How to manage an aggressive competitor

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How can firms develop a competitive defense strategy that minimizes both the self- and competitor-inflicted damages of price competition? Before acting to defend market share or initiate price cuts, managers must anticipate the long-term strategic consequences and weigh them against the short-term benefits. A pricing decision should never be made simply to make the next sale or meet some short-term sales objective, but to enhance the firm's long-term ability to operate profitably. Pricing is like playing chess. Those who make moves one at a time—seeking to minimize immediate losses or exploit immediate opportunities—will invariably be beaten by those who envision the game a few moves ahead.

While the US economy bottoms out, managers are pressured to continue growing their businesses. But the relatively easy growth of the 1990s has given way to a more challenging marketplace. As in the past, some managers will be tempted to use price competition to keep their companies growing. Lucent Technologies was recently reduced to a candidate for bankruptcy by such an effort from one of the most profitable companies in America. More thoughtful managers may well recognize that it is advisable to initiate price competition only in very specific circumstances. They too, however, may be forced to manage price competition initiated by others. The key to succeeding in this increasingly common scenario is deciding when and how to respond to those competitors.

For many managers, competitive attacks trigger a visceral "fight" response as they try to match price cuts to prevent the attacker from "stealing" market share. The wisdom of this reaction seems obvious to most managers because they believe that (1) it is usually more costly to acquire a new customer than to keep a current one, and (2) some profit contribution from selling at a lower price is preferable to losing the entire sale. The flaw in this thinking is its limited scope. Today's price concession will change the market you compete in tomorrow, usually for the worse:

1. A customer who wins a price concession due to a competitive offer learns that encouraging competitive offers is a profitable activity. In the future, the customer will solicit and occasionally accept competitive offers simply to win more leverage over the preferred vendor.
2. Competitors losing deals because of higher prices may choose to push prices even lower.
3. Many customers not initially interested in the competitor's offer eventually learn that other customers who were less loyal got better deals. They resolve to stop "getting taken" and become more aggressive negotiators.

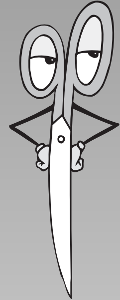
These "secondary" effects can have financial implications far in excess of the cost of the initial price concession. How, then, can a firm develop a competitive defense strat-

egy that minimizes both the competitor-inflicted and self-inflicted damages of price competition?

We do not suggest that management should avoid defending market share or should never initiate price cuts. Instead, we argue that it must first anticipate the long-run strategic consequences and weigh them against the short-run benefits. Managers should never set a price simply to make the next sale or meet some immediate sales goal; rather, the price decision should enhance the firm's long-term ability to operate profitably. Pricing is like playing chess; players who fail to envision the game a few moves ahead will almost always be beaten by those who do.

When should you price compete?

Price competition does make sense in certain circumstances:



- *When the business has a substantial, and sustainable, cost advantage.* The important notion here is the degree of cost advantage. In industries where competitors have significant investments and/or high fixed costs, small cost advantages will not support price competition. Competitors with significant investments or high fixed costs will be inclined to compete on price to fill that capacity or spread fixed costs. Unless a competitor has a substantial cost advantage, price moves to take more volume are likely to provoke a response, and price wars follow. Southwest Airlines and Wal-Mart have created the kind of substantial and sustainable cost positions that allow them to use price competition to grow their business; many other companies, however, do not have this kind of cost advantage.
- *When managers have good reason to believe competition cannot or will not respond.* This may happen if the firm is small compared to other firms in the industry, or if managers can hide their pricing moves from competitors. Price competition employed by small long-distance telecom firms did not provoke reactions from the large carriers until more recently.
- *When a strategic objective of the firm is market share growth regardless of profitability concerns.* This has happened in some industries that have received governmental support as targeted growth sectors.

