10.1	19.8
Sample size	7	8

Table VII.
Aggregated cost data (percentage of retail sales value) for all five product categories, average values

	Manufacturer v. retailer brands
Basic costs	0.04
Other manufacturing costs	0.82
Advertising	N/A
Unexplained costs	0.001
Retailer gross margin	0.15

Table VIII.
Significance test for cost data differences

when actual costs are compared. Own-brand packaging costs tended to be lower but the prices paid for all raw materials were very similar (with the exception of washing-up liquid, where the leading brand's raw materials were more expensive).

Advertising costs are higher for supplier brands because own brands are rarely advertised individually and so we do not compare them statistically. Retailer gross margins tend to be lower for supplier brands but the differences are only marginally significant. When actual costs are compared, the yield to the retailer for each unit sold is still far higher for their own brands. Thus if the cost to the retailer of selling each product is similar (similar stock turn, shelf space, wastage), then retailers are better off selling own-brand products, as long as customers will buy the goods.

What we have termed "unexplained costs" represent the most interesting issue to explore further. The difference between supplier brands and own brands is the most significant here. The difference of nearly 14 percentage points explains, together with manufacturer advertising, most of the price premium commanded by the manufacturers' brands.

One element of "unexplained cost" comes from payments made to retailers. These consist of retrospective volume discounts, allowances for retailers to spend on advertising where the retailer features the supplier's product in its own advertising, price promotions to consumers and other allowances such as premiums paid for special product displays. Our estimates are that such promotions cost manufacturers a very similar percentage of their turnover to that of advertising; 8 per cent on average of the final selling price. Some of this money will accrue to the retailer in extra profit, some they have to spend. The amount retained varies by product, by retailer and over time and we were unable to obtain consistent data on this. We estimate that this represented an average of 3 per cent of the selling price of the supplier brand prices. This narrows the difference between the profit made on own brands and supplier brands.

The second largest element in unexplained cost differences is in higher employee costs (other than in labour cost to manufacture). For example, we calculate that the total wage cost per tonne of product for Kellogg's cornflakes was more than double that in own brand cereal manufacturers, due more to a higher average remuneration than to employing larger numbers of people. What remains of the unexplained costs goes to fund losses on other product lines made by the supplier and on development activities, particularly R&D.

Research and development costs explain some of the differences in unexplained costs. Own brands tend to be imitations of established brands. While it is possible to protect a chemical formulation through patenting, it is not always possible to protect a recipe other than by guarding it and any processing expertise that enhances flavour and texture. An imitative strategy by the retailer is always valid if the volumes of own brand are sufficient to

obtain reasonable economies of scale, so that the retailer can sell at a low price. Investment in R&D becomes a risk for a branded goods manufacturer if any innovation can be copied. Of the companies in our study Procter & Gamble appear to invest the highest percentage of sales in R&D at 3.8 per cent (DTI, 1996). We were unable to estimate R&D costs for individual products but, as R&D tends to be spent on new rather than existing products, it is unlikely that R&D costs can explain much of the differences between the cost structures observed here. However, existing supplier brands do need to produce surpluses that can be used to support R&D into new products or more innovative versions of existing lines. It is unlikely, therefore, that cutting R&D costs is an option for the manufacturer.

Overall, the main strategic problem facing most brand manufacturers still appears to be to reduce the price gap between own brands and their own products on sale in the same stores. The price premium being demanded was, on average in our study, 42.6 per cent in a range of 8.7 per cent to 93.5 per cent. The current focus on interface costs will not close the larger gaps significantly. A radical improvement will only come from a reduction in the manufacturer's own internal costs, but it is still difficult to envisage cost savings of the size needed to do more than narrow the price gap.

