

# Price wars

**No-nonsense advice on how to avoid the death spiral of permanently lost profit, declining value, and heightened price sensitivity.**

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Price wars have racked industry after industry in recent years: from personal computers to airlines, from grocery retailing to computer software, from cigarettes to frozen diet dinners, from automobile tires to disposable diapers. All too often, there are no winners—and few healthy survivors. The destruction such battles cause can be so severe and linger so long that the only reliable way to come out ahead is to avoid them altogether.

**No company, however well run, is immune from price wars**

The threat is real—and universal. No company, however well run, is immune. Even companies with superior overall strategies and exceptional execution can destroy themselves by not managing this make-or-break issue effectively. After all, most price wars start by accident, through some apparently trivial misreading or misjudgment of market conditions. Rare is the price war that is initiated as a deliberate competitive tactic—and rarer still the one that achieves a satisfactory outcome.

Recent price wars raise four topics that we want to explore:

- Why companies should do everything they can to avoid them;
- What has been causing their spread in recent years;
- How to stay out of a price war; and
- If all else has failed, how to get out of one—and minimize the damage.

## Why to avoid price wars

If you have ever imagined that reducing prices to gain share might be a sound strategy for your business, think again. Reducing prices, unless you have a significant cost advantage (30 percent plus), all too often triggers a suicidal price war. Price reductions are almost always copied; no one wants to lose customers, volume, or share. You should go to almost any lengths to avoid a price war, for several compelling reasons:

**1. Profits are extremely sensitive even to slight declines in average price levels.** Everyone knows that price is the most sensitive economic lever in business. Any decrease goes straight to the bottom line. Take, for example, the average S&P 1000 company—the largest publicly traded companies in the US—as shown in Exhibit 1. If price falls by a single percentage point and costs and volume remain unchanged, then operating profit drops from 8.1 to 7.1—a 12.3 percent profit reduction from only a single percentage point decline in price.

But can you make up the profit shortfall from lower prices with an increase in volume? Suppose that a price war causes a "modest" 5 percent decline in price. Given the marginal contribution of 29.4 percent for the S&P 1000, that means that volume would have to increase by 20 percent for a company just to break even in operating profit. For this to happen, price elasticity would have to be four to one—that is, every percentage point

price cut would have to result in a 4 percent increase in volume. Price elasticities in the real world only occasionally exceed two to one.

It is, therefore, highly unlikely that demand will increase nearly enough to offset the slumps in price that occur in typical price wars. When you do battle on the basis of price alone, you just cannot win from a profit standpoint. Moreover, if you have any success whatsoever in attracting additional volume with your price cut, your competitors will most likely cut their own prices to meet or beat yours. After all, slashing prices is pretty much the easiest of strategies to emulate. Anyone can do it.

**2. Price advantages over competitors are usually short lived.** Trying to boost market share by dropping prices normally leads to traditional shares being retained, but at lower price levels. In a recent skirmish in US bookselling, for example, one leading company discounted prices by 10 percent; its major competitors let only a single day pass before matching the cut. Similarly, during last summer's personal computer pricing slugfest, companies responded in a day or two to almost every competitive move.

**3. Customers have their expectations distorted.** Customers' perceptions of acceptable prices are harmed long after price wars end. The \$199 New York to Los Angeles round-trip fare was widely offered for the first time in years during the summer 1992 airfare battle. Tens of thousands of travelers now have it etched in their minds that \$199 is the correct and acceptable price for that trip. They will not take it again until fares return to that level. Weak vacation flight demand during the summer of 1993 confirms that travelers' reference points were altered—downwards—by the previous year's fare war.

These developments are consistent with current research on price psychology and price recall. This work shows that the lowest price someone pays for a product or service is remembered longest, and remains his or her reference point for a very long time—often for life. Maybe that's why grandfathers remember what they paid for their first Model T Ford. The point, of course, is that the low prices accompanying price wars influence a customer's perception of what is a "reasonable" price long after the war ends.

**4. Customers become sensitive to price at the expense of value and benefits.** If you are the provider of a quality product or service, you probably tend to charge a higher price than competitors. Customers buy your product because they perceive that the benefits it confers more than outweigh the price premium they must pay. And as long as customers focus on the benefits side of the equation, superior suppliers can sustain the premium.

