Price Effects on Vertical Brand Extensions: A Conceptual Framework

Nicolas Pontes, Monash University, nicolas.pontes@buseco.monash.edu.au

Nicolas Pontes  
Department of Marketing  
Monash University, Caulfield campus  
26 Sir John Monash Drive (P O Box 197)  
Caulfield East Vic 3145, Australia  
Tel: +61 3 9903 1884

Colin Jevons, Monash University, colin.jevons@buseco.monash.edu.au (contact author)

Dr Colin Jevons*  
Department of Marketing  
Monash University, Caulfield campus  
26 Sir John Monash Drive (P O Box 197)  
Caulfield East Vic 3145, Australia  
Tel: +61 3 9903 2304
Abstract

Brand extension has been extensively discussed during the past two decades, however, most of the work has focused on horizontal extensions and little attention has been paid to vertical extensions. To address this imbalance of existing knowledge, we propose in this article a conceptual framework that integrates existing brand extension knowledge with insights from the pricing literature. Drawing from reference price and social judgement theories we propose a conceptual model that illustrates the effects of core brand price on consumers’ price expectancy which in turn affect evaluations of the extension perceived quality. Moderating factors that influence this relationship are also identified, namely step size and direction of the extension. The conceptual model is subsequently used to develop concrete research propositions to guide further research in the area.

Keywords: brand extension, vertical line extensions, reference price theory, step size, latitude of acceptance.
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Introduction

Introducing a new brand can be risky due to high failure rates and high costs of new products introductions (Aaker, 1991, Reddy et al., 1994, Pitta and Katsanis, 1995). It has been suggested that brand extensions spend less in advertising and promotion when compared to new brands. Brand managers have frequently used brand extensions to target new markets and segments reducing marketing expenditures, while increasing retail shelf share (Kadiyali et al., 1998). This practice is so often used that most of new product introductions are made through extension of existing brands (Reddy et al., 1994, Pitta and Katsanis, 1995, Kirmani et al., 1999, Musante, 2007).

According to Aaker (1991), there are two types of extensions: line extensions and category extension. Category extensions stretch the brand to a new category or product class (Reddy et al., 1994). On the other hand, a line extension is the use of the core brand name in the new offering in the same product category as the parent brand. It is within the scope of this later strategy that managers most commonly choose to introduce a new product in the market (Reddy et al., 1994, Pitta and Katsanis, 1995). A study of business launches in 108 companies reveal that 86% of new products were line extensions accounting for 62% of the total revenues, but delivering only 39% of total profits, numbers that imply that there is lower reward associated with the lower risk of extensions (Kim and Mauborgne, 2004).

As suggested by Pitta and Katsanis (1995), line extensions can be either horizontally or vertically differentiated. In the case of horizontal extensions the most common types of product differentiation are related to flavor, color, size, and fragrance. A vertical line extension, however, represents the differentiation through the introduction of a new product under the same brand name at a higher or lower point of price and quality level in comparison to the core brand (Kim and Lavack, 1996), such as Intel Pentium and Intel Celeron. There are two directions which companies can use vertical line extensions to stretch their portfolio: up or down. A step-up extension is introduced at a higher quality level and price point than the core brand. A step-down extension is an extension that is introduced at a lower price and lower quality level than the core brand (Kim and Lavack, 1996).

Previous research in the vertical line extension research stream, focused on extensions’ evaluation (Dacin and Smith, 1994, Kim and Lavack, 1996, Kirmani et al., 1999, Kim et al., 2001, Musante, 2007, Lei et al., 2008) finding that independent variables such as: direction of the extension, number of products in the line, and product/brand ownership affect consumers’ evaluation. Additionally, they’ve found that these relations are moderated by consumer’s prior knowledge, brand concept and distancing techniques. When examining the core brand evaluation after an extension has been introduced, the direction of the extension, brand concept, distancing techniques (Kirmani et al., 1999, Kim et al., 2001), prior usage, and brand loyalty (Chu-Mei, 2002) were found to be the main independent variables.

Despite the fact that considerable progress has been made in the area, one of the main variables that affect vertical line extensions evaluations, that of price, has been largely under-investigated. Price is an attribute in which change is readily perceived, since in vertical line extensions the core brand is in a higher or lower price position than its extension. As a result, this paper addresses the effects of price on vertical line extensions.