Full service retailers are not without their own price problems. The selling prices of own brands in discount stores were on average 17.9 per cent lower in our study than own brands in full service stores. As mentioned earlier, difference in costs are relatively easy to explain. Employee costs as a percentage of turnover in the leading British grocery retailer were 9.9 per cent compared to 6.7 per cent in the leading discount store operator. The discounter specialises in turning its stock far faster than the superstore and so a similar return on capital can be achieved at lower gross margin and lower operating cost. Yet again, internal costs explain the differences in cost structure. Other than cutting labour costs, inevitably by reducing the service provided to shoppers, it is difficult to see how full service retailers can address the problem by cutting costs internally. If they were to opt for this approach, then one of their main points of differentiation over the discounters would be eroded. Inevitably, they will be looking up-stream at the costs of their suppliers to achieve any significant cost savings.

We were surprised at the low level of difference between the total cost per tonne of finished product represented by raw materials. For the food products the differences were so small as to be irrelevant. That is not to say that the raw materials used were the same. Own-brand products tended to be made from slightly cheaper raw materials but the supplier brand companies also obtained slightly better terms on the purchase of more expensive ingredients. Whether this or any differences in processing affected the quality in use of the final product is considered next.

Consumer tests
Thus far, one important factor has been omitted from our analysis, the relative acceptability or quality of individual products. This has two components, extrinsic cues such as brand image and packaging, and intrinsic cues such as better taste, texture or performance in use. For example in objective tests of the relative efficiency of washing-up liquids, the Procter & Gamble product Fairy has been shown to offer better value for money (washing more dishes per penny) than its competitors despite its higher price (Consumers Association, 1991). The product sells at a premium but the consumer is not paying extra just for brand image. The price difference between the leading brand and own brands can be justified by the higher quality of the leading brand. The brand leader contains a patented chemical, which provides better performance in use. Similar test data were not available for the four other product types and it was necessary to test any differences in the intrinsic qualities of competing products to see if they too explained the price differences.

Samples of all the competing food products for which data were presented earlier were tested "blind" with consumers using conjoint analysis. From such data, a regression model can be constructed to represent an individual respondent's product preference at different price points (Green and Wind, 1975; Parasuraman, 1991; Poste *et al.*, 1991; Aaker *et al.*, 1995). Respondents were given samples of three products from the same category to consume under a strict protocol. For example, with margarine the test was conducted under controlled lighting, with products at the same temperature. One-day-old bread was used as a carrier for the margarine, which was spread by respondents at a uniform rate for each sample. After tasting the products, respondents were asked for their preference with each product at the same price, using the lowest of the actual selling prices of the three products. Once they had expressed an initial preference, the price of the preferred product was raised and a preference asked for again. The same procedure was repeated until the highest price of the three products was reached. The research was conducted on samples of 50 respondents for each product category.

Table IX shows that, while the products most often purchased by the 200 respondents were supplier brands (72 per cent of respondents reported that they normally purchased a supplier brand in the sector under evaluation), when tasted blind these same brands were not necessarily preferred for their intrinsic qualities. When the higher prices demanded were included as a factor, preferences for the leading brand fell further.

For example, 90 per cent of respondents reported buying Kellogg's cornflakes on a regular basis, but only 38 per cent preferred the product over the two own brands when tested blind, and only 16 per cent would buy when they were asked to pay the higher market price (but without knowing the identity of each brand). In the blind preference testing, only 25 per cent would have purchased a supplier brand (compared with a random figure of 33 per

	Margarine			Cornflakes			Cream Crackers			Mayonnaise		
	Flora	Vitalite	Superstore own brand	Kellogg	Superstore own brand	Discounter own brand	Jacobs	Superstore own brand	Discounter own brand	Hellmanns	Superstore own brand	Discounter own brand
Preferred product at equal price	32	32	36	38	42	20	34	42	24	36	46	18
Preferred product at market price	12	16	72	16	16	68	12	20	68	10	42	48
Usual brand purchased	50	10	N/A	90	N/A	N/A	80	N/A	N/A	68	N/A	N/A
Market prices used (p)	84	89	49	102	89	79	45	41	31	119	75	65

Table IX.
Results of conjoint analysis

cent). Our conclusion is that brand image is the only explanation for the premium commanded by the supplier brands in the four food product markets. The consumer is paying a premium for the, often intangible, benefits inherent in a branded product. Only in washing-up liquid did the leading brand offer better intrinsically superior value for money. Generally, a lower selling price for own brands is no indication of lower intrinsic quality. None of the higher prices charged for supplier food brands could be justified by higher quality.

