An empirical investigation of manufacturing Chinese private labels

Wei Song
Thompson Rivers University

ABSTRACT

The factors leading to retailers developing private labels have been examined extensively in Western literature. However, it has not been fully explored whether these factors are also applicable to non-Western markets such as China, Eastern Europe, and Africa. This empirical work presents a study that was conducted in Shanghai, China. Two main research questions were investigated. First, why do manufacturers make Chinese private labels? Secondly, why do some manufacturers not supply Chinese private labels? This investigation was undertaken by using semi-structured interviews with a group of ten private label suppliers and three retail consultants. The findings revealed that the difference exists while the relevance is also present. Several managerial implications have been addressed. The results of the study will enhance the current understanding of this subject area and serve as the basis for further studies.

Keywords: Private label, manufacturers; Chinese retailers; grocery sector; Shanghai

INTRODUCTION

The role of private labels in the retail market has become increasingly important (Groznik, Heese, & Sebastian, 2010). Developing private labels has become the mutual interest of both retailers and manufacturers because the development of private labels directly affects the market shares and profits of manufacturers and retailers (Burt, 2000; Verhoef et al., 2000; McGoldrick, 2002; Wu & Wang, 2005; Groznik et al., 2010). The significant development and growth of private labels has caused numerous researchers to explore this field of studies. However, the development of private labels varies notably from Western to non-Western markets. The former market has a very advanced private label program in terms of quality and market share, while the latter is at an early stage of development. As a result, the majority of the research has been drawn from the Western market, and the focus of these studies is mainly on the retailers themselves, and on consumers' perspectives. However, a few studies have addressed the issues from manufacturers' standpoints (e.g. Dunne & Narasimhan, 1999; Oubina, Rubio, & Yague, 2006). Therefore, more research is needed in the non-Western market regarding the private label manufacturer's perspectives.

Based on prior research, the motivation in the Western markets for manufacturers to support the private labels can be illustrated by three aspects: Improved profitability of the firm (Dunne & Narasimhan, 1999; Burt & Johansson; 2004); gaining a new direction for the manufacturers (Morris, 1979; Hughes, 1996; Cullen & Whelan, 1997; Timmor, 2007); and enhancing relationships with retailers (Kalwani & Narayandas, 1995; Dunne & Narasimhan, 1999; Davies & Brito, 2004). This study explores whether these motivating factors from the Western market are similar to the motivations for Chinese manufacturers to supply private label production as well as the reasons that discourage manufacturing private labels. The article begins with the review of relevant literature pertaining to manufacturers' motives in making private labels for retailers in the context of the Chinese market. Next will be an explanation of the methodology and approach employed in this study. Subsequently, results and findings will be reported. Finally, the implications for management and limitations of the research as well as suggested directions for future study are presented.

LITERATURE REVIEW

The extant research has revealed possible motivating factors behind manufacturing private labels for retailers. The reported research identified three factors: Improving the company's profitability, offering new directions for the firm, and enhancing the relationship with the retailers.

Improving the Company's Profitability

Studies have shown that manufacturing brands may improve profits and market share for both manufactures and retailers (Bontemps, Orozco, & Requillart, 2008; Karray & Martin-Herran, 2009). One of the motives for manufacturing private labels is to improve profitability by increasing sales volume and reducing unit production cost, as well as alleviating inter firm-competition among the manufacturers (Laaksonen, 1994; Dunne & Narasimhan, 1999; Tarzijan, 2004; Bontemps et al., 2008; Hyman, Kopf, & Lee, 2010).

By producing private labels for retailers, manufacturers can increase their product lines and make full use of their excess capacity (Morris & Nightingale, 1980; Parker & Kim, 1997). Some UK companies have taken this approach. Although their core business was not food or drink production, when these companies started producing food and drink products for retailers (Business Insights, 2003), they improved their revenues as well as their market share. In comparison to making manufacturers' brands, supporting retailers' private labels can decrease unit production cost by increasing economies of scale and reducing expenditures on advertising and promotion (Karray & Martın-Herran, 2009). With larger quantities output through a private label contract, firms can see decreased unit costs and increased profit margins (McMaster, 1987). A good example is AGFA, a Canadian film company that has significantly improved its financial performance by developing private labels for supermarkets (Oubina, et al., 2006).