The objectives of this conceptual paper are as follows: first, we provide a brief background on two theories widely used in the pricing literature: reference price and social judgment. Secondly, drawing from these theories we propose the effects of expected prices on the vertical extension’s perceived quality. Then, we highlight how price point distance may affect core brand evaluations following an extension introduction. Finally, a set of research
propositions is introduced corresponding to the linkages in the conceptual model. The paper concludes with an agenda for future research.

**Literature Background**

Consumers use reference prices as standards against which the purchase price of a product is judged. A common conceptualization has reference price as a predictive price expectation. Corroborating with Kalwani et al. (1990), Mazumdar et al. (2005) suggests that expected reference price formation depends not only on consumer’s prior knowledge also on situational factors. Consumer’s prior purchase experiences have been shown to influence expected prices in many different ways, specifically: (a) prior prices he or she observes, (b) prices encountered on recent occasions or last paid price (Cox, 1986), (c) greater share of prior promotional purchases results in a lower expected price by the consumer (Mazumdar et al., 2005), (d) the range of prices in the category, and (e) end prices (highest/lowest) of alternatives (Della Bitta and Monroe, 1974, Petroshius and Monroe, 1987, Kalwani et al., 1990). While prior experiences create a price memory, several contextual factors may moderate this influence: purchase occasion, store environment, type of product, and store price image. Hamilton and Chernev (2009) found that consumer’s shopping goal (browsing/shopping) moderates the price image formation such that they can result in opposite perceptions. Kahn and Schmittlein (1992) suggest that consumers in regular shopping trips use more out-of-store promotions while consumers in fill-in trips tend to use in-store promotions in order to decide which brand to buy. Furthermore, store price image (high/low) and reputation also affect consumer price expectations (Merrilees and Miller, 2010). Kalwani & Yim (1992) suggest that promotion frequency has a strong influence price perceptions, in such that brands sold in an everyday low price type store are likely to be lower than those of brands sold in a Hi-Low price store type.

Reference price theory is of great importance to vertical line extension context. Despite the fact that extensions are new products and have no prior price history or prior consumer experience with the specific product, customers will use core brand beliefs and associations when evaluating the new extensions, and an important cue or reference for the new product is the core brand price history. As individuals create a price expectation, they create also a frame of reference which they will compare the new product to.

According to social judgment theory an individual’s response towards stimuli cannot be represented by a single score; instead zones or latitudes are used to represent one’s attitude or response. This theory shows that individual’s judgements comprises of latitudes of acceptance, rejection and non-commitment. Latitude of acceptance is the acceptable range of stimuli, latitude of rejection is the range where the stimuli are found objectionable, and latitude of non-commitment comprises neither the acceptance or rejection of the stimuli (Sherif, 1963). The similar process occurs when price is the stimuli. Hence individuals don’t have one single price in mind that they will accept or reject to pay. Instead, a price range is formulated as frame of reference which is used to access evaluations about the vertical extension.

Another body of literature that discuss a similar concept is the service marketing research stream. Because disconfirmation theory argues that customers’ expectations of the level of a given service attribute are thought and measured as one singular level of expectation, Berry and Parasuraman (1991) introduced the zone of tolerance concept. It states that consumers don’t have expectations of a service at one given level rather they tolerate, and therefore accept, a level of variance of performance by the company. The concept implies an upper and a lower limit of acceptance, called desired and acceptable level of service. The first, is the level of service and performance that consumers desire for and expect while the latter
represents the minimum level of performance that a company can give. These two represents the boundaries of expectation that a consumer have for a service. Any performance within this acceptable range is considered good by consumers (Grönroos, 2007).

In the pricing context, Monroe (1973) argues that consumer responses are either positive (acceptance) or negative (rejection). However, in an evaluative mind set, consumers may have non-commitment latitudes where they are uncertain or indifferent about the stimuli. Different from this view, we argue that in the vertical line extensions context it is possible that brands have latitudes of non commitment, acceptance and rejection.

**Expected prices effects**

Previous literature has argued that perceived quality is a function of price, brand name, store name and product-related attributes (Dodds et al., 1991, Brucks et al., 2000). However, this literature is based on a single product/service evaluation. The effect of expected prices on the perceived product quality has not yet been established in the literature.