The dangers of the quick fix

Because price changes affect sales more quickly than other marketing decisions, they are often used as a quick-fix solution to short-term problems. Profitable pricing, however, requires that managers also consider how each decision will affect future competitive behavior and profitability. A manufacturer of materials for a highly technical manufacturing process was told by its largest customer that a competitor would be awarded the customer's business if the firm did not immediately cut the price. Managers did not check to see whether the competitor was offering lower prices anywhere else. The customer had never bought from the competitor, but the managers neglected to explore whether this was because the manufacturer's products were superior or because of the significant switching costs the customer would incur in moving to the competitor.

The results were predictable: As soon as the manufacturer offered a lower bid, the customer showed it to the competitor and asked for an even lower price. The push for lower prices then ricocheted back to the manufacturer, and back and forth until prices had fallen some 20 percent. The intensity of this competition for one customer quickly spilled over into other customer accounts, and a full-blown price war quickly broke out. The price war has lasted over three years, with substantial profit damage to all suppliers.

Pricing decisions should always be developed as part of a longer-term marketing strategy to generate and capture more total profit. Otherwise, it is possible to win many individual battles for market share and still end up losing the war for profitability. This is not to argue that underpricing the competition is never a successful strategy in the long run (see the box above), but the conditions necessary to make it succeed depend critically on how customers and competitors react to such a move. Managers need a systematic thought process to determine how they will respond to competitor price attacks. Such a mechanism forces them to weigh the costs and benefits of various potential responses to competitor attacks, while challenging them to design strategies that improve their defensive abilities when competitors do attack.

Reacting to competition: Think before you act

Figure 1 outlines the systematic thought process for developing a strategy to deal with a competitive attack. Thinking through these questions does much more than prepare you, intellectually and psychologically, to make the best competitive response. It also forces you to assess 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 strategy that either ups your advantage or moves you further from harm's way. To facilitate understanding strategy development using our process, we will dissect individual components of the process.

Figure 1 is based on the assumption that one or more competitors have attacked by cutting 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 because there are better, value-creating ways to compete on product or service attributes. Although that is often true, the time to explore and implement them is usually long before a competitive price cut occurs. At the onset of an attack, a firm has little time to respond and its strategic capabilities are fixed in the short run. So the question at hand is whether to respond with price cuts when threatened with the loss of sales to a lower-priced competitor. To determine whether a price response is better than no response, managers should answer the questions and explore the interrelationships illustrated in Figure 1.

1. Is there a response that would cost you 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 respond to the competitive attack with a "strategic" price cut without exploring the profit implications. Such price cuts can be dangerous, because:

- Price competition is usually costlier to larger competitors than to smaller ones; the former have more share volume affected by the price cut.
- Although competitors may exit the market, their assets rarely do; as competitors weakened by price wars exit, they frequently sell their assets at distress prices, creating a new, unpredictable, and lower-cost competitor.
- With each price war, incumbent competitors become weaker because they have fewer reserves left. The poor financial condition of the US airline industry is an example of this problem.

Before responding to a price cut, managers should ask: Is the cost justified by the benefit? Or could the same benefit be achieved by structuring a more thoughtful response? If reacting to a price change is cheaper than losing the sales, a price move may be a good business decision. On the other hand, if a competitor threatens only a small portion of expected sales, the sales loss associated with ignoring the threat may be much less than the cost associated with retaliation. When the threat is small, the cost of cutting price on all sales volume to prevent the small loss is likely to be prohibitively expensive. Even for larger threats, the cost of retaliation sometimes exceeds the benefits. For example, regional telecom companies may find that retaliating against smaller market share raiders drives regulatory agencies to limit entry to other lucrative telecom markets, including long-distance phone service and cable television.

