

STRATEGIC OPTIONS OF FIRMS CONSIDERING PRIVATE LABEL PRODUCTION

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ABSTRACT

Private labels are a growing phenomenon globally. Retailers become stronger and stronger by offering their own quality private label product for customers in all segments. Certainly they do not open factories to produce these items but rather search for dedicated private label producers or pressure branded goods manufacturers to produce it for them. The article deals with the strategic choices manufacturers can have and suggest the necessary factors that are necessary to be evaluated to decide on the winning business model—in considering whether to enter or not in the private label production – through literature and a case study on the ice cream market in Hungary.

Keywords: private label, production, branding

INTRODUCTION

Private labels have been a well known phenomenon now for decades, but they became a threat to branded goods only in the 21. century. They have started out as low quality me- too products that copied the leading branded ones and have been offered at the cheapest price available on the market using very simple packaging. Today these private labels are among the leading brands according to their yearly turnover (*Lincoln and Thomassen, 2007*), and the leader Wal-Mart private label sales exceeds the total sales of Procter&Gamble and Johnson and Johnson's total cumulated brand sales. *Wal-Mart also took over the 1st position from Coca Cola on the World's Most Valuable Brands 500 list in 2009* according to the evaluation of the Brand Finance independent Consultancy Firm. Such success provides the distribution channels with overwhelming negotiations power and profit. Production companies meet the challenge of how to go ahead under these circumstances. Cooperate or contradict? This tendency varies by product category, but is very strong in the CPG (Consumer Packaged Goods) markets, as in the ice cream market as well.

MATERIALS AND METHODS

In my research I have used international and domestic literature available. I have used many recent publications and books, and also Hungarian market research data. Through the secondary research I was able to draw a picture about the changes that have taken place in the CPG market driven by the development of private labels. I have chosen the in depth case study methodology. This included *observations, documentation and in depth interview* to have an overall picture about the ice

cream market and the applied strategy of the leading ice cream manufacturer. Documentation covers company brochures, annual reports, and other resources provided by the respondents and gained from the companies websites. Observations were made about the competitors' activities inside and outside the shops and indepth interviews were made with the leading Hungarian ice cream manufacturer company: the Ledo Kft.

I have analysed the correspondance of the literature theories and their application possibilities through this real life example.

THE PRIVATE LABEL PHENOMENON

The private label phenomenon has been widely researched since the 1990s. *Montezemolo* already pointed out in 1997 that the fast growth of private labels transforms the role of the distributor from a friendly client to a fierce competitor with knowledge about the manufacturer's marketing plans, cost structures, product innovations, product quality that no other competitors have. This tendency is not only true for the CPG market but has diversified into other markets like investment funds, securities, software, electronics, contact lenses and others.

Different arguments have emerged dealing with the necessity of discussing the advantages of branding strategies. According to *Quelch and Harding* (1996) private labels are not any more a phenomenon of economic downturn, but they are strongly growing regardless of the economic situation. This trend is driven by several factors. Among them is the fact that private labels substantially improved their quality. Thus, customers view most of the private label categories as the counterpart of branded products, but at a lower price. Hypermarkets like Tesco and Loblaw's succeeded in introducing premium categories (*Hoch*, 1996), some – like President's Choice chocolate chip cookie – became so successful that it turned into the national market leader in its category. At the same time, research has proved that branded goods still have a great advantage over private labels: their brand image (*Kumar and Steenkamp*, 2007). The issue of branded goods' manufacturer's producing private labels has become one of the most researched topics recently.

STRATEGICAL OPTIONS

Some decade ago almost all manufacturers produced branded goods. There were certainly some stronger brands and some weaker ones, but they all had their right to be in the market. Today only strong brands have the biggest chance to remain profitable on the market, while the second and third brands in the category are significantly losing share to private labels. So the manufacturers' strategic options depend on the category they are operating in and also on the position they have in the market. According to *Kumar and Steenkamp* (2007) and *Koen A.M. de Jong* (2007) companies can choose from the following strategical options:

1. Be an only branded goods manufacturer (BGM)
2. Be a dedicated private label manufacturer (DPLM)
3. Be dual tracker producing both private label and branded goods

J.T. Gomez-Arias and L. Bello-Acebron (2008) have set up an economic model that suggests that *the strategy chosen by a manufacturer to start private label manufacturing should be based on the strength of the image of the company's brands*. If the company has a strong brand, they should only engage in private label manufacturing if the retailer will price it in the premium segment. If a manufacturer has low quality brand, they also need to consider the retailer's pricing considerations.

