



# MANAGING PRICING COMPETITION THOUGHTFULLY

*By John E. Hogan and Thomas T. Nagle*

STRATEGIC PRICING GROUP  
A MEMBER OF MONITOR GROUP

## **Reacting to Competition: Think Before You Act**

Pricing against competition is far more challenging than pricing a unique product. In the absence of competition, managers can anticipate the effect of a price change entirely by analyzing buyers' price sensitivity. When a product is one among many, however, competitors can wreak havoc with such predictions. Price discounting in competitive markets—whether explicit or disguised with rebates, coupons, or generous payment terms—is almost a sure bet to boost immediate sales. However, it is easy to become seduced by these quick highs and fail to recognize the long-term consequences. The price cut that increases your sales today will invariably change the industry you compete in tomorrow. Frequently that change is for the worse.

While most managers think logically before initiating price competition, it is much harder to think rationally about how (or whether) to respond when you are already under attack. When is it financially more prudent to accommodate a competitive threat, at least in the near term until you can improve your capabilities, than to retaliate? Thinking through this question does much more than prepare you, intellectually and psychologically, to make the best

competitive response—it also reveals weakness in your competitive position. If

you do not like how often you must accommodate a competitor because your company cannot fight the threat successfully, you will begin searching for a competitive strategy that either increases your advantage or moves you further from harm's way.

When one or more competitors have cut their prices or have introduced new products that offer at least some of your customers more value for their money, how should you respond? Some theorists argue that one should never respond since there are better, positive-sum ways to compete on product or service attributes. While this is often true, the time to have explored and implemented those ways was usually long before a competitive price threat. At the time of the threat, a firm's strategic capabilities are fixed in the short run. The question at hand is whether to respond with price when threatened with a loss of sales by a lower-priced competitor. To determine whether a price response is better than no response, one must answer the following interrelated questions.

### **1. Is there a response that would cost less than the preventable sales loss?**

Although the need to ask this question might seem obvious, many managers simply stop thinking rationally when threatened. They match any price cut without asking whether the cost is justified by the benefit, or whether the same benefit could be achieved by structuring a more thoughtful response. If

we conclude that reacting to a price change is cheaper than losing the sales, then it may be a good business decision. On the other hand, if a competitor threatens only a small portion of your expected sales, the sales loss associated with ignoring the threat may be much less than the cost associated with retaliation. Since the threat is small, the cost of cutting the price on all of your sales in order to prevent the small loss is likely to be prohibitively costly. Sometimes the cost of retaliation exceeds the benefits even when the competitor is larger.

## **2. If you respond, is your competitor willing and able to cut price again to reestablish the price difference?**

Matching a price cut will do you no good if the competitor will simply reestablish the advantage. Ask yourself why the competitor chose to compete on price in the first place. If that competitor currently has little market share relative to the share that could be gained with a price advantage, and has no other way to attract customers, then it has little to lose from bringing price down as low as necessary to gain sales. This is especially the case where large sunk costs create substantial “exit barriers.”

At one point, we had a pharmaceutical company ask us to recommend a pricing strategy to defend against a new entrant. Management was initially surprised when we told them that defending their sales with price was foolhardy. Only after thinking about the problem from the competitor’s standpoint did they fully understand the competitive dynamics they faced. Customers had no reason to try the competitor’s new drug without a price advantage since it offered no clinical advantages. The new entrant had absolutely nothing to lose by taking the price down, since it had no sales anyway. Given that the huge investment to develop and test the drug was entirely sunk but that the manufacturing cost was small, winning sales even at a low price would be a gain. The obvious conclusion was that the competitor would cut price as often as necessary to establish a price advantage.

## **3. Will the multiple responses required to**

## **match a competitor still cost less than the avoidable sales loss?**

Think about the total cost of a price war, not just the cost of the first shot, before concluding that the cost is worth bearing to defend the sales at risk. If our pharmaceutical client had retaliated and closed the price gap enough to keep the competitor from winning sales, the competitor would simply have to cut its price further. The process would have continued until one or the other stopped it, which was likely to be our client, who had much more to lose from a downward price spiral. If our client was ultimately going to let the competitor have a price advantage, it was better to let them have it at a high price than at a low one. Once the competitor gained some sales, it too would have something to lose from a downward price spiral. At that time, an effort to stop the discount and redirect competition to more positive-sum activities, such as sales calls, product improvement, and patient education, would be more likely to succeed.