While pricing competition among the manufacturers and retailers could eventually hurt the firms' overall profits, making private labels for retailers may be a way to lessen such a battle as the private label suppliers would be less likely to engage in product promotions, thus discouraging other manufacturers from competing with each other (Soberman & Parker, 2006). As a result, the price of manufacturers' brands increases following the introduction of private label products, as the manufacturers tend to focus on quality differentiation rather than price competition (Ward, Shimshack, Perloff, & Harris, 2002; Wedel & Zhang, 2004; Bontemps, et al., 2008).

New Direction for Manufacturers

The decrease in the number of manufacturer brands on store shelves (Simmons & Meredith, 1983; Burt, 2000) and the stronger power of retailers (Burt & Sparks, 2003) creates a sales challenge for the manufacturers. Asymmetrical competition between manufacturer and retail brands at the point of sale could also create a favorable condition to sell the private labels over manufacturers' brands (Oubina et al., 2006). Some manufacturers have opted to supply the private labels for retailers. From the traditional view, it shows that manufacturers should not participate in private label productions because it may negatively affect the perceived value of the manufacturers' brands and profits (Quelch & Harding, 1996; Timmor, 2007). Other schools of studies believe manufacturers supplying private labels would make "good economic and strategic sense" (Dunne & Narasimhan, 1999). Some empirical studies show a trend that national brand producers started to actively support private labels, which provides new direction for the manufacturers (Dawar & Parker, 1994; Craig & Douglas, 1997; Cullen & Whelan, 1997; Tarzijan, 2004; Hyman, et al., 2010). Especially for firms with non-leading brands, the fierce competition places them in a weaker position as they cannot compete with leading or retailers' brands (Pauwels & Srinivasan, 2004; Meza & Sudhir, 2008). These firms have the capability to make the products, but lack the resources to develop a strong brand or establish a distribution network. Therefore, producing retailers' brands becomes a convenient way for these firms in order to enter the highly competitive market (Dunne & Narasimhan, 1999). The success of manufacturers' efforts in making private label products has turned a less competitive advantage situation into a sustainable competitive advantage. Thereby, developing private labels for retailers could be a new opportunity for these manufacturers (Cullen & Whelan, 1997; Tarzijan, 2004).

Enhance the Relationships with the Retailers

Existing empirical studies have established that making private labels can enhance the relationship with retailers in both the short-term (Burt & Sparks, 2003; Oubina et al., 2006) and the long-term (Dunne & Narasimhan, 1999; Tarzijan, 2004). For the former, the manufacturers could use customer information gathered from retailers which could benefit the manufacturers' brands (Bontemps, et al., 2008). For the latter, the manufacturers could build a closer relationship with both customers, i.e., retailers and final customers, i.e., consumers, (Burt, 2000). Heinz's practice of producing private labels for retailers provides a good example of the cooperative relationship between manufacturers and retailers (Dunne & Narasimhan, 1999). Supporting private labels enables manufacturers to play a greater role in category management (Dunne & Narasimhan, 1999). The enhanced relationship with retailers positively affects overall category prices and permits both parties to charge higher brand prices (Ward, et al., 2002; Bontemps, et al., 2008). Joined complementarily rather than competitively, advertising from manufacturers or retailers could further boost consumer demand for both manufacturers' and retailers' brands (Karray & Martin-Herran, 2009). Higher transfer and consumer prices will be achieved through increased market power from manufacturers and retailers (Bontemps, et al. 2008). With profit-sharing schemes in place, the relationship between manufacturers and retailers would improve because of the mutual benefits of private label production (Burt, 2000; Collins-Dodd & Lindley, 2003). As a result, stronger market power, higher profit margin and better brand quality can benefit both manufacturers and retailers in the long run (Bontemps, et al., 2008; Martin-Herran, 2009).

Among these factors, improving relationships with retailers is the most important reason encouraging manufacturers to produce private labels for retailers. It also explains why manufacturers are inclined to make long-term commitments for the private label production. However, these studies were conducted primarily in the Western market. Research in the non-Western market, especially the emerging markets in China, Eastern Europe and Africa, is scarce.

