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Selling through outlets: The impact of quality, product development risk, and market awareness☆

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ABSTRACT

We consider a monopolist manufacturer of a luxury good who currently sells a product through a retail store. The manufacturer must decide whether to also offer this product, at a lower quality level, through a factory outlet store. We study how this decision depends on the relative qualities of the products offered on the two channels, as well as the manufacturer's ability to develop successful new products. Our multi-period model captures both risky new product development and the impact of outlet sales on the manufacturer's brand awareness. We find that the manufacturer's optimal strategy will be one of three options: expand into the existing outlet channel by introducing a low-quality version of the product, do not expand into the outlet channel, or expand into the outlet channel only when new product development is successful. The "wait and see" strategy becomes optimal when the fixed cost associated with expanding into the outlet channel is moderate and the likelihood of successful new product development is low. In this case, expanding into the outlet channel is only preferred when new product development is successful because successful development helps counteract the negative impact of outlet sales on the perceived exclusivity of the brand. Finally, we demonstrate that the manufacturer's optimal strategy is dependent on the level of product differentiation provided by the outlet and the impact of brand awareness on brand quality.

1. Introduction and motivation

Manufacturer-owned outlet stores have become an important segment of the retail industry. Outlet stores were the fastest growing segment of the retail sector in the US during the 1990 s, with the number of stores doubling between 1990 and 2005 (Barnes, 2005). While outlet stores were originally established to provide an outlet for excess inventory or imperfect goods, today outlet merchandise tends to be manufactured specifically for sale in outlet stores. In most cases, these outlet products have a lower quality (and price) than the products sold in traditional retail stores (Sherman, 2008). Thus, selling the product through an outlet, in addition to a retail store, enables the manufacturer to reach more price-sensitive customers and engage in market segmentation. In this paper, we study a manufacturer's problem of determining whether and when to introduce a lower quality version of a product for sale exclusively through an existing outlet channel.

The research presented in this paper is motivated by Coach, Inc., a manufacturer of leather hand bags and other accessories. A recent article in the *Wall Street Journal* notes that Coach's outlet business grew from 30% of total retail sales in 2006 to 60% in 2014 (Cheng, 2013). In addition, more than 85% of the goods sold at Coach outlets are manufactured specifically for the outlet stores. These outlet-only products may share the design or style of the retail products, but they are generally of lower quality, e.g., they are made of inferior materials or to less exacting standards. The *Wall Street Journal* article goes on to document Coach's current financial struggles, as well as the difficulties Coach faced in trying to maintain and enhance its brand image in the face of these growing outlet sales:

> "Consumers may increasingly perceive Coach as an off-price brand, which, if valid, could challenge [Coach's] efforts to elevate and transform the brand," Ms. Landes [a Cowen & Co. analyst] said in a report this week, adding that while most of the retailer's outlet products are made for that channel, they are still easily identifiable as Coach. "Our findings raise a concern of possible over-democratization of the brand which may counter efforts to appeal to aspirational shoppers and build a sense of exclusivity and cachet."

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Thus, despite the growth of its outlet sales, Coach's profits declined significantly in 2014 as the company lost market share to competitors such as Michael Kors, which has seen rapid growth in recent years (Kapner and McCarthy, 2014). The success of Michael Kors has been attributed, in part, to the firm's growing brand awareness, as well as its reputation for innovative products and, in particular, its success at "adapting to the needs of the modern consumer".[1] According to one analyst, Michael Kors has seen success by "driving a frequent flow of new and innovative products through its own stores and wholesale shops" (Shrivastava, 2013). In an effort to recover from its recent downturn and win back market share, Coach is also seeking to become more innovative. The company recently unveiled a new flagship store to be used as a "lab" to test out new innovations (Shropshire, 2012).

Inspired by this example, we consider the question of whether and when a luxury brand manufacturer should sell a similar, but lower quality, product through its outlet stores. As noted above, selling a product through the outlet, as well as through the retail store, can enable market segmentation, allowing the manufacturer to attract more customers. Thus, selling through the outlet can increase the product's short-term sales. Selling through an outlet can also lead to a higher degree of brand awareness, as more consumers become familiar with the brand. Since consumers are more likely to purchase a more well-known brand (Laurent et al., 1995), this can increase long-term sales. However, selling a low quality version of the product through the outlet can also lead to cannibalization, i.e., some customers will purchase the low quality product rather than buying the higher quality version, which may reduce the manufacturer's short-term profits. In addition, for a luxury brand manufacturer, selling similar, but lower quality, products to a wider array of customers may diminish the customers' perception of both the quality and the exclusivity of the product (Geller and Wahba, 2010), which can hurt the manufacturer's profits in the long run. The *Wall Street Journal* article on Coach summarizes this dilemma: "As upscale brands seek to...expand their outlet businesses and even produce merchandise specifically for that channel, they face an age-old dilemma: sales growth vs. brand exclusivity."

