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## Can a weak retailer benefit from manufacturer-dominant retailer alliance?

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## ABSTRACT

The paper provides a framework to help the weak retailer delineate the circumstances that allow him to benefit from an alliance between the dominant retailer and the common manufacturer. We use a game-theoretic model to determine the optimal pricing and service strategies when channel members act independently then when the dominant retailer forms an alliance with the manufacturer. We find that: (i) the alliance is formed only if the market is not strongly competitive in terms of price, (ii) differentiation in terms of price and service is beneficial to all channel members under alliance, (iii) an interaction between spillover and service effects plays a crucial role to make the weak retailer gain or lose from the alliance.

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## 1. Introduction

Today, dominant retailers (i.e., Wal-Mart, Home Depot, Lowe's, Best Buy, Circuit City, etc.) are becoming more and more powerful in retailing industry. The channel coordination via strategic alliance between manufacturers and dominant retailers has significantly reshaped supply-chain management. The topic has recently gained big interest for academicians as well as professionals. There are several reasons for such interest. First, the dominant retailer is enjoying a large demand in the market (Epstein, 1994; Wahl, 1992) and frequently is the largest distributor for the manufacturer. As an example, Wal-Mart is the world's largest retail seller. The total market share of Home Depot and Lowe's is more than 50% in home improvement (Knight, 2003). Second, the dominant retailer can run unique feature advertisements, information seminars and trade shows to promote the manufacturer's products but the weak retailer is not able to implement such activities. As a result, the dominant retailer has made him-self very attractive for many manufacturers to engage in channel coordination via strategic alliance. We note that there is critical difference between "strategic alliance" and "vertical integration". The former means that both parties try to reach common goals through a synergy of strengths (knowledge, expertise, reputation, financial resources, etc.) but remain independent. The latter means that two parties at two different levels of the distribution channel (for instance a manufacturer and a retailer) are under the same management and are controlled by the same

company to increase its power in the market. Vertical integration is widely studied in previous marketing literature (e.g., Chiang et al., 2003; McGuire and Staelin, 1983) but strategic alliance was tackled by very few marketing papers (e.g., Yue et al., 2006). The main omission of the literature is the effect of strategic alliance on service strategy in the context of non-equal powered retailers.

The importance of strategic alliance in the real business and the shortage of marketing studies about that topic have motivated us to explore the impact of strategic alliance on channel performance and channel's members decisions. In this paper, we consider a supply chain made up of one manufacturer and two retailers. One retailer is dominant by enjoying a high primary demand and the other retailer is weak as his primary demand is lower than the dominant's one. We extend the literature on strategic alliance by considering asymmetric retailers and studying, for the first time, pricing and service decisions simultaneously in that context. We determine the optimal pricing and service strategies under different market structures: (1) alliance between the manufacturer and the dominant retailer versus (2) no alliance. We use a game-theoretic approach to specifically study the following questions:

- For each market structure (no-cooperation versus cooperative-strategic alliance), what should be the optimal pricing and service strategies that the manufacturer, the dominant retailer as well as the weak retailer should adopt?
- Under which market structure can the manufacturer and the dominant retailer draw higher profit?
- Is it always harmful for the weak retailer that the manufacturer and the dominant retailer form an alliance or are there circumstances that allow him to avoid such harm and also benefit from such cooperation?

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The rest of the paper is organized as follows. Section 2 provides a summary of the relevant literature. Section 3 presents the modeling framework and analyzes the cases of no-cooperation versus cooperative-strategic alliance. Section 4 presents our main results of the simulations and profit sharing. Conclusions and managerial implications are presented in the last Section 5.

## 2. Literature review

In this section, we review the relevant marketing literature to position our paper. Though vertical integration is widely addressed in previous marketing studies (e.g., Chiang et al., 2003; McGuire and Staelin, 1983), it is not the case for strategic alliance. Indeed, strategic alliance was mainly studied to deal with financial and economic topics (Baker et al., 2003; Bleeke and Ernst, 1995; Chan et al., 1997; Gulati and Singh, 1998; Noe et al., 2002; Pisano, 1989). Some papers studied the issue of strategic alliance but they focused only on the effect of strategic alliance on pricing and other factors (e.g., economic incentives and communication) and did not address the effect of strategic alliance on service strategy in the context of non-equal powered retailers (e.g., Agarwal et al., 2009; Das and Rahman, 2010; Yue et al., 2006). Our paper investigates the value of strategic alliance as an effective coordinating mechanism and its impact on pricing and service strategies for all channel members. We focus on a manufacturer–multi retailers supply chain where two retailers have different power (one dominant and one weak retailer).