In addition, extant studies have not addressed the issue of whether these factors are necessary conditions for manufacturers to produce private labels for retailers in a developing market. Having consulted a range of literature referencing these factors, we will verify the existing aspects and discover those not yet identified in the non-Western market. This study undertakes an exploratory investigation guided by theoretical work with a sample of retail suppliers and consultants relevant to manufacturing private labels specifically in China.

RESEARCH METHODS

For this empirical research, a qualitative method was used. Qualitative research is appropriate in an area where there is little known and limited research as it can reveal processes going beyond surface appearances (Holloway & Wheeler, 2000). The intent of this research is to examine the "process" rather than "test" of the measurement and causation between the variables (Denzin &Lincoln, 1998). The nature of the qualitative method is to explore the truth rather than facts alone. The guiding interpretive ontology assumption is that "the social reality is a product of the process" (Blaikie, 1993). Therefore, qualitative research better suits the present research. The aim of semi-structured interviewing is to gain the perspectives of the interviewees so that the investigated topics could be explored (Daymon & Holloway, 2004). It also allows the interviewees' perspectives to unfold rather than the researcher imposing their views, which is the case with quantitative methodology. This study takes an inside-out approach, which permits the interviewees (i.e., suppliers and consultants) to explain the situation from their perspective. The Shanghai Chain Store Association recommended a panel of consultants. The author obtained a list of manufacturers through a visit to the store and obtained the input of the Shanghai Chain Store Association as well as suggestions from consultants. The interviews consisted of thirteen people, including ten manufacturers and three retailing consultants.

In order to gain a full understanding of the factors related to manufacturing private labels for retailers, four groups of suppliers were sampled: Four current private labels suppliers, two future private label suppliers, two past private label suppliers and two who were considering supporting private labels, but decided not to become private label providers. In addition, three retail consultants were also invited to enrich the quality of the interview results as they are experts in this area. The average time for each interview was 48 minutes. Table 1 shows a summary of interview data obtained from the interviews.

Table 1 Summary of Interview Data

Types of Interviewees	Numbers of Interviewees	Firms' Products	Length of Interviews
Current Private Label Suppliers	4 (S3-S6)		
Supplier 3 (S3)		Canned Meat	35 Minutes
Supplier 4 (S4)		Paper Cup	45 Minutes
Supplier 5 (S5)		Wine	50 Minutes
Supplier 6 (S6)		Soybean Products	40 Minutes
Future Private label Suppliers	2 (S7-S8)		
Supplier 7 (S7)		Tea	50 Minutes
Supplier 8 (S8)		Biscuit	45 Minutes
Past Private Label Suppliers	2 (S1-S2)		
Supplier S1 (S1)		Noodle	90 Minutes
Supplier S2 (S2)		Chemical Products	55 Minutes
Not Private label Suppliers	2 (S9-S10)		
Supplier 9 (S9)		Dairy Products	30 Minutes
Supplier 10 (S10)		Soft Drink	35 Minutes
Retail Consultants	3 (C1-C3)	Retail Marketing	
Consultant 1 (C1)		Chain Store Association	50 Minutes
Consultant 2 (C2)		Internet Consulting Firm	45 Minutes
Consultant 3 (C3)		Retail Consultation	90 Minutes

The interviewees were encouraged to discuss their views in order to determine the reasons that they wanted to supply private labels or why they did not want to supply private labels. These interviewees were either the owners of the companies or the managers of the firms. All of them had good knowledge about private label products via their own experience with retailers. The interviews were conducted on an individual basis as the executives and senior managers would feel more comfortable when doing an interview alone (Hair, Babin, Money, & Samuel, 2003). Although, for convenience and accuracy of transcription, tape recording is common practice in most Western countries in conducting an interview, this is not the case in China, where tape recording during interviews with managers is strongly discouraged. This is partly due to the different political and cultural environment and partly because of the Chinese low-profile personality. On-site and off-site note taking methods were adopted. Data were grouped by categories created based on researcher judgment or the theoretical work. Then a careful comparison with the extant studies from Western countries was conducted and the differences and similarities were identified. Member checking was also conducted at the end of each interview.