How much of the customer base is really at risk to a specific competitive attack? It is important to be realistic

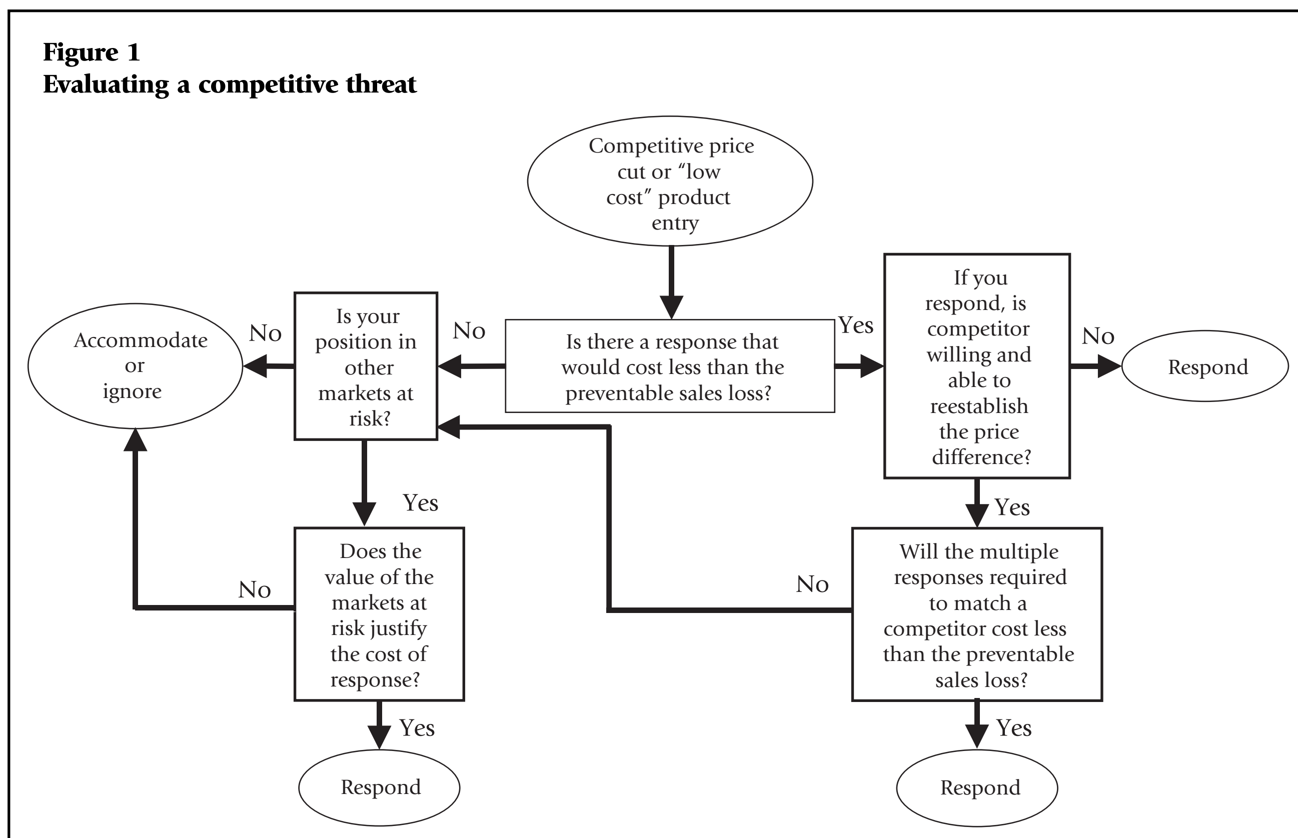


Figure 1
Evaluating a competitive threat

about how much of the projected sales loss can actually be prevented. When a new grocery chain opens with lower prices, the established competitors can surely reduce the sales loss by matching its prices. Still, even if the prices match, some people will shift to the new store simply because it is newer or more convenient to where they live. They will not return even if the competitor's price advantage is eliminated.

By constraining a firm's competitive reactions only to those that are cost-effective, managers are forced to think about how to react more cost-effectively. Incorporating one or more of the following principles when reacting to a competitive price threat can substantially lower the expense of retaliation.