## **4. Is your position in other (geographic or product) markets threatened if a competitor is successful in gaining share? Does the value of the markets at risk justify the cost of a response?**

Some sales have a value that far exceeds the contribution directly associated with them. Following Dell’s introduction of a new line of computer printers, Hewlett-Packard (HP) immediately severed its relationship to supply HP printers to Dell, signaling the strategic importance to HP of its printer business. HP also retaliated by cutting its PC prices to match Dell’s, where Dell had much more to lose. Finally, HP realized that Dell’s printer strategy had its own limitations. Dell sources its printers and cartridges from a third-party supplier, Lexmark, limiting Dell’s typical cost advantage. So HP defended its lucrative printer business not with price, but with aggressive product innovations. It introduced new printer models, including digital printing with greater savings for corporate customers; this led to higher revenues and overall printer market share. As a result, HP defended and even expanded its business in printing and

copying for major corporations.

### **When Should You Compete on Price?**

Some companies have clearly benefited from underpricing their competitors. Japanese automakers in the 1970s, Wal-Mart in the 1980s, and Dell Computer in the 1990s, built their strategies around gaining share with lower prices. Understanding the special circumstances that enabled them to grow using price is necessary for anyone trying to replicate such success. Every one of these successful price competitors first created business models that enabled them to cut incremental costs below those of their competitors. So long as each could attract customers with a price difference smaller than its cost advantage, it could win customers without reducing industry profitability. In fact, by serving customers more cost-effectively, these companies actually earned profits from each customer in excess of those earned by the competition—making their competitive efforts a positive-sum game.

However, a competitive cost advantage by itself was not enough to succeed. All of these companies also orchestrated a campaign of information to convince their competitors that their cost advantages were decisive. Consequently, their competitors wisely allowed them to maintain attractive price differentials, at least temporarily, until the competitors could figure out how to replicate those costs. Eventually, even these companies recognize that unless they can continue to cut costs faster than competitors, price-cutting cannot be a profitable growth strategy indefinitely. Therefore, they ultimately shift their strategies toward adding more value in ways that enable them to sustain their large market shares without having to sustain a price advantage indefinitely.

Under what conditions are the rewards of aggressive pricing large enough to justify such a move? There are only four:

1. If a company enjoys a substantial incremental cost advantage or can achieve one with a low-price strategy, its competitors may be unable to match its price

cuts. Wal-Mart, Dell, and Southwest Airlines created low-cost business models that enabled them to grow profitably using price. In some markets, there may be an “experience effect” that justifies aggressive pricing based on the promise of lower costs. By pricing low and accumulating volume faster than competitors, a firm reduces its costs below those of competitors, thus creating a competitive advantage through low pricing.

2. If a company’s product offering is attractive to only a small share of the market served by competitors, it may rightly assume that competitors will be unwilling to respond to the threat. The key to such a strategy, however, is to remain focused. Southwest Airlines began as a small upstart that got little attention. It flew out of little-used airports, such as Hobby Airport in Houston, Texas. Its point-to-point short-hop business model was dramatically different than other established competitors with expensive hub-and-spoke operations in large airports, and consequently appeared to appeal to only a small niche market. It was easy for bigger competitors to ignore Southwest—until it began to expand to other markets and increasingly took market share away from the major air carriers.

3. If a company can effectively subsidize losses in one market because of the profits it can generate selling complementary products, it may be able to establish a price differential that competitors will be unable to close. Microsoft, for example, priced its Windows software very low relative to value in order to increase sales of other Microsoft software that runs on it. Amazon.com’s rationale for its low pricing on books was to build up a body of loyal customers to which it could sell a broad range of other products.

4. Sometimes price competition expands a market sufficiently that, despite lower margins and competitors’ refusals to allow another company to undercut them, industry profitability can still increase. Managers who take this course are assuming that they have insight that their competitors lack, and are, in effect, leading the industry toward pricing that is in everyone’s best interest.

Before embarking on a price-based strategy, ask which of these is your rationale, and recognize that the strategy can rarely be built on price alone or sustained indefinitely.

### **In Summary**

No other weapon in a marketer's arsenal can boost sales more quickly or effectively than price. Price discounting is usually a sure way to enhance immediate profitability; however, gaining sales with price is consistent with long-term profitability only when managed as part of a marketing strategy for achieving, exploiting, or sustaining a longer-term competitive advantage. No price cut should ever be initiated simply to make the next sale or to meet some short-term sales objective without being balanced against the likely reactions of competitors and customers. The key to profitable pricing is building and sustaining competitive advantage. There are times when price-cutting is consistent with building advantage, but it is never an appropriate substitute for it.

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Tom Nagle and John Hogan are Partners in the Cambridge office of Strategic Pricing Group, a member of Monitor Group. They can be reached at [tom\\_nagle@monitor.com](mailto:tom_nagle@monitor.com) and [john\\_hogan@monitor.com](mailto:john_hogan@monitor.com).

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