Various mechanisms for coordinating supply-chain channels have been proposed in previous literature. For example, Jeuland and Shugan (1983) explore different issues related to channel coordination (e.g., effect and difficulty to achieve it) and show that quantity discount is one effective mechanism to reach coordination in the context of one manufacturer–retailer channel. Roth and Nigh (1992) conducted an empirical study to show that the effectiveness of the relationship between the headquarters and their subsidiaries is positively related to the coordination of both primary and support activities (e.g., personal integration) and negatively related to the level of conflict. Another early work by McGuire and Staelin (1983), studies the strategic importance of product substitutability in a duopoly where each of two manufacturers sells his product through a single retailer. McGuire and Staelin (1983) recommend that if the degree of product substitutability is high (i.e., high competitiveness), it is better to sell through competing retailers; otherwise selling through company-owned store is recommended. Gerstner and Hess (1995) propose pull price discounts targeting price-conscious consumer as an effective mechanism to increase total channel profit in the case of one manufacturer–retailer channel. The authors show that using jointly push and pull pricing strategies enhances coordination's likelihood. On the other hand, Ingene and Parry (1995) shows that coordination is not in the interest of the manufacturer when there is competition between retailers. More specifically, neither quantity discounts nor two-part tariffs with constant per-unit fee are able to coordinate the channel. Iyer (1998) examines how manufacturers should coordinate channel distribution when two retailers compete under price and non-price attributes (e.g., free repair services). The author identifies the type of contract that implies symmetry versus differentiation among retailers in terms of price and service decisions. He explains that travel costs, time costs and consumer willingness to pay are all important factors affecting the type of contract. Also, the author extends the model to the competition at the manufacturer level. He shows that a distribution channel where one manufacturer chooses to coordinate the channel and the other not is the optimal solution when there is a

weak brand loyalty. Raju and Zhang (2005) show that a manufacturer should choose quantity discounts to coordinate a dominant–retailer channel when the cost of retail services is high and should choose a menu of two-part tariffs when the cost is low or when the dominant retailer is sufficiently dominant. Koulamas (2006) conducts a theoretic study to show that manufacturers and retailers can implement a revenue-sharing policy to achieve channel coordination effectively. Mottner and Smith (2009) studied the relationship between Wal-Mart and its suppliers and showed that suppliers always like to give concessions to Wal-Mart in order to keep a strong relationship.

With the emergence of the Internet as a viable channel of distribution, some studies show that the direct channel can be used also to improve channel coordination. For example, Yan and Pei (2009) show that adding a direct channel to a traditional one and offering retail services effectively improves supply-chain performance. Yan et al. (2011) show that coordination is crucial in multi-channel context. To do so, brand differentiation is not required to coordinate channel conflict. However, offering identical brands through a direct-online channel and a traditional one and using an appropriate cooperative mechanism are sufficient to enhance the performance of all channel members. Yan (2010) studies the issue of information sharing between the online and traditional retailers and found that both can benefit from that sharing.

Our paper contributes to the literature as follows. First, Yan and Pei (2009) and Yan et al. (2011) focus on a channel structure with one manufacturer and one retailer. Our paper focuses on a channel structure with one manufacturer and two competitive retailers. Second, these two papers focus on how to alleviate the channel conflict between the direct online channel owned by the manufacturer and the traditional channel. In our paper, the manufacturer does not open any direct online channel and the focus is on the impact of cooperation between the manufacturer and the dominant retailer on the weak retailer. Third, these two papers do not address the importance of retail service on channel members' performance, but our paper includes that factor. Contrary to Yan (2010), our paper considers the upstream (manufacturer) channel member and the value of competitive retail services on channel members' performance. Besides, Yan (2010) focuses on information sharing, however, our paper focuses on how the cooperation of the manufacturer and the dominant retailer impacts the performance and strategies of the weak retailer.

Tsay and Agrawal (2000) address service and pricing competition as it is the case in our paper but they take into account a competition at a horizontal level between two retailers having equal power. Moreover, their purpose is to characterize wholesale pricing structure as a coordination mechanism while our paper compares the impact of forming strategic alliance on pricing and service decisions of channel members. Raju and Zhang (2005) address channel coordination in the context of one manufacturer and one dominant retailer but they did not address the strategic value of the alliance and its effect on retailer's service level. Chen and Xiao (2009) propose two coordination models (namely quantity discount and Groves wholesale pricing schedule) in the context of a dominant retailer, multiple fringe retailers and a common manufacturer and they showed that the choice of the best schedule depends on the demand's amount and market share of the dominant retailer as well as the production cost level. Our paper, however, has another purpose as stated previously and considers price and service effect (direct effects and cross effects) as well as service–spillover effect as main parameters impacting optimal decisions and performances. Chen and Xiao (2009) allowed only the dominant retailer to use service to promote his sales which is different from our paper as we allow both retailers to use service which is more realistic. When the

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