Focus reactive price cuts on only those customers likely to be attracted by the competitor's offer. This requires developing a "flanking" offer that is attractive or available only to the more price-sensitive buyer. As the home computer market grew, so too did the demand for cheap semiconductors that could quickly process graphics. Consequently, Intel began losing sales for that segment to lower-priced competitors willing to provide inferior products. Rather than cut the price of its flagship Pentium chip, Intel responded by creating the Cerrus chip, which involved no additional design or tooling costs because it was based on the Pentium design and thus could be sold cheaply. To minimize the impact of Cerrus pricing on the value of the entire Pentium line, the Cerrus chips merely had some Pentium coprocessor capabilities turned off so they would run poorly on business networks and in data-intensive applications, but comparably to a Pentium on PCs. In maturity, markets often fragment into many segments. Intel's flanking move allowed it to serve multiple segments without having to move price down on a premium product.

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Focus reactive price cuts on a particular geography, distribution channel, or product line where the competitor has the most to lose compared to you from cutting the price. Kodak's response in the US to Fuji's retail price promotions would risk a price war in a significant Kodak market. Instead, Kodak might respond with retail price promotions in Japan, where Fuji has a larger market share and margins and thus more to lose. The purpose of the retaliation is not necessarily to defend the sales at risk, but to get Fuji to stop the price-cutting that puts Kodak's sales at risk.

Focus reactive price cuts only on the incremental volume at risk. A cheaper competitor will often be unable to displace an incumbent completely, but it will be able to gain a share of a customer's business. If Fox Broadcasting cuts its ad rates, advertisers are not going to abandon ABC, NBC, and CBS. They are, however, more likely to divert some dollars to Fox from the other networks. A big network could neutralize that threat by offering to discount its ad rates to the level of Fox's rates *just for the amount of advertising likely to be diverted*. This could be structured as a discount either for all purchases in excess of, say, 80 percent of the prior year's purchases, or for expected purchases.

Raise the cost to the competitor of its discounting. When a competitor has an existing customer base and is discounting only to new customers, it may be possible to retaliate without cutting your own price. Instead, educate the competitor's existing customers that they are being treated differently. A client of ours did this simply by making sales calls to its competitor's most profitable accounts. The salespeople casually suggested that "you are probably paying about $X for this product now." When the customers questioned this, the callers confessed that they really did not know the price but guessed it based on the prices the competitor had recently offered to some other accounts, which they named. The customers shortly began demanding similar discounts, and the competitor quickly withdrew its aggressive offers. Managers may also institute responses to price moves using non-price marketing tools. Large brewers in the US often respond to smaller competitors' price moves by raising advertising levels. Smaller companies may not be able to match the higher resource demands.

Leverage any competitive advantages to increase the value of your offer as an alternative to matching the price. The key to doing this without simply replacing a price war with a quality or service war is to make offers that are less costly for you to offer than for your competitor to match. If you have much better quality, offer a better warranty. If you have more service centers in more locations, offer faster service. Major airlines responded to price competition from smaller upstarts by offering frequent flyer programs. Because of their large route systems, flyers could accumulate miles faster and had more choices of locations for which to use them. Although exploiting forms of competitive advantage is a powerful way to counter price attacks, managers should carefully analyze the potential for competitors to neutralize a competitive advantage. For many years, Xerox dominated the copier market by providing superior service through an extensive

maintenance network. Canon overcame this advantage by developing copiers that required much lower levels of service and by providing on-machine diagnostics that allowed users to maintain the machines themselves.

If any of these options is less costly than simply allowing the competitor to take some sales, then it is worth continuing to evaluate a price response, using the questions on the right side of Figure 1. If, on the other hand, it would cost more to respond than to accept the sales loss, then managers should continue to examine the option of not responding using the questions on the left-hand side of the figure.