FINDINGS AND DISCUSSION

There are three main motivations for the Western manufacturers to support private labels: increasing the profitability of the firms, gaining a new direction for a non-leading brand manufacturer (Morris, 1979; Cullen & Whelan, 1997) and enhancing the relationship with the retailers (Dunne & Narasimhan, 1999). In China's market, the motives for Chinese manufacturers to make private labels are different from those of the Western countries. The first reason is for the firm's survival needs. These companies lack the capabilities and resources to develop their manufacturers' brands. They face challenges selling their products in supermarkets because their products essentially are unknown labels to both retailers and consumers. In addition, high slotting fees and shelf allowances put these firms at a disadvantaged position to cover their operational costs (S4 and S5). As a result, the sales volumes are not guaranteed, which could lead the firm to operate at a net loss (C2).Therefore producing the retailers' private labels is the best solution for them (C1 and C3). Having contracts with retailers to produce the private labels provides these firms with the opportunity to keep their businesses running, even though the profit margin is either very slim or just break-even (S4). The interviewees (S5 and C2) further stated that the retailers in Shanghai had absolute power in pricing negotiations and suppliers had no room to negotiate (S5). This was a "take it or leave it" deal for manufacturers rather than a cooperative project (S4). However, the manufacturer could avoid bankruptcy in the short term and gained additional time in which to find better business deals. This is the economic motivation for Chinese manufacturers to produce private labels.

The second reason is to use retailers as a means to enter new markets by using excess capacity without needing any additional investment. This shortcut enables manufacturers to improve their revenue. These firms have established products, but the level of brand acceptance by consumers is weak. They need a retailer to act as a bridge to the final customers while producing private labels would be manufacturers' preferred choice. According to regulations in China, the suppliers of private labels must print their contact information on the product labels. Customers then recognize the products when they purchase the manufacturers' private labels products. The cost of advertising and slotting fees could be avoided, as they are already supplying private label products to the retailers (C1). By taking this route, the manufacturers reduce their costs, but gains would be also limited. This is the marketing reason for Chinese manufacturers to produce private labels.

The third factor is to reduce the risk of cannibalizing, (i.e., reducing the sales due to the introduction of a new product by the same manufacturer), and improve their competitive advantage in the future. These firms are usually national brand manufacturers. They preferred making private labels instead of developing cost-fighter brands, which could ruin their image and raise the risk of cannibalization. The private label products had a reduced cost and served well in the supermarket setting as customers could enjoy high-quality products at a lower price. This was a strategic consideration. Table 2 shows the reasons that the interviewed suppliers chose to make private labels.

Table 2 Reasons to Make Private Labels

Interviewees	Position	Firm Products	Reasons
Supplier 3 (S3)	Manager	Canned Meat	Strategic
Supplier 4 (S4)	Owner	Paper Cups	Economic
Supplier 5 (S5)	Owner	Cooking Wine	Economic
Supplier 6 (S6)	Manager	Soybean Products	Marketing
Supplier 7 (S7)	Manager	Noodle Soup	Strategic
Supplier 8 (S8)	Manager	Biscuits	Marketing

The Reasons for the Chinese to Manufacture Private Labels

Economic reason: survival needs. Although both Western and Chinese manufacturers make the private labels for economic reasons, there is a fundamental difference. The former is to succeed while the latter is to survive. For the Western manufacturers, making private labels is an endeavor for improvement. They want to make better quality products in cooperation with retailers. Making a long-term commitment and generating profits is the strategic goal. The relationship with retailers is a partnership. Nevertheless, for the group of Chinese manufacturers, supplying private labels is a temporary solution to avoid going out of business. Signing a private label contract is critical for the firm. Therefore, the manufacturers will often take the wholesale price offered by retailers. Typically, it is very low (S3 and S4) as Chinese supermarket retailers have strong bargaining powers, particularly the tertiary brands' manufacturers (C1 and C2).

The interviewees (S3 and S4) indicated that they knew that with this unreasonably low price, the quality of private labels could be an issue. However, they had no choice, as the retailers would always select the lowest bid for their private label contract work. They further stated they had the option of being private label suppliers just for a short period. This was partly due to the consumer complaints and partly due to the availability of other private label suppliers, enabling Chinese retailers to easily find alternative suppliers in need of private label contracts. This practice could explain why the Chinese private label image is not regarded positively, yet it could also explain why the private label suppliers' turnover rates are so high (C2). In the meantime, Chinese retail executives should reconsider their policy when selecting a private label bid, because the lowest cost may not be the best indicator for choosing the right private label supplier. The manager needs to recognize that there is a difference between producing private labels and building private brands. The latter would enable the retailer to achieve brand leadership, while the former would not.