**As price wars play out, suppliers bombard their customers with price rather than benefit messages**

Price wars, however, tend to upset this price/benefit balance. As they play out, suppliers place increasing emphasis on price, bombarding their customers with price rather than benefit messages. The inevitable result is that customers become more and more price-sensitive—and less and less benefit-sensitive. This is, for example, now happening in the personal computer industry. Despite a steady stream of quantum performance

improvements, evidence is growing that PC demand may collapse as soon as prices stop falling at their current dramatic rate. Worse, even when such a war is over, the price/benefit seesaw does not automatically tip back the way it was before. Here, too, price wars change customers—usually adversely, often forever.

**5. Industry "shakeouts" that price war combatants hope for seldom transpire.** Managers often justify taking part in a price war by claiming it will knock out weak competitors and "rationalize" the industry. There are at least two problems with this approach:

- Regulators or the courts may construe such a strategy as illegal predatory pricing—that is, pricing with the intent of forcing a competitor out of business.
- Emotions kick in during price wars, leading companies to stay in business years after it has stopped making economic sense for them to do so. In a segment of the electrical equipment industry, for instance, companies engaged in a price war for five full years, each enduring huge annual losses—yet not a single competitor exited the business.

**Even when a weak competitor calls it quits, its capacity often stays**

Even when a weak competitor does call it quits, its capacity often stays. Take the US domestic airline industry: brutally competitive, chronically price-embattled, 30 to 40 percent excess capacity, and some \$8 billion in losses during the past three years. Not a pretty picture; not an industry that you would expect entrepreneurs to be lining up to enter. But that's exactly what is happening. New players like Kiwi Air and Reno Air are snatching up for 25 cents on the dollar the assets of Pan Am, Eastern, and other airlines that have collapsed. Pan Am and Eastern may be gone, but much of their capacity has re-emerged and is operating on a lower cost basis than before.

**Price wars destroy huge chunks of company and industry profits, and rarely provide a business with a sustainable advantage**

As the airline example suggests, preventing and avoiding price wars should be high on every company's list of strategic priorities. Price wars destroy huge chunks of company and industry profits, and rarely provide a business with a sustainable advantage. They undermine the customer base and seldom alleviate an industry's structural or capacity problems.

## **What really causes price wars**

Given all these reasons for avoiding price wars, why is it that so many companies find themselves fighting them today? On rare occasions, a company will intentionally embark on a price war as part of a sound overall strategic program. It might, for instance, invest in a new technology that slashes costs and then lower its prices to gain share and block competitors from acquiring that technology. But few price wars are started so deliberately or thoughtfully. Far more often, companies accidentally stumble into them—victims of misreads of competitor actions and market changes, or misjudgments of how competitors will react to their own pricing maneuvers.

## Misreads

Managers usually hear about competitors' prices when someone in the field tells them, "Company X is selling at price y. We need to match it to survive in this market." But important collateral information about the price (say, "Price y applies for no more than two days, exclusively to qualified distributors, and then only to truckload quantities") may never be picked up or communicated back to decision makers. As a result, the first company matches price y across the board, without qualification or limitation. Company X then sees price y offered by its rival to a wide market, compelling it, in turn, to offer y to more customers for longer than was ever intended.

This is one common way that price wars begin and escalate. The misreading company will swear that competitor X started the war; competitor X will see things in exactly the opposite fashion.

One tire company sold a particular item to retailers at an invoice price of \$35. An end-of-year volume bonus of \$2 and a marketing allowance of \$1.50 brought the net price down to \$31.50. The company then heard from the field that a competitor was selling a similar tire to retailers at an invoice price of \$32. So, fearing loss of business, it lowered its own invoice price from \$35 to \$32. Only later did it learn that its competitor was not paying a volume bonus or marketing allowance on its \$32 invoice price (see Exhibit 2). Unable to judge true price comparability, it had lowered its price by \$3 to meet a competitor's price that was actually 50¢ higher when compared like for like. Unfortunately, this realization came too late to prevent a costly and protracted price war.

