Manufacturer Encroachment in a Non-Exclusive Reselling Channel

With recent development in electronic commerce, the practice of manufacturer encroachment, where a manufacturer sells directly into a market as well as though a reseller, has become widespread. Amazon sells its Kindle through its own website as well as through other resellers like Best Buy; Apple sells its products through its own on-line and in-store channels as well as through third-party resellers. Fashion apparel firms, such as Calvin Klien, Tommy Hilfiger, and Nike, sell through both traditional resellers as well as through their own factory outlets. Similar trends are observed in the airline industry, where airlines sell flight tickets through common on-line resellers like TraveloCity, Kayak and also directly through their websites. In all of these examples, the resellers include the products of more than one manufacturer in their assortments. In spite of this, nearly all of the literature on manufacturer encroachment is focused on bilateral monopolies.

In the context of a bilateral monopoly, it is by now well understood that by selling directly into a reseller's market, a manufacturer can exert downward pressure upon the retail prices. In addition, because this can incentivize the manufacturer to reduce her wholesale prices, the practice of encroachment can benefit both the reseller and the manufacturer.

Yet in practice, a resellers are rarely exclusive, and typically sell the products of multiple manufacturers, some of which can have direct channels while others do not. For example, although BestBuy carries both LG tablets and Samsung Galaxy tablets, only Samsung operates its own direct channel. Such competition can have a dramatic impact on the interactions
between an encroaching manufacturer and a reseller, and can in turn affect the benefits associated with encroachment. To explore the implications of encroachment when more than one manufacturer sells through a common reseller, we develop a model of two manufacturers who sell partially substitutable products through a single reseller.

We show the way that a manufacturer pursues encroachment in this competitive environment affects both the strength of the incentives that she creates for the reseller and her competitive position vis-a-vis her rival manufacturer. The balance between these two imperatives is most interesting when only one of the two manufacturers operates a direct channel, i.e., possesses encroachment capability, and much of our analysis is focused on this case.

When only one of the two manufacturers has the ability to encroach, the timing of her production decision for her direct channel becomes a non-trivial strategic variable. Recall, that in a bilateral monopoly encroachment setting, it is always to the manufacturer’s advantage to strengthen the incentives for the reseller by postponing her decision about the quantity to sell through her direct channel until after she receives the reseller’s order. However, this is not necessarily true when there is another non-encroaching manufacturer selling through the same reseller. In this case, postponing the decision about the quantity to sell through her direct channel can put an encroaching manufacturer in a disadvantageous follower position vis-a-vis the rival manufacturer.

To highlight this issue, we endogenize the timing of when the manufacturer produces for her direct channel. In particular, we allow the manufacturer to produce once prior to receiving the reseller’s order, and again after receiving the order if it is to her advantage to supplement her original quantity. We show that when both the efficiency of her own direct channel and the competition from the rival manufacturer are sufficiently strong, then the encroaching manufacturer may prefer to produce a sufficiently large quantity for her direct channel prior to receiving the reseller’s order that she will have no incentive to produce more later. This contrasts with the results for encroachment in a bilateral monopoly where it is always to an encroaching manufacturer’s advantage to postpone the quantity decision for
her direct channel.

In addition, we find several other important ways in which the implications of manufacturer encroachment are altered when more than one manufacturer sells through a common reseller. First, the potential for the reseller to benefit from encroachment decreases in the substitutability of the manufacturer’s products, and vanishes once the substitutability exceeds a threshold. Second, we find that for some values of the substitutability parameter, the encroaching manufacturer may sell exclusively through her own direct channel, bypassing the reseller altogether, even when her channel is strictly less efficient than that of the reseller. This never occurs in a bilateral monopoly. We show that when there is a rival manufacturer, the development of encroachment capability does not necessarily reduce the wholesale prices. Consequently, when one manufacturer develops the ability to encroach, it can be beneficial to the other manufacturer as well.

Interestingly, we also find that when the products are sufficiently substitutable, the encroaching manufacturer chooses to sell through reseller even when her direct channel is efficient. The encroaching manufacturer uses her direct channel to credibly commit to more of her product in the market through decentralizing. This explains why, in spite of its notoriously efficient logistics systems, Amazon sells its own branded products like Kindle through resellers where other similar products are also sold.