"...when the store brand enters below the low quality brand as a generic, the competition is so direct that, given the chance to make the store brand; the low quality manufacturer should drop its prices low enough to make the generic product unprofitable to the retailer."

"If the store brand enters in the middle as a traditional private label, it is the store brand that squeezes the low quality brand out of the market. ... the best course of action for the low quality manufacturer is to drop its own brand and become a private label specialist."

Their result also includes that if the retailer decides to launch the provided product in the premium segment, it should be taken as an opportunity as there is no downside of it. But the retailers choose high quality manufacturers for their premium private label source so this latent version is not highly possible. The above mentioned criterion is not widely used among companies as it has many restrictions also mentioned by the authors, but it is valid to consider the scenarios presented.

The advantages of producing private labels even for brand manufacturers are clear: economies of scale, fill idle capacity, smooth production, less time and effort per unit to sell (Quelch and Harding, 1996), have better influence on the category management, generate extra profits and have better relationship with retailers, although for this later there is no evidence for being a valid claim (Kumar and Steenkamp, 2007). These reasons in today's economic situation and competitive environment are very convincing, but what starts out as an idle capacity filling up operation on an opportunistic basis could turn into a narcotic to the firm. *Some branded goods manufacturers (BGM) do not "advertise" the fact that they do supply private labels*, among them: Bausch and Lomb, H. J. Heinz, Birds Eye, Del Monte, *some others explicitly vow that they will never engage in private label supply* like Coca Cola, Nestlé, Procter and Gamble, Heineken etc. (Kumar and Steenkamp, 2007). Companies with strong brands have the chance to choose this later option as their brands are mostly category leaders that have several significant advantages over private labels, among them the price premium. However, as the premium private label category and retailers' power grows there will be more pressure on these BGM as well to supply private labels. Their only possible way to avoid it is to build their brand equity further and to be the preferred brand by customers.

ADVANTAGES AND DISADVANTAGES OF PRIVATE LABEL PRODUCTION

Quelch and Harding (1996) advised BGM not to start with private label production. The main reasons that support their view are:

- the private label will cannibalize the branded products,
- it will also complicate production and logistics of the costs which can exceed the gain by economies of scale,

- they will have to keep two separate sales teams,
- sales forces generate sales where they are welcome,
- private labels can end up in the manufacturer's strongest accounts,
- emerging "strategic schizophrenia, pressure from demanding retailers to give priority to less profitable private label shipments."

Many times though there is not much choice left for BGM to say no for private label production. Lately Wal-Mart announced that they would only work with those BGM who are ready to make private labels as well. Considering the position that for example Wal-Mart's turnover holds in their main accounts' portfolio - 21% of Revlon, 16% of P&G, 14% of Kraft, 13% of Gillette - it is probably just a matter of time that all BGM will produce private labels in some form. In such a case the company would employ a dual strategy and will become a "dual tracker"

There are some additional, but less quantifiable threats in dual tracking operations besides the above-mentioned ones. Many companies view private label production on an opportunistic basis and as a profitable way as well. But in many cases this profitability can only be achieved if the profit is calculated on a marginal basis without considering fix costs. If fix costs are also calculated in the contribution analysis, then private label production in many cases is not profitable all. Also the advantage of economies of scale is dual sided as well. If the BGM wants to reach economies of scale, it will use the same raw materials, use the same material for packaging, which results in a similar quality of the branded good to the private label. Today's customers are very sophisticated and informed, thus such a similar quality would result in favour of the private label because of its more competitive price positioning and a delusion of the brand equity for the brand. Moreover, this quality gap cannot be increased, as the production of private label will result in more demanding retailers who want their products to be manufactured according to the latest technology. "This small quality gap is one of the key drivers of private label success" (Kumar and Steenkamp, 2007). It is necessary to mention though that there are some examples when companies were able to use private label production as a competitive tool. "In Europe, Pepsi Co. captured a private label tender from its key competitor forcing it to close plants and more importantly, weakening its national brand" (Quelch and Harding, 1996).

The other strategical *opportunity mainly for secondary brands is to become a dedicated private label supplier*. The biggest retailers give a period to see how products perform and if this performance is not acceptable, they will delist the brand. That is what happens to *smaller companies* that are not strong enough financially to build brands and will lose their distribution. For them the only strategic option is to become a dedicated private label producer. These companies are generally specialised in a few categories and are high volume-low margin firms. Their *key success factor is low cost management and highly flexible production*. Their research and development activity is restricted to spotting and copying the newest trends mostly before the newly developed branded goods even come out. In the retailer's eye the winning factor in this case is price. This can be a win-win solution to both parties if additional expectations on organizational management are also met, but the risk to depend too much on the retailer is considerable.