Discussion and conclusion

Previously, it has been held that cost reductions in value systems can be best obtained by focusing on the interfaces between individual value chains (Porter, 1985). This thinking is also reflected in the various ECR initiatives where high service retailers and brand manufacturers are collaborating to reduce logistics and other interface costs. There is no evidence from our data that such a focus can produce the substantial reductions in the large price differences that exist between own brands and supplier brands as has been claimed (Lee *et al.*, 1997). Logistics costs totaled some 5 to 6 per cent of retail sales prices in our study. Even if these could be eliminated, the typical price gap of over 40 per cent would not be reduced significantly. ECR would appear to be more relevant to price competition between supplier brands or to making small improvements in the profits available to manufacturer or retailer.

The marketing costs incurred by the typical manufacturer are mainly consumer advertising and trade marketing, the latter including payments to the retailer such as volume discounts and price promotions support. We estimate that, together, these averaged some 16 per cent of retail sales price for the products we examined and are an obvious focus for cost reduction. Improvements in advertising efficiency and effectiveness are possibilities for suppliers to consider, as are reductions in the cost of price promotions, particularly if their strategy becomes one of everyday low prices. Procter & Gamble, for example, have estimated that their costs of marketing average 25 per cent of turnover and are aiming to reduce this to 20 per cent. Instead of a price promotion to retailers, which may not be passed on to customers, they aim to reduce the regular retail selling price.

Yet it is difficult to see how total marketing costs can be, say, halved so as to reduce the price gap with own brands substantially. The key advantage of the own-brand value system is that the own-brand manufacturer needs little or no expenditure on marketing, as this role is subsumed by the retailer or is unnecessary in maintaining relationships with the retailer. One of the value chain activities in one member of the value system has been eliminated by the actions of another member, in this case the retailer, by subsuming the role of marketing for the entire system. In the case of the discount retailers, any imagery they had came mainly from their low prices and utilitarian premises. They spent only a small amount on advertising. In the value systems of

branded supplier and full service retailer, marketing activities were duplicated. Retailers promoted themselves as a source of products while suppliers promoted themselves to be the first choice within the retailer's premises. Such marketing actually competes within the same value system.

In the value systems containing an own brand, R&D was a small expense, rationalised between the manufacturer and retailer, and of limited scale. (Both typically undertook quality management and some product development.) In the branded supplier system R&D expenditure was always a significant element, albeit not as high as the marketing costs. Product development was aimed at evolving new products that could be launched with some confidence in their market success. New own-brand products could be tested at lower cost by test marketing in a few stores. If the own-brand products aped existing lines, development costs were particularly low.

The five product categories featured in this survey offer some contrasting insights into the different approaches used by manufacturers to maintain their relationships with retailers. In the example of washing-up liquid, the leading brand offered the retailer a similar gross margin to that of other brands and the retailer's own brand. This contrasts with the approach used by the leading brands of breakfast cereal, mayonnaise and cream crackers, where the gross margin was extremely low or even negative. Any profit the retailer made would have been enhanced, but not substantially, by payments such as discounts or promotional allowances. The selling price of the brand was almost identical in all the leading retailers over the 12-month period, so the lack of apparent margin was not a result of retailers using the product as a promotional line to gain advantage over another retailer. Unless Kellogg and other suppliers change their strategy, so that the retailer obtains a higher margin, larger retailers in particular will inevitably focus more on their own brands. Products such as Kellogg's cornflakes are well-known brands, ones that retailers feel they have to sell to retain custom, but that does not mean that they do not have to compete with them.

Procter & Gamble's approach to R&D is worthy of note. If retailers' own brands match the intrinsic qualities of their suppliers' brands (and in all but this one case in our study they did) then the branded supplier is left with nothing but its brand image to justify the premium it needs due to its higher costs. A combination of superior intrinsic quality and brand image is a better strategy than relying just on the latter. That is not to say that brand image had ceased to be an asset. Those who undertook the blind taste tests were told afterwards the identity of the brands they had tasted and that they had, often, chosen a product other than their normal brand, particularly when asked to consider the price trade-off. A number were asked six months later whether they had changed their purchasing behaviour as a result of their participation in the research. None had. While the follow-up sample was too small to be

statistically valid, the result does illustrate the continued power of product branding.

