Economics Seminar, Indian Statistical Institute, New Delhi.

SPEAKER: **Sridhar Moorty,** University of Toronto

TITLE: **Can Brand Extension Signal Product Quality?**

TIME: 3:30 PM - 5:00 PM.

DAY & DATE: Friday, 6th January, 2012

PLACE: Seminar Room 2

Abstract:

This paper asks whether brand extension can serve as a signal of product quality given that it costs less than a new brand. (Existing literature has assumed either that brand extension is cost-neutral or that it costs more.) I show that it can as a Perfect Bayesian Equilibrium, but the argument is unconvincing. For one thing, the separating equilibrium is not unique; a pooling equilibrium also exists in which brand extension signals nothing. For another, the separating equilibrium relies on off-equilibrium beliefs that are poorly motivated in the model. I propose a refinement of Perfect Bayesian Equilibrium that resolves both issues. Empirical off-equilibrium beliefs requires that consumers off-equilibrium beliefs be justifiable on the basis of their prior beliefs and their product performance observations. With empirical off-equilibrium beliefs, two necessary conditions for brand extension to signal product quality are identified: (i) consumers must perceive old and new products of the firm to be positively correlated in quality, and (ii) at least some consumers must identify with brands, and not the firm behind the brand. Even with these conditions in place, the signaling argument is fragile: firm observability of past performance diminishes brand extensions signaling capability; an arbitrarily small probability of failure for good products eliminates it. My results suggest that going forward the case for brand extension must rest on foundations other than signaling product quality.

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