Expected prices play a major role in brand and line extension context. The research by Sung Youl *et al* (2003, 2005) has shown that expected prices may impact the extension’s overall perception of quality. Also that core brand prices, price variation among the brands in the extensions’ category, and price difference between core brand category and extension’s category are predictors of expected prices. Corroborating with this argument, we first assume that consumers may use core brand price information to formulate their price expectation, but different from previous studies we consider the category price segments as orientation for core brand price positioning instead of assuming only a high or low price. Second, we also argue that the product category price variation moderates the core brand price effect on expected prices, but further to Sung Youl *et al* (2003, 2005) this research paper also explores the effects of category end prices on consumer’s price expectations. Finally, store price image may also influence how consumers expect prices they will encounter.

**Core brand price**

Extensions are new products which consumers don’t have prior experiences with. There is no price history or past price other than the core brand traits that can be accessed from memory (Hardie et al., 1993). Since expected prices depend on consumer’s prior knowledge (Kalwani et al., 1990, Mazumdar et al., 2005) and the core brand previous experience is the only available information consumers can retrieve from memory, along with context and other variables, it is reasonable to assume that consumers use price of the core brand as the expected price for the extension once they are based on existing brand names.

Consumers usually expect that extension of brands will follow the status quo, namely the same price and quality levels that the brand usually offers (Tversky and Kahneman, 1991). Thus, if the core brand is of high price-quality level, consumers’ expectation is that the extension will have the same characteristics and vice-versa. We propose the following:

\[ P_{1a} \]: Core brand price positively affects the extensions’ expected price.

Consumers have poor price memory (Dickson and Sawyer, 1990, Rosa-Diaz, 2004), therefore they tend to record prices not as actual numbers, but as price levels – e.g. low price, medium price, and high prices (Adaval and Monroe, 2002). As it is very common for consumers to differentiate high price stores from discount stores we argue that they also use price levels to differentiate products in a given category (Desai and Talukdar, 2003). Therefore we propose:

\[ P_{1b} \]: Consumers do not only use actual core brand prices to compose price expectation but also categorize them based on price levels, namely: low, medium, and high or premium prices.
Furthermore, the effect of core brand price on the extensions’ expected price is moderated by two variables: price variation in the product category and store price image.

**Category price variation**

Some categories are known for their wide price variations. For example, in the automobile industry it is very common for brands to have a wide range of prices. In the wine industry price width is also high while the beer industry has a much narrower price range. As consumers use their experience with prices to form price expectations, it is reasonable to say that the price variation of the category may affect consumers’ expected prices for a given brand or product. Petroshius and Monroe (1987) found that price ranges influence specific model evaluations within a price range, however, the impact of end prices on subjects’ perceptions depends in part on the position in the market model being evaluated.

According to the narrow focusing concept (Leclerc et al., 2005), even if broad information (category prices) about items is available, people tend to focus on narrow information (core brand prices). Hence, we propose that in a wide price variation category the impact of core brand price on price expectations is stronger than when price variation in the product category is narrow. In the case of a narrow price variation in the product category, consumers benefit from using category information as they have difficulty in distinguishing between high and low price-perceived quality within the range.

**P2:** Core brand price effects on extensions’ expected price is stronger for wide than for narrow price variation in the product category.

Also, because consumers use end prices to form their price expectation (Della Bitta and Monroe, 1974, Randall et al., 1998), core brand price categorization is influenced by category’s end prices. Thus we propose that:

**P3:** Consumers will classify core brand price in more price categories (i.e. low, medium, high, premium, luxury) for wide price variation in the product category than in a narrow price variation (i.e. low, medium, and high).

**Store Price Image**

Store price image has been shown in previous studies to affect consumer expectancy (Dodds et al., 1991, Hamilton and Chernev, 2009). We argue that the effect of store price image on the extension expected price is the same in vertical line context than in a one product situation, as suggested by literature. In other words, a store with high price image will lead consumers to expect to pay higher prices for a given product, while discount stores or lower price stores will lead consumers to expect to pay lower prices for a given brand or product. Consequently, as consumers do not perfectly adjust their price expectations, we propose that:

**P4:** Core brand price effects on extensions’ expected price are stronger/weaker for store price image that is congruent/incongruent with the core brand price positioning.