However, the long-term problem facing brand suppliers is that retailers' names are also becoming strong brand names. The pricing of own brands is already sometimes close to that of supplier brands. In one instance in Britain, own-branded groceries are routinely sold at higher price points than equivalent supplier brands. The retailer concerned is Marks & Spencer, who markets only own-branded goods. It is the sixth largest food retailer in Britain but its selling prices are (as recorded in retail audit data) average above those for all other food retailers. The retailer is regarded as a brand in its own right. Its products have a good reputation for quality. It spends heavily on product development even though it is not a manufacturer.

Any improvement in retailer brand imagery generally could well alter the difference in price elasticity that currently favours supplier brands (Hoch, 1996) as the price gap between supplier and retailer brands falls. One way forward for retailers is therefore to increase their expenditure on building their own-brand imagery, even if this means raising their prices. The price difference between own brands and supplier brands is often very high, too high perhaps for own brands to be credible as brands in the fullest sense, but offering scope for extra expenditure if prices can be raised. It is interesting to see Tesco introducing a premium range (called Finest) in an attempt to position a product range at or above the price of many supplier branded products.

Retailer branding costs can be spread across a range of products and retailer branding can be achieved in a number of ways. If the retailer chooses to use the store name as its own brand name, then opportunities for synergy exist. Whether it is possible to develop the same level of emotional attachment to a retail name as is apparent with many supplier brands is unclear There are many examples of supplier brand names in the fashion sector that are now used to brand retail premises, such as Reebok and Gucci. Lipton is now a product brand that started out as a retail name. If it is possible for a retailer's name to be a strong brand, then the price difference to supplier brands can be narrowed or eliminated. Retailer experiments with higher price own brands has created an interesting feature in the British market, the introduction of supplier brands such as Cresta by CocaCola-Schweppes at price points below those of the retailer's premium own brand. Somewhat against these examples is the trend for retailers to use names that are different from their store names in naming their own brands. If they were confident in the efficacy of their store name as a brand name, then surely they would not resort to the cost of launching a new name?

If suppliers cannot out-brand the retailer, then they will have to rely on other sources of advantage. One option that our work points to is investment in product development so as to out-innovate the retailer. Of the suppliers we included in our survey, Procter & Gamble spent the highest percentage of

turnover on R&D. Spread across its global markets, such an investment makes sense as no individual own-brand manufacturer or retailer can match its expenditure. In markets where the technical content of the product is high, and consequently the research expenditure on the product is high, such as electrical products and cars, own-brand penetration is low or non-existent. Whether R&D expenditure is a general panacea is more doubtful, as exemplified by Coca Cola, where a product improvement was rejected by customers and the traditional formula had to be reintroduced. As one own-brand manufacturer explained to us, "the leading brand is a static target for us to aim at. It does not, nor can it change radically". However, in product categories where technical innovation is both possible and valued by the customer, suppliers should consider a far greater emphasis on R&D. Like Procter & Gamble, others appear to be emphasising technical innovation in their product markets. Unilever's latest version of Flora contains an anti-cholesterol agent. Kellogg has built a new research and development facility and expects to increase its level of innovation.

A major concern for supplier brands is internal cost. Own-brand suppliers are often more cost-effective. Procter & Gamble and Kellogg have already moved to cut their selling prices by reducing internal costs. Typical moves also involve a reduction in promotional expenditure as mentioned earlier, but also by eliminating tiers of management and rationalising manufacturing plant (MERIC, 1995). Since our study, the selling price of Kellogg's Corn Flakes in the British market has reduced by 6 per cent in real terms.