However, this trade-off is only part of the story. A manufacturer's ability to successfully introduce new variations to its existing products can also be a critical success factor (Rigby et al., 2009). By regularly introducing new, high-quality products to the market, a luxury brand manufacturer can compensate for the negative impact of outlet sales on the manufacturer's brand image. The product can continue to be seen as "must have," despite the lower quality offerings being sold through the outlet (Wetlaufer, 2001). However, new product development can be risky, i.e., new products are not always well-received, particularly in the fashion industry. Analysts have noted the risks inherent in Coach's attempts to introduce new products, due in part to the "finicky" nature of fashion.[2] Thus, when considering a manufacturer's decision regarding whether to expand its outlet channel, it is critical to consider the benefits and risks associated with new product development.

In summary, we consider a manufacturer of a luxury good who must decide whether to sell an existing product only through a traditional retail store or to expand into the factory outlet store by developing a low-quality version of the product. We study how this decision depends on the qualities of the products, as well as the manufacturer's ability to successfully introduce new products. In addition, our multi-period model captures the fact that brand image is often increasing in the manufacturer's market share. We find that the manufacturer's optimal strategy will be one of three options: expand into the outlet channel by introducing a low-quality version of the product, do not expand into the outlet channel, or expand into the outlet channel only when new product development is successful. The latter "wait and see" strategy is optimal when the fixed cost (associated with developing a new variation of the product) is moderate and the likelihood of successful new product development is low. In this case, expanding into the outlet channel is only preferred when new product development is successful because the introduction of new high-quality products helps counteract the negative impact of the outlet on the exclusivity of the product.

2. Literature review

In this section, we review the relevant literature considering a manufacturer who sells his product through dual channels. Much of this literature assumes that one of the channels is a manufacturer-owned direct channel, while the other channel is independent of the manufacturer, e.g., Dumrongsiri et al. (2008), Chiang et al. (2003), Cattani et al. (2006), Lee (2007) and Bell et al. (2003). In contrast, we consider a manufacturer who sells its product through two manufacturer-owned channels and jointly sets the prices on these channels.

Our model has some similarities to the literature on product line design. Mussa and Rosen (1978) define a product line as "a quality-differentiated spectrum of goods of the same generic type." These goods may be similar, but they are not perfect substitutes since "all customers do not place the same valuations on all attributes of the goods." Pricing is an important aspect of product line design. By strategically pricing the products, the manufacturer can price discriminate among the various market segments while still allowing free consumer choice, while avoiding cannibalization. Mussa and Rosen (1978) consider the problem of designing and pricing a product line where products are characterized by a continuous level of quality, consumer preferences are indexed by a parameter θ, utility for quality varies in proportion to θ, and the preferences of the set of consumers are described by a density function on θ. The authors demonstrate how a monopolist can use quality differences in the product line to get customers to self-select into the highest quality product closest to their willingness to pay. Moorthy (1984) considers a similar model when consumer preferences are assumed to be nonlinear. Bhargava and Choudhary (2001) study the impact of cost structure on a monopolist's choice between offering a set of vertically differentiated products and a single product.

In this paper, we consider the question of whether a manufacturer should introduce a low quality version of the product for sale through its outlet channel. This paper differs from the previous research on product line design by incorporating the consumers' valuation for the manufacturer's brand, in addition to the usual valuation for product quality. This valuation for brand incorporates several factors, including the dilution of the brand when the manufacturer expands into the outlet channel, and the effects of market share and successful new product introduction. When considering the manufacturer's outlet decision, we incorporate the risk that product development may not be successful. Previous literature has also incorporated the impact of market size, and the desire of some consumers for exclusivity, into the product line design decision, e.g., Amaldoss and Jain (2005a), Amaldoss and Jain (2005b) and Agrawal et al. (2015). However, our paper is the first to also consider the benefits and risks of new product development using a product line design framework.

3. Model description

In this section, we describe our model setting and assumptions. We first describe the decision problem faced by the manufacturer. We then describe the consumer choice model. Table 1 summarizes the notation that will be used in these models.

[1] http://www.bidnessetc.com/business/10-reasons-why-everyone-loves-michael-kors/

[2] http://analysisreport.morningstar.com/stock/research?t=COH & region=USA & culture=en-US & productcode=MLE, http://seekingalpha.com/article/1713382-coach-aspiring-to-be-your-aspiration

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