Marketing reason: a new direction for the firm

In the Western market, supplying private labels is a positive direction for companies to take, as they believe that cooperation with the retailers generates synergy between them. Chinese manufacturers consider making private labels merely as an effective way to enter a new market. Suppliers S6 and S8 initially had their existing products for the current market in another province, where they made reasonable progress. After years of operation, the firms wanted to enter Shanghai's market. However, the financial barrier was high due to the expensive cost of Shanghai in general and its complicated distribution network.

In addition, the advertising and entry fees into the supermarkets would cost a fortune as an initial investment is necessary to place their products in Shanghai's market. Based on the net present value analysis, their NPVs would be negative over the three years of investment, while the initial investment is insignificant when using the entry method of making private labels for retailers (S8). At least some cost reduction could be achieved. Therefore, the company has decided to start making private labels for retailers and its products have entered Shanghai's market smoothly. During the interview, S8 stressed that the profit margin was near zero but the feedback of the products seemed positive. The manager (S8) further indicated that supplying private labels would only be a short term alternative for the firm. The firm would produce its own products when market shares improved (S8). Maybe the Chinese retailers ought to find a way to keep this type of suppliers whose products were well received by the consumers. One of the important components for building strong private labels is to have a reliable supplier (C2).

Strategic reason: reducing cannibalizing risk

From the Western literature (e.g. Tarzijan, 2004), one of the shortcomings for making private labels is the creation of the cannibalization risk. However, this may not be the concern for Chinese private label manufacturers as Chinese has strong brand consciousness. The consumers with brand loyalty are not prone to switching to an unknown private label even though they know the products are produced by the same manufacturers (C1). The cultural characteristic provides Chinese manufacturers a unique opportunity to make private labels without increasing the cannibalization risk in a short term (C3). Interviewees, S3 and S7 both have been supporting private label products for over five years. The firms sell both their national brand and private label products concurrently. These private labels with good quality and fair prices have attracted customers who are more price-conscious but require higher quality products.

The firms with this practice are usually national brand manufacturers and have well-established products. Because of the high price on manufacturers' brands, increasing sales volumes in China's market still remains challenging. Although the companies could develop sub-brands or cost fighter products to bring up the sales traffic, the cannibalization risk becomes inevitable (C1 and C3). In comparison to making sub-brand products, manufacturing private labels yields some advantages. First, consumers would subconsciously believe that the quality of the products is sound since it is made by national brand manufacturers. Secondly, customers also believe the low price is justified because the retailers have removed channel cost rather than lowering the standard of products. Thirdly, brand consciousness is strong historically in Chinese culture; therefore, the brand-loyal customers would still purchase name brand products and the risk level of cannibalization could be reduced. The manager from S3 pointed out that the brand reputation would be affected in the long term since the company information by law must be available for the consumers. Sooner or later, customers would raise a question: Why would this name brand company manufacture private labels if the firm does not have the financial constraints or quality issues? The manufacturers have not found the justification yet for this inquiry (C1 and C3). Hence, in the long run, both the company and brand image could be damaged (S3). The companies making such a move to supply private labels must consider these risks (C2 and C3). The retailers may use these groups of manufacturers to develop premium lines, which build true retailer brands.

During the interview with the consultants (C2 and C3), both mentioned that some manufacturers did not want to supply private labels. Either these manufacturers had supplied private labels in the past or had considered developing private labels but ultimately decided not to. The following section will discuss the factors that discouraged manufacturers from supplying the private label products.

The Reasons for the Chinese to Not Manufacture Private Labels

The interviews with the consultants (C1, C2 and C3) revealed that there are numerous manufacturers who want to supply the private labels to retailers. Therefore, Chinese retailers do not have difficulty in finding a supplier who is willing to make private label products; however, some manufacturers do not want to make private labels for retailers. Four firms were chosen based on suggestions from the consultants (C2 and C3). Two of these firms were past private label producers and the other two abandoned their plan to make private labels. There are two main reasons that caused some manufactures to abstain shown in Table 3.