Accidents happen. Some years back, an industry association journal erred when it reported a market volume total for industrial equipment that was 15 percent larger than it should have been. Reading the inflated number, the four major competitors in that market all feared they had suffered a serious loss of market share, and immediately dropped their prices in an attempt to recover it, although, of course, it had never really been lost. A correction of the error was published three months later—much too late to prevent a destructive price war that ravaged the industry for more than a year.

Consider still another example: this past summer, a consumer packaged goods supplier observed a competitor making an unexpected 10 percent price cut. The supplier assumed that the competitor was strategically re-positioning its product line and so matched the price cut. In reality, however, the supplier had misread not the fact of the cut itself, but the reason behind it.

Earlier that year, the serving size stipulated by the FDA for the purpose of reporting nutritional information about packaged foods had been reset to 6 oz. The competitor decided to replace all its 6 1/2 oz packs with a 6 oz size to align with the new regulations. Thus, far from intending to reposition its product line, the competitor was discounting prices only to get its obsolete 6 1/2 oz packages out of the supply pipeline before introducing its new, smaller size. If the misreading company had not reacted with its own deep cuts, prices would have returned to normal in a month or so, once the competitor's obsolete inventory had sold out. Instead, a severe price war erupted which destroyed all industry profits for the year.

## Misjudgments

Managers often assume that only the lowest-priced supplier in a market can ignite a price war. They are mistaken: the culprit can easily be the highest-priced supplier. Here's how: Customers do not buy simply on price; they buy on value, which is the perceived benefits that a product provides minus the perceived price. Benefits are defined here as the attributes of a product or service that determine customer choice, such as product quality, features, performance, design, technical service and support, and sales staff competence. An analytic framework called the value map (Exhibit 3) embodies this concept and its important pricing implications. The horizontal axis quantifies the benefits that a product provides to a customer. The vertical axis reflects its price. Each dot on the map represents a competitor that offers products in a given market.

If that market is stable—that is, if market shares are not changing—the competitive alternatives from which customers can choose will align in a straight diagonal line, the "value equivalence line," provided, of course, that the right measure of price and benefits is used. This makes intuitive sense: there is a clear, logical choice for any customer, regardless of the price or benefit level he or she is seeking.

If, however, market shares are changing, the share gainers will be in a "value-advantage" position *below* the value equivalence line (Exhibit 4). This means they deliver greater benefits for the same price, or equal benefits at a lower price, compared with competitors on the value equivalence line. The opposite is true for "value-disadvantaged" competitors, which will find themselves above the line because they deliver fewer benefits for the same price, or equal benefits at a higher price. Over time, competitors above the line will lose market share, and those below will gain it.

Now, suppose you have a stable market with four competitors situated along the line (Exhibit 5). The one at the upper right will be the high-price, high-benefit—that is, the premium—supplier. Suppose further that this supplier develops a new, improved version of its product, which delivers an even higher level of perceived benefits to customers.

Where will it price this superior product?

Quite often, premium suppliers do not price an improved product on the line. Instead, they raise their price slightly—far less, perhaps, than the benefit would justify—and hope to use the product to grab incremental market share. In other words, they position it below the line.

The outcome of this "value-advantage" situation is predictable: a temporary share increase to which lower-benefit suppliers ultimately make the only response they can—a cut in price to defend market share. What results is a downward shift in the line until competitors reclaim their traditional market position, but at lower price levels (Exhibit 6). Thus, by misjudging the value of its new product and so failing to charge appropriately for the increased benefits it provides, the premium supplier gives away most of the value to its customers—and starts a price war. It seldom understands the role it has played in igniting the price war. It will usually blame low-priced competitors—whose hand it forced by its own action—for causing the battle.

## How to avoid price wars

When we look at ways of staying out of price wars, it is worth remembering that some industries run an inherently higher risk than others. As Exhibit 7 suggests, if a product is an undifferentiated commodity, price is likely to be a more important buying factor, which increases the likelihood of competition on price and, hence, of price wars. So do low capacity utilization and declining market size, which ratchet up competitors' volume desperation. And so does customer concentration: when an industry has only a few large customers, they tend to exert strong price pressure on all competitors.