POSSIBLE BUSINESS MODELS

Koen A.M. de Jong (2007) explains the fundamental differences between a BGM and a private label manufacturer's business mode (Table 1).

Table 1

**Differences between a BGM
and a private label manufacturer's business model**

Private label operation	Manufacturer brand operation
Single target group approach	Approaches two target groups
Focus on relationship with retailer	Focus on building brands
Account managers cover direction	Marketing governs direction
Activities determined by retail	Activities determined by consumers
Variation in production	Standardization in production

Source: De Jong K. (2007)

The main differences in the single and dual target approaches are that BGM focuses on end consumers and the DPLM focuses on the retailer following rather a B2B strategy. Another point of difference is the focus on the relationship with the retailer and for the latter on building brand equity. DPLM is a sales driven manufacturing company following retailer needs employing highly flexible production, while BGM is marketing driven following consumer trends, trying to reach standardization.

The key success factors for private label producers are also different from that of the BGM. As mentioned earlier ability to *manage complex production* is vital. Although this complexity suggests a result in higher production costs, *cost leadership* is still the basis for success. This paradox is only manageable if the producer is able to manage labour and capital with extreme efficiency. And thirdly the company has to be *innovative* in introduction of new products in the shortest time or even before the branded version comes out.

As we have seen, there are several factors that influence the decision on which strategy to take, also considering the situational circumstances and positions. The debate on whether to deal with private label production or not is still going on among researchers, but it seems that there are no right or wrong answers, but rather starting points to consider which help to decide the right strategic move.

Case study: Ledo Kft.

I have chosen the ice cream industry as a case study as it is a very competitive market with substantial private label sales and strong competition. According to MEMRB data in 2008 there were four big manufacturers covering 93% of the market in volume in the hypermarket and supermarket chains. Unilever is the market leader, it is followed by private vendors, the third player is Ledo and at the fourth position was Nestlé. Nestlé decided to outsource its ice-cream operations

from the Hungarian subsidiary to distributors, so now there are actually three big players left in 2009 as local distributors are lacking the financial background of a multinational company and most probably will not be able to list in these products in the big chains thus losing market share. A big share of the private label vendors' sales volume is made by Ledo Kft. Therefore on a company level the market share of Ledo in these chains would be actually close to that of Algida who is not producing private label at all. They all have different company structures and operate different business strategies. Unilever is a multinational company with several global brands such as Magnum, Carte d'Or, Vienetta being sold in almost all retail channels. Ledo is a Croatian owned Hungarian company that owns the King Family, Quattro, Ledo 2L brands and is active also in all channels. The ice cream market has some very special features that are necessary to investigate to understand the underlying reasons for business decisions. As a result of the product attributes being in the frozen business logistics and warehousing makes up most of the company's costs beside sales costs. Therefore effective and cost efficient transportation is a key success factor in this industry.

Ledo Kft. is a dual tracker company producing private labels and their own brands as well. They have premium brands like King Family and Quattro, the Ledo brand is positioned in the medium segment of the market and they have some fighter brands such as the Grande Familiare ice creams. These products are differentiated by quality, packaging, and price. One of the most important factors is differentiating. It can be achieved by building a strong brand, but a lot of investments are necessary for such a strategy, or for smaller firms there is the opportunity to differentiate by a very good price-value ratio supported by a successful recipe and packaging. For example, their Ledo products that have a medium price are packaged in buckets with handle in 2 litre versions. This is an extremely successful product as people use the bucket afterwards as well. The Quattro premium ice cream has an excellent recipe and its packaging also enables the product to show its premium quality: sauce, nuts, colours are visible and all integrated in an appealing serving style. Their other premium brand, King Family is popular because of its good price-quality ratio even in the premium segment (*Figure 1*).

The company is innovating continuously by spotting consumer trends and accordingly, offering a wide flavour selection. The branded competitors avoid launching the same flavour that another product has already launched. There is Gundel Pancake flavour in King Family's assortment and Somlói Galuska in Carte D'Ors. The firm has introduced a fighter brand in the lower price segment, the Grande Familiare product line. It was necessary to position according to quality and price segmentation. Although in this lower price segment of the market, customers prefer private labels versus cheap branded products. This segment is growing year by year, but the trend is clearly visible that consumers also look for quality at this price.