Table 3: Reasons Not to Make Private Labels

Manufacturers	Positions	Firm Products	Reasons
Supplier 1	Owner	Noodles	No Profits
Supplier 2	Owner	Chemical Products	Low Profit Margin
Supplier 9 (S9)	Manager	Dairy Products	Damage Firm Reputation
Supplier 10 (S10)	Manager	Soft Drinks	Hurting Brand Image

The first reason is the profit margin in making private labels. The second reason is possible damage to name brand image in the end as the current private label products are positioned at the low end of the product spectrum. The chance for slim to no profits is the main reason for many suppliers to withdraw from being private label suppliers.
The owner from S1 stated that the company could not afford to make private labels because it made almost no profit. The price that the retailers set was extremely low. The firm did not have any bargaining power which almost drove the company into the corner (S1). In addition, there were many restrictions and specifications in the contract which put the firm in a passive position. They supported the retailers in private labels for two years and stopped making them thereafter. S2 is in almost the same situation as S1 due to a low profit margin, the firm withdrew from making private labels.

Concern about reputation is the main reason nationally recognized brand manufacturers do not make private labels for retailers. The manager of a dairy company (S9) stressed that making private labels for retailers would be a strategic mistake. In the long run, the brand image would be damaged. The short-term gains would never compensate for the long-term losses, namely the reputation and brand image set in the customers' minds. The price would be too high to become a private label supplier, said the manager of S10. The firm has been approached with offers by a major supermarket chain, but thus far has not agreed to sign the contract. This is because if a national brand manufacturer makes its private labels, consumers would view the branded products either as overpriced or misleadingly positioned, (e.g., making consumers think of the mediocre products as high-end products) (S10). Consumers would infer that the private label suppliers are unqualified or less capable of producing private labels since the other major brand manufacturers would not usually be private label suppliers (S10).

The study reveals that contributing factors from the Western market may not be the necessary conditions for manufacturing private labels in China's market in the short-term, but these factors may be relevant when manufacturing private labels in the long-term. The study also suggests that although the motivating factors behind manufacturing private labels are different between Western and China markets, the absence of these factors in the Western market could discourage firms from making Chinese private labels. The study further evaluates the importance of improving relationships that could be the key motivator for Chinese firms to manufacture private labels when it becomes a long-term cooperative strategy rather than a short-term alternative.

CONCLUSION

This empirical work has investigated motives behind manufacturing private labels and the reasons Chinese firms do not want to supply private labels in the Chinese market. These verified and identified factors concerning manufacturing private labels could be the basis for scholars to further test the validity of the results. It also provides guidance for practitioners when they make the strategic decision to manufacture private labels.

The results from this empirical investigation provided several managerial implications. Different factors associated with manufacturing private labels exist between the Western and non-Western markets. Consequently, there is need for more investigation of non-Western markets. Secondly, the factors generalized from Western literature are relevant when manufacturers abandon the approach to make private labels. It implicates the association of these factors between the two markets is present. Thirdly, factors motivating Western manufacturers could be more relevant when producing private labels as a long-term commitment rather than a short-term objective. As a result, enhancing relationships with retailers would be much more crucial when the long-term strategy in making private labels is implemented in China's market.

Limited English literature regarding manufacturing private labels in the non-Western market makes it more challenging to compare and contrast with other studies. A small sample size within a single city could result in biased results and an incomplete view towards the subject. These research limitations are unavoidable in the early stages of the study.

Nonetheless, the study does not provide sufficient evidence to confirm whether these factors from the Western market are relevant only in the context of manufacturing private labels over the long-term, as opposed to the short term. The study does not explore the possible reasons why Chinese manufacturers do not make the long-term commitment to making private labels rather than viewing this as a short-term objective. Moreover, the factors identified from this study would be valid only when manufacturing private labels as part of a short-term plan. These factors might be invalid when the condition is changed. Therefore, it is necessary to broaden the scope of the research from different non-Western regions, markets and countries. In addition, a quantitative methodology would be complementary to this study for further examining and explaining the factors explored.

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