**The risk of price wars mounts when barriers to switching suppliers are low, when price sensitivity is high, and when costs are unstable or declining**

In addition, the more competitors there are in a market and the more visible a company's prices are to them, the greater the risk. Similarly, risk mounts when barriers to switching suppliers are low, when price sensitivity is high, and when costs are unstable or declining.

Given these different levels of risk, and the kinds of misreads and misjudgments that, as we have seen, usually start price wars, how can managers build an effective "fire wall" to keep their companies safe? Below, we suggest seven steps that managers can take to build such a wall. They all target the unintentional misperceptions that regularly put tinder to flame.

**Steer clear of actions that shift the competitive playing field from benefits to price**

**1. Avoid strategies that force competitors to respond with lower prices**—that is, encourage constructive rather than destructive competition by steering clear of actions that shift the competitive playing field from benefits to price. Keep your customers focused on differences in benefits, do not over-emphasize price in your advertising, and pass up initiatives designed to steal market share rapidly from one or two main competitors. If you want to gain share, do so gradually. The more quickly you grab share from your key rivals, the higher the likelihood that they will respond with an aggressive price move, igniting a price war.

**2. Avoid all possible misreads of competitive and market developments.** They will kill you. Invest in understanding the qualifiers—and comparability—of competitors' prices. Similarly, do not react until you understand the reason *behind* your competitor's price cut. If what your competitor is doing does not make sense to you, you probably do not understand it well enough to react wisely.

In other words, delay your response until you are confident of the facts. If you are not sure, do not react with a lower price. In particular, strive for a balanced reading of the full range of prices at which your competitor is selling. Never base a reactive price cut on just one or two competitive quotes. They might not be representative; they might be plain wrong. Find out. The cost of a delayed reaction is always lower than that of a misread that triggers a price war.

**Not every competitive price initiative deserves or demands a reaction**

**3. Avoid over-reaction.** Once you get the "what" and "why" of your competitor's price cut in focus, avoid the knee-jerk response of lowering your price. Counter-intuitive though it may sound, the best thing to do is often nothing. Not every competitive price initiative deserves or demands a reaction.

If, however, a response is required, use something other than price if possible. One successful medical supplier reacts to every competitor price cut by so increasing benefit delivery—accelerating product improvements, boosting service levels, and shaving lead times—as to make its price premium increasingly justifiable to customers. And if a *price* response is required, make it as limited and surgical as possible. If you are feeling pressure in southeast Florida, do not lower your prices across the entire country: close just a portion of the price gap, and do it *only* in southeast Florida.

**4. Play your value map right.** For important market segments, make the research investment to understand your value position and the amount and value of the benefit advantages you hold. A wide array of research tools, including conjoint analysis, is available. Once you understand the magnitude of your advantage, make sure your price is as high as it will support. Moreover, when you introduce a new or improved product, do the research to determine the value customers will assign to your incremental benefits. Goodyear, for example, wisely charged a fair premium for its superior new rain tire, establishing a market position for it without placing undue downward pressure on already volatile industry price levels.

**Price communications should be designed to minimize the likelihood that customers or competitors will misread your price levels or the reasons behind your actions**

**5. Communicate your price effectively.** Price communications should be designed to minimize the likelihood that customers or competitors will misread your price levels or the reasons behind your actions. Having your own prices misread by competitors can be just as damaging as your misreading theirs; both can start a price war. But, of course, do not "price signal" to your competitors. There are laws against it. But if you find yourself taking actions that might be construed by your competitors as price slashing, it is proper to include in your normal price communications to the market a clear description of all qualifiers and limitations and, in some circumstances, an explanation of your action—for instance, "This price will remain in force until our inventory of obsolete goods is exhausted."

**6. Jawbone on pricing.** Companies that successfully avoid price wars consistently write and speak publicly about the horrors of price competition and the virtues of benefit competition. They do this price "jawboning" in articles, in their own house organs, in industry association meetings, and in every available public forum.

**7. Exploit market niches.** If you are a minor player in a price war prone industry, the smartest thing to do may be to find a place to hide from the crossfire. Look for a product niche, segment niche, or even distribution channel niche that is too specialized, small, or obscure for the big players. Several small computer companies have escaped being

harmed by the recent PC price war because they found specialized, high-performance application niches in which to hide.