**Effect of expected prices on extension’s perceived quality**

The price-perceived quality relationship has been explored extensively in the pricing literature (Monroe and Krishnan, 1985, Dodds et al., 1991, Brucks et al., 2000). Although some studies have had conflicting results (Gabor and Granger, 1966, Brown, 1969, Gerstner, 1985) it has become clearer in recent studies (Adaval and Monroe, 2002, Shiv et al., 2005) that this relation in fact exists, is positive, and affects consumers’ judgements not only about overall product quality, but also specific quality dimensions (e.g. product performance). However, this relation was almost exclusively examined in a one product context. When brands are extended to another category or within the product line, the new product (extension) is expected to benefit from the associations consumers already have with the brand. Amongst all
attributes consumers recall from the core brand, price is an important one. In this sense, we argue that in a vertical line extension context not only perceived prices, but also expected prices impacts consumers evaluation of the extension’s quality and that this relation is moderated by the step size, extension direction and the presence of the core brand at the time consumers assess the extension’s quality.

**Step size and direction effects**

So far, previous literature has presented inconsistent results about the effects of an extension on the core brand. Kim, Lavack and Smith (2001) suggest that the introduction of a vertical extension has a negative impact on the core brand regardless of its direction and regardless of its brand concept. However, a recent study by Lei, de Ruyter and Wetzels (2008) argues that inconsistent information may not always have a negative impact on the core brand. Results indicate that step-up line extensions, although inconsistent with the core brand, may be perceived as positive information that enhances the core brand beliefs. Adding to the discussion we argue that the effect of a vertical extension introduction on the core brand depends on how far or close is the price point of the extension compared to the core brand, and especially on how big a step the company takes when introducing a new product in the line. Musante (2007) presents some empirical evidence that consumers’ acceptance of up-market extensions is somehow related to the price point distance between the extension and the core brand.

It is simplistic to assume that all vertical extensions can be simply classified as upward or downward. In fact, companies can extend their product lines to different price points upward or downward. Market evidence can be found in many product categories that brands extend their product lines within the same price segment (e.g. Havaianas Fit and Havaianas Slim, in the sandals main stream market or Brahma Chopp and Brahma Fresh in the Brazilian main stream beer market) or outside their original price segment (e.g. Giorgio Armani and Armani Exchange or Intel Pentium and Intel Celeron).

Drawing on social judgment theory, namely the latitude of acceptance principle (Sherif, 1963) and on the zone of tolerance concept (Berry and Parasuraman, 1991) we suggest that there are three step sizes that brands can use as reference price points when extending their product line: (1) small step, (2) medium step, and (3) large step. The first is when a company decides to extend their product line up or down within the original price segment but not necessarily to the same consumer segment (e.g. Volkswagen Gol and Volkswagen Fox in the Brazilian small car automobile market). It comprises the consumers’ latitude of acceptance, where the stimulus is in its most acceptable zone.

Medium step represents the change of price segments however; in this case, firms position their products at a price point that is within the lower or upper part of the segment in a way that is closer to the next price segment. It comprises the consumers’ latitude of non-commitment, where the stimulus is in the zone of indifference and consumers may not react favourably or negatively regarding this brand positioning. For example, suppose that the bottled (2lts) fruit-juice market is divided as follows (prices per unit): (a) low price: from $1.00 to $2.00; (b) main stream: from $2.01 to $4.00; and, (c) premium: from $4.01 to $8.00. One could further subdivide each price category in upper and lower segment. In that sense, a medium step for a low price brand would be introducing a new product at the main stream market at a price no higher than $3.00.

In the case of a large step, the introduction of an extension is at a price point at an upper or lower part of the next segment in a way that is further from the core brand’s price segment or even two or more (if possible) price segments above/below. It comprises the consumers’ latitude of rejection, where the stimulus is in its most objectionable zone and consumers may react negatively regarding this brand positioning diluting core brand beliefs. Following the
previous example would be a low price brand introducing premium products at a price point no lower than $4.01. It is clear that the distinction between upper and lower price segments is not as clear as the example above as consumers categorize price rather than processing actual prices. However, even if the lines that split price segments are blurred, consumers do act upon them. Hence, we argue:

P5a: Consumers have three latitudes of response to vertical line extensions: latitude of acceptance, latitude of non-commitment and latitude of rejection.
P5b: Step sizes are direct related the consumers’ latitudes of response to vertical line extensions.