Ledo Kft. started producing private label on an opportunistic basis in Hungary – the Croatian mother company does not supply private labels at all - to fill in capacity, but as brand building is very expensive this strategy seemed to be a good viable alternative if managed well. They produce the private label ice creams for almost every chain. For all dual tracker companies the biggest challenge is to

differentiate their branded goods and their private labels and at the same time to keep economies of scale. One way is to put the logo only on the branded products, and on the private labelled ones the company is only represented as the producer, and in some cases they are not mentioned at all. They also differentiate the way in new product launch for branded products and for private labels. For their branded products the operation to choose raw materials, doing tasting tests, comparing design and packaging alternatives is a much more sophisticated activity than for private labels – where retailers specify expectations – resulting in quality and visibility differentiation. What counts for retailers is the number of product types that they can buy from the same supplier, not only if they supply private label or not. *This supports the doubt of many researchers that supplying private label does not necessarily result in better relationship with the distribution.* It is the overall performance and the strategic goals of the chain. It is also visible that big chains are paying a lot of attention to standing several feet. They do not want to decrease their negotiation power toward big multinational companies, so they give opportunity and support to other players. If such companies can live up to the expectations, the relationship can result in a win-win situation for both. Certainly there are risks that such a business model reserves.

Figure 1

Ice cream brands: Ledo Kft: Ledo, Quattro, King brand,
Unilever: Carte D'Or



There is an interesting trend among retailers in this business, *they are not only copying the products of the branded manufacturers, but they started to copy other retailers' private label products as well.* Distributors are closely monitoring their main competitors and if they see a successful product, they copy as close as they can by back engineering it. In case of seasonal products such as ice cream, it can go as far as integrating the complete assortment of the competitor's private labels.

To purchase private labels *retailers call for a tender.* Participants are invited to the tender, they have to submit sample products and certainly all required information – price, quantity, source, official information. In case of an open tender after submitting the sample product there is no possibility to change anything unlike in case of a closed tender where recipe, packaging, design can still be modified. In food purchasing the most important criterion is taste, especially in Hungary (*Simon, 2009*). Therefore, retailers emphasise this factor the most in selecting suppliers. Some use committees, some blind tests. *Internet tendering* is a new approach used only by Auchan in Hungary now. At an internet tender applicants submit a sample product and a price. Based on these two factors participants will be chosen, given a date and a time period, usually 30 minutes, when they can bid for the tender. The retailer puts the lowest price offer as the starting price and suppliers can bid offering lower ones until the time is over. Such tenders are for huge quantities and committed for a long period, for a year, or for a season, so considering manufacturing capacity fill up and smoothening production is a good mean. But only if the requested products do not require too much production adjustment. Ledo makes the best possible offers to the tenders, but considering their limits. Their products are of good enough quality because of their modern and efficient production facility, good quality raw materials and recipes proved by customers, but the next question is the *price and profitability.*

A big mistake mentioned by *Kumar and Steenkamp (2007)* made by private label supplier companies is that they do not calculate correctly the fix cost contribution of private labels. These suppliers should use total cost as a basis for their unit margin calculation thereby avoiding giving too low prices even for such big quantities. They need to keep in mind as well that as for the low profitability of private labels but their main focus usually still needs to be their branded products.

For Ledo Kft. using the dual tracker business model – having several well-established brands in all price segments and producing also private labels for most of the Hungarian retailers – *improved competitiveness in a very crowded market.* They are able to profit from economies of scale, from enjoying support from dealers for their good quality products and wide portfolio and moreover there are no signs of organic or strategic schizophrenia. Producing private labels is considered a good strategic move by the company but by admitting that it is necessary to closely monitor its effects on all of their business operations.

CONCLUSIONS

Quelch and Harding (1996) are strongly opposing private label production if a firm also produces its own brands. At the same time there are other researchers like

Taylor and Rao (1982) and *Kumar and Steenkamp* (2007) who are in favour of national brands but not against private label production. The latter ones suggest analysing the situation of the company and the market, and then the firm needs to decide the best viable alternative. In case of Ledo Kft., operating on the seasonal ice cream market, the business model of a dual tracker company proved to be the best. They do produce private label for most of the retailers in Hungary in value, standard and premium price segment and they also have their own brands in these price segments. The biggest advantages of producing private labels for them are the economies of scale in production, raw material purchasing, logistics, smoother production and more profit. The challenges include controlling branding activities of the retailers for their own brands, but not being extended also to private labels produced by them. Cannibalization is visible in the first price segment with their fighting brand, where consumers prefer a store brand instead of a lower quality manufacturer's brand. Private label tenders many times are aimed at another retailer's private label product to be reproduced enabling the company to defend the uniqueness of their own brands and to produce private labels at the same time. The concerns regarding private label production are valid, but it is necessary to evaluate all by company and category to be able to decide on the right strategic move.

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