## How to get out of price wars

If all preventive measures fail, and you find yourself, through no fault of your own, in the middle of a price war, what can you do to extricate your company and limit the damage? First, try the seven methods listed above for avoiding a price war. These are just plain good practices; they are easy to do and they just might elicit a positive competitive response. If they fail, here are two more aggressive (and riskier) ways to get yourself out of a price war.

**If possible, try to get your major customers out of the crossfire of a price war by signing them up early to extended supply contracts**

**1. Seek long-term contracts with key customers.** If at all possible, try to get your major customers out of the crossfire of a price war by signing them up early to extended supply contracts. This, of course, is hard to do once your customers realize there is a price war raging. Such contracts also allow prudent suppliers an extended opportunity to demonstrate benefit superiority to key customers and to create a sustainable barrier to future price incursions by competitors.

**2. Actively engage the enemy.** A last-resort strategy is to engage in "tit for tat": whenever your competitor makes an aggressive price move, you immediately and publicly match it. If your rival steals one of your biggest customers, you immediately go after one of its major customers in the same market. The point is to communicate to your competitor that price aggression is a no-win proposition. You want to make it crystal clear that you intend to match its every move. Similarly, you should immediately act in kind to support any return to rational price behavior by that competitor so that it knows there is no risk attached to more responsible pricing behavior.<sup>1</sup>

That this strategy is fraught with risk cannot be overemphasized. Your competitor may take an inordinately long time to realize that its actions can do it nothing but harm; rivalry across the entire industry may escalate precipitously; and as the "tit for tat" game plays itself out, all of a price war's detrimental effects on customers will make themselves felt. Only take this step with extreme care, and after all else has failed.

Just as the causes of price wars are highly variable, their severity spans a broad range. Simple competitive misreads are quite different from a situation where competitors are hell-bent on putting you out of business. It is vital, therefore, that you align your response with the level of severity. The worst thing you can do is to take a high-severity response like "tit for tat" in a low-severity circumstance. Such action will quickly escalate an isolated skirmish into all-out price war.

**Price wars can become highly emotional, and it is easy for those involved in them drastically to over-estimate their severity**

So, before plotting your response, do a careful assessment of just how severe the situation really is. Be cautious: price wars can become highly emotional, and it is easy for those




involved in them drastically to over-estimate their severity. More than likely, this will lead in turn to an excessive response, which then throws a company and its industry into a truly severe and devastating price war.

## The price war prevention lifestyle

What does all this mean for today's management teams, who must deal with the threat of price wars daily? A colleague shared an interesting, albeit bleak, perspective recently. "You know," he said, "price wars are like heart disease." Heart disease is serious, and it can kill you. We all are at risk. Some of us have higher inherited risk than others, just as some industries have an inherently higher risk of price wars than others. Still, however great the risk, you can affect your risk of heart disease by the way you behave every day: by your diet, whether you smoke or not, how much you exercise, and so on.

In much the same way, your day-to-day pricing behavior will affect your risk of a price war. You increase it with every competitive misread, with every market misread, with every over-reaction, with every failure to charge an adequate premium for your superior benefits. Prevention is the best cure.

### **Each and every pricing action needs to be passed through a price war screen**

The notion that managers should aim "to win the business that is best for you at the highest possible price" seemed wise in the past. But an amendment is in order: the right managerial objective should be "to win the business that is best for you at the highest possible price consistent with behavior that minimizes the risk of price war." Each and every pricing action needs to be passed through a price war screen. Managers need constantly to ask themselves, "Will this action contribute to the creation or extension of a price war in my industry?" If the answer is "Yes"—or even "Maybe"—*don't* do it. Ultimately, it will be a string of seemingly insignificant but correct day-to-day pricing actions that provides the fire wall to keep your company from suffering the ravages of a price war. Building that wall and keeping it strong is a disciplined and endless struggle—but a struggle well worth confronting and winning. 

### **About the Authors**

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### **Notes**

<sup>1</sup>For a detailed discussion of "tit for tat" strategies, see Robert Axelrod, *The Evolution of Cooperation*, Basic Books, New York, 1984.