Placing an extension far or close to the core brand has different effects which are enhanced by the size of step the firm decides to take. The closer the price point of the extension compared to the parent brand, the easier is consumer acceptance of the new product. Brands, like prices, have acceptable ranges which consumers tolerate or accept. That way, we shall investigate whether stepping upward from low price but remaining in a low price market (small step) has similar effects on the core brand from stepping upward to lower main stream price markets (medium step), but different effects than stepping upward from low price to premium price markets (large step). We also investigate whether similar effects apply for step-down extensions of different magnitudes.

Moreover, previous literature has argued that introducing a flanker brand may have better results than exposing the core brand to a doubtful situation (Aaker, 1997). A flanker brand represent the introduction of a new brand into the same product category that the firm has already market position (e.g. General Motors with Chevrolet introducing Saturn). Firms may choose to introduce a new brand instead of spreading the usual brand for the category when there is a possibility that the new product may negatively affect the core brand or that the associations consumers have with the core brand may harm new product acceptability. A good example of the latter is the introduction of Lexus by Toyota.

However, we argue that there is not enough noticeable difference (Monroe, 1973) in small and medium steps, therefore, core brand evaluation post extension’s introduction tend to be positive since it aggregates market share, introduces a premium over competitors (for step-up) or a lower perceived sacrifice to acquire the brand (for step-down), and enhances brand awareness. We therefore make the following propositions:

P6a: For a low price core brand, the perceived quality of an upward extension, when the step-size is large is lower than the perceived quality of a flanker brand.
P6b: For a medium price core brand, the perceived quality of an upward extension, when the step-size is large is lower than the perceived quality of a flanker brand.
P7: For a medium price core brand, the perceived quality of an upward extension, when the step-size is medium is the same as the perceived quality of a flanker brand.
P8: For a low price core brand, the perceived quality of an upward extension, when the step-size is medium is higher than the perceived quality of a flanker brand.
P9: Across all three price levels of the core brand, the perceived quality of an upward extension, when the step-size is small is higher than the perceived quality of a flanker brand.
P10: For a downward extension, across all three price levels and all three step sizes the perceived quality is higher than a flanker brand.

**Conceptual Model**
Summary and directions for future research

This paper has provided a short review of brand and line extension literature, reference price theory and social judgment theory. Drawing from these theories we offered a conceptual framework that can be used to understand the effects of expected prices in consumer evaluations of vertical line extensions plus how expected prices in this context are formed. We have also identified important gaps of existing vertical extension literature and generated specific propositions providing concrete directions for future study.

First, we argue that, different from the traditional pricing literature perspective, expected prices may affect product quality perceptions in different contexts. Furthermore, we propose that core brand prices is the main variable that affects consumers price expectancy and that the price variation in the product category, along with the store price image moderate this relation. Secondly, corroborating with Sung Youl et al (2005), we argue that expected prices influence consumers’ evaluation of quality and that this relation is moderated by extension’s direction and step size, which is an important concept that we have introduced to clarify the understanding of vertical brand extension.

Regarding future research, firstly there is a need to measure and properly test these propositions. Further, segmentation processes should be clarified to better understand the price/quality segmentation across industries and propose a general taxonomy of price/quality segments. Although this paper focuses on consumers’ evaluations of the extension, reciprocal evaluations on the core brand should also be addressed in the future. Secondly, one could examine other moderating variables that could influence the extension’s expected price, such as the presence or not of the core brand in the consideration set. According to the assimilation-contrast principle, the presence of the core brand within the consideration set might result in contrast effects since the consumer will have a narrow focus comparing core brand and its extension. However, in the absence of the core brand in the consideration set, an assimilation effect may occur and consumers evaluate the extension accordingly and comparing with the other brands’ prices in the category.

Finally, this conceptual paper has treated reference price as consequence of consumer’s prior knowledge and situational factors. However, future research could investigate the effects of consumer’s characteristics in this relation. To conclude this paper, as suggested by Grime et al (2002) other moderating variables such as: consumer knowledge, brand concept, brand strategy, portfolio characteristics could be considered. The authors will address all these issues in their future research.
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