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

Matching a price cut will be ineffective if the competitor simply reestablishes the differential at a lower price. If a profitable response cannot be initiated, managers should accommodate the competitor to minimize the cost of responding. The key to assessing the potential for a profitable response lies in understanding why the competitor chose to compete on price in the first place. If the competitor 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 there is little to lose from bringing the price down as low as necessary to gain sales. This is especially true when large sunk costs create substantial perceived "exit barriers."

At one point, a pharmaceutical firm asked us to recommend a pricing strategy to defend against a new entrant. Managers were initially surprised when we told them that defending their sales with price was foolhardy. Only after thinking about the problem from their rival's standpoint did they fully understand the competitive dynamics they faced. Customers had no reason to try the new drug without a price advantage because 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 and manufacturing cost was small, winning sales even at a low price was a gain. The conclusion was obvious: The competitor would cut price as often as necessary to establish a price advantage. In this case, accommodation—with share loss—was less costly than fighting with price.

3. Will the multiple responses required to match a competitor still cost less than the avoidable sales loss?

When attacked, managers should evaluate the long-term costs of an initial price response. A single response by an incumbent is not enough to stop price moves by entrants struggling to establish a market position; competitive entry may trigger a prolonged price war. If our pharmaceutical client had retaliated and closed the price gap enough to keep the competitor from winning sales, the competitor would simply have had to cut its price still further. The process would have continued until one or the other stopped—which likely would have been 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 allow 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 move market interactions to some other basis for competition would be more apt to succeed.

In industries where entry requires significant investment in fixed manufacturing capacity, any competitor that has made the required investment is likely to compete in any way necessary to operate the investment—often using price competition. Operating in a way that makes at least some contribution to covering fixed costs is often better than explaining why the manufacturing facilities are idle. In such situations, an effective accommodation is often to allow the competing entrant to fill its capacity with low-margin business. The share loss may be discouraging, but allowing the entrant to win low-margin customers may be much less costly than waging a price war.

If competitors are likely to continue cutting price, and they have less to lose than the defender, the best short-term strategy is to let them win share. The defender should actively manage the process, however, to undermine the competitor's incentive to continue aggressive pricing in the future. The following three principles guide such a strategy.

The key to assessing the potential for a profitable response is in understanding why the competitor chose to compete on price in the first place.

Let the competitor have something to lose. Competitors will continue cutting prices until they have something to lose by doing so. Let them win some profitable business. Then convince them you will not let them continue to earn good margins on the business they won if they drive margins lower on additional business they are trying to acquire.

Direct the competitor to more price-sensitive, lower-margin customer segments. Allow the competitor to win where it is least damaging for you and where the competitor is most vulnerable to a price war. For example, it is often wise to let competitors win low-margin, sealed-bid contracts from governments. Because government contracts often have "best price" clauses, the competitors are then constrained in how they compete for other business. In other markets, let them win the most price-sensitive business at the best margins possible, since that business is the most vulnerable to retaliatory price competition.

Build barriers to competitive movement into the less price-sensitive, more profitable customer segments. Create switching barriers by building and communicating unique value aimed at the most desirable customers. By promising high-margin customers either special services or a price concession in return for a long-term contract, you take their business "off the table" before a price war.

4. Is your position in other (geographic or product) markets threatened if a competitor gains share? Is the net present value of all markets at risk enough to justify the cost of a response?

Some sales have a value that far exceeds the contribution directly associated with them. In 1999, AT&T slashed its lowest long-distance price from 10¢ to 7¢ per minute for residential customers. The purpose was to stop losing customers to cheap second-tier providers, which AT&T had previously allowed to maintain a large price differential. Why had AT&T now, at a huge cost, become so much less accepting of that differential? Because its strategy had changed. Rather than competing in the long-distance market alone, it intended to become a "one-stop" supplier of an integrated bundle of telecom services (long-distance, local, TV, Internet access, and others being developed). AT&T had assembled a nationwide network of cable and cellular providers that would be the core of a new strategy its smaller competitors could not match. The key to that strategy was to win a customer's long-distance business first, even at prices that did not maximize AT&T's profits in long distance alone.