The response by large store retailers to the threat to them from discounters has varied across Europe. Wholesalers have often been eliminated from the supply chain in markets such as Italy where retailers are now purchasing directly from suppliers. A two-tier structure of own brands has been introduced in Britain, one to compete with supplier brands, the other, simply packaged, to compete with the price points of discounters. Superstore retailers have seen their market shares grow, but the discounters have also prospered. Middle-sized retailers have lost market share and so it is difficult to decide whether the larger, full service retailers really have countered the price challenge of the discounters in the longer term.

The limited range discounter selling mainly own brand, dealing directly with an own-brand manufacturer, represents the heart of a comparatively low cost value system. The two other main competing systems rely more on branding. In future, a greater emphasis on innovation can be expected in systems involving a supplier brand and a greater emphasis on branding in systems with a retailer-branded product as they endeavour to close the gap with technically similar products. Currently there is a far greater apparent level of technical innovation at the beginning of the value systems we examined with the production of genetically modified versions of commodities. The focus on technical innovation is likely to move further forward in the value system.

Some suppliers have been experimenting with methods of selling directly to the consumer using vending or electronic commerce. Further growth in direct selling can be expected as suppliers try to configure new value systems by eliminating one of the value chains, in particular the one that is the greatest threat to themselves. Unilever, Bass, Cadbury Schweppes and others have co-founded the "Consumer needs consortium", part of whose mission is to regain the manufacturers' relationship with the consumer. One possible innovation is to sell jointly directly to the consumer.

Brand suppliers will become more innovative in their search for lower costs. It is not inconceivable that many will relocate their production to lower labour cost areas within or even outside of the EU if the latter's tariff barriers are lowered on food. Alternatively, they may purchase products from more cost efficient suppliers, including those who are currently making only own brands. If the leading brand has no intrinsic quality advantage, then this is a clear option to consider.

In the data presented here we have concentrated on the leading supplier brands in each sector. Each held a high market share, ranging from 43 to 76 per cent of market value. The number two brand's market share ranged from 5 to 18 per cent of value, somewhat less than that for own brand, and vulnerably low, particularly in the context of an individual retailer who might have as much as 50 per cent of its sales in own-brand product. In margarine and cream crackers the supply of own brand was divided among a large number of suppliers. In cornflakes and detergents the supply of own brands was in the hands of a few suppliers, most of which did not market their own national brand. This raises the issue of what might happen to the manufacturers of secondary brands in the longer term? Some have focussed on a limited number of large retailers and tried to work closely with them. Some have tried to segment the consumer market and produce specialist products. Others manufacture a wide range of products, making them less vulnerable but also likely to withdraw from any one product market with the possibility of adding to the own brand capacity and potential in that market. Leading brand suppliers will often purchase a firm coming onto the market so as to reduce the capacity for own-brand production. However, during our study one such plant (the source of the product that did well against the market leader in our consumer tests) was purchased by the leading European supplier of own -brands. What is likely, therefore, is that, as retailer power grows, more and more production capacity will become devoted to own-brand production and this capacity will be drawn from that which is currently used to make secondary supplier brands. One value system will benefit at the expense of another. Suppliers of secondary brands could find that they are members of a declining type of value system and will seek to join another that is growing, in this case that supplying own brand.

A general lesson from our study for value system competition is that competitive advantage in one system can be better gained over another by rationalising primary activities across the system as a whole, rather than focusing on the interface between value chains. The same lesson is apparent in other markets. One advantage of e-business over traditional means of trading is the elimination of value chain activities. Amazon eliminates the need for its own retail premises by selling on the Internet. Dell eliminates the need to use a distributor's retail premises when selling direct to users. Eliminating the wholesaler as a result of ECR analysis is in reality more about subsuming the wholesaler's value chain into those originally either side of it. Component suppliers who widen their manufacturing scope to produce complete assemblies (rather than individual parts) in the automotive and aerospace industries reduce the need for the purchasing role in their customers' organisations and rationalise the manufacturing elements of both sides.

Suggestions for further work include a longitudinal study of the sectors we have analysed here. Consumer markets are dynamic and we have presented a snapshot during one particular year. Similar analyses should be conducted in other country markets, those with different retail structures, such as in the Far East. Similar methodologies should be applied to other product categories including consumer durables where the technical content of the product is high.

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