Still, retaliatory price cuts are all too often justified by vague "strategic" reasons unrelated to profitability. Before approving such a cut, two things should be required. The first is a clear statement of what the long-term strategic benefits and risks are. The benefits can be additional sales in this market in the future, or additional immediate sales of complementary products (such as software and peripherals if one wins the sale of a computer), or a lower cost of future sales due to the added volume.

The second requirement to justify a strategic price cut is a quantitative estimate of the value of the benefit. This need to quantify often encounters resistance because managers feel the task is too onerous and will require unnecessary delay. Usually, however, rough estimates are all that is necessary to achieve enough precision to decide. One company told us it always defended price in the institutional segment of its market because sales in that segment drove retail sales. While the relationship was no doubt true, the magnitude of the effect was important given that pricing to the institutional segment had fallen to less than manufacturing cost. A simple survey of retail customers asking how they began using the product revealed that only about 16 percent of retail sales were driven by institutions. The cost of maintaining those sales by retaining all of the current level of institutional sales could not be economically justified. The cost of replacing them through expenditures on alternative forms of promotion was much less.

How should you react?

Dealing with aggressive competitors requires more than a will to fight. It requires a competitive strategy. In addition to the costs and benefits of retaliation that are weighed using the process described in Figure 1, managers must invest in developing relative competitive advantage.

When you decide that retaliation is not cost-effective, one option is simply to *ignore* the threat. This is the appropriate response when facing a "weak" competitor, with no competitive product or cost advantages. In that case, the amount of your sales at risk is small and likely to remain so. In these same circumstances, some authors and consultants recommend a more aggressive option commonly known as the "deep pockets" strategy—but managers pursue that option to their own detriment. The logic is that even if retaliation is too costly compared to the immediate sales gained, a large company can win a price war because it can afford to subsidize losses in a market longer than its weak competitor can.

Two misconceptions lead people down this dead-end path. One is the meaning of "winning." This is no doubt a strategy to defend market share successfully. But the goal, at least for a publicly owned company, is profit rather than market share. The second misconception is that by destroying a weak competitor one can actually destroy competition. In fact, often the assets of a bankrupt competitor are bought cheaply by a new competitor now able to compete from a lower cost base. Even if the assets are not bought, eliminating a weak competitor serving the price-sensitive segment of the market creates the opportunity for a stronger competitor to enter and use that as a basis from which to grow. Thus, an expensive strategy to kill weak competitors makes sense only in an unprofitable industry where a new entrant is unlikely to replace the one eliminated.

When a price-cutting competitor is relatively "strong" and the cost of retaliation is greater than the value of the sales loss prevented, managers must develop a response. A strong competitor gaining share creates a survival threat. To maintain a profitable future, you must actively accommodate the threat with changes in strategy. This is what Sears faced as Wal-Mart's network of stores grew to include Sears's traditional suburban markets. There was simply no way Sears could match Wal-Mart's prices, given Wal-Mart's efficient distribution system and Sears's more costly locations. Its only logical response was to *accommodate* Wal-Mart as a competitor in its markets. Accommodating a threat is not the same as ignoring or confronting it. It means actively adjusting competitive strategy to minimize the adverse impact of the threat. Sears opted to eliminate its lower-margin product lines, remaking its image as a high-fashion retailer that competed less with Wal-Mart and more with typical department stores.

The only situation in which it makes sense to use an *attack* response is when the competitor is weaker and the attack is justified by profit. This is rare because it usually requires a misjudgment on the part of the competitor, who attempts to use price as a weapon from a position of weakness. Still, such misjudgments do occur. The largest grocery chain in America effectively destroyed itself in the 1970s after initiating a discount pricing strategy to regain market share. Its major competitors initially followed an accommodation strategy, believing that the A&P chain's huge buying power and well-known house brands gave it a cost advantage. When A&P began reporting huge losses, however, its competitors figured out that its high labor costs made the company much more vulnerable than they had thought. They switched to an attack strategy that ultimately forced the company to close half its stores and sell the others to a more efficient suitor.

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More common is the case in which the price-cutting competitor is strong, or at least as strong as the defending companies whose sales are under attack. Often because of the attacker's strength, the amount of sales at risk is so great that a vigorous defense is profit-justified. The purpose of a *defend* response is not to eliminate the competitor; it is simply to convince the competitor to back off. The goal is get the competitor to recognize that aggressive pricing is not really in its financial interest and to refrain from it in the future. This is often the position taken by American Airlines in its competition with other carriers, many of which have lower cost structures. American is careful to limit the time period and the depth of its price responses, signaling a willingness to return prices to previous levels as soon as the competitor withdraws the threat. Sometimes these battles last no more than days, or even hours, as competitors watch to see if American can fashion a cost-effective defense.

Partisans of pricing for market share would no doubt disagree with the restrained approach we have prescribed. Companies with large market share, they would argue, are often better capitalized and thus better able to finance a price war than the smaller competitors. Although price-cutting might be more expensive for the larger firm in the short run, it can bankrupt smaller competitors and, in the long run, re-establish the leader's market share and its freedom to control market prices. Although such a "predatory" response to competition sounds good in theory, there are two reasons why it rarely works in practice. First, predatory pricing is a violation of US and European antitrust laws if the price is below the predator's variable cost. Such a pricing tactic may sometimes be a violation when the price is below the average of all costs. Consequently, even if a large company can afford to price low enough to bankrupt its smaller competitors, it often cannot do so legally. Second, and more important, predation is cost-effective only if the predator gains some competitive advantage as a result of winning the war. This occurs in only two cases: when eliminating a competitor destroys an important differentiating asset (such as its accumulated good will with customers), or when the predator is able to gain such a cost advantage (say, economies of experience or scale) that it can profitably keep its prices low enough to discourage new entrants. In the absence of this, new entrants can purchase the assets of the bankrupt competitor, operating at a lower cost base and competing against a large firm now itself financially weakened by the cost of the price war.

Still, for many managers, the idea of choosing some confrontations while avoiding others seems weak. With their visceral "fight" response triggered, managers often retaliate against price-aggressive competitors by using the price weapon—and starting a war. A more profitable response involves understanding when it is wiser to ignore, accommodate, and retaliate. There are two general principles managers should adhere to in all of their competitive strategy development:

- Never participate in a competitive engagement you cannot win. Fight those battles where you have competitive strength, and avoid those where you are clearly at a disadvantage. Moreover, be especially vigilant in assessing when you have the advantage.
- Always participate in competitive engagements from a position of advantage. Don't fight by competitors' rules (which they select for their advantage); use what is advantageous for you. Of course, this implies convincing the market that your strengths are important to it.

These guidelines are useful for businesses in hostile competitive environments. Managers must choose their confrontations carefully and structure them to leverage their strengths. AT&T did this adroitly when facing intense competition in the mobile telephone market. With the proliferation of small mobile carriers in most major markets, price competition initiated by new entrants fighting to gain share grew more and more intense. AT&T's response was to compete from its strength. As a long-distance carrier with plenty of capacity, and having coverage in most major markets, AT&T bundled air time, long-distance charges, and roaming fees to create its One Rate™ plan. The smaller competitors, who would have to buy long distance and pay other companies roaming charges, were at a severe cost disadvantage in matching the package.

The key to surviving an engagement with an aggressive competitor is to avoid confrontations, unless you can structure them so you can win and the likely benefit from winning exceeds the likely cost. Do not initiate price discounts unless the short-term gain is worth it *after taking account of competitors' long-term reactions.* Do not react to competitor's price discounts except with price and non-price tactics that cost *less than accommodating the competitor's behavior would cost.* If managers in general were to follow these two simple rules, far fewer industries would be ravaged by destructive price competition. ❍