Avoiding Price Wars

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Price wars have plagued industry after industry in recent years. Indeed, price wars must be avoided like the plague! More often than not, there are no winners, only losers. The effects of price wars are not only severe but also enduring. We have seen this in India in industries like PCs, consumer appliances, detergents and ice creams.

Price wars can lead to a severe erosion of profits. Unless there is a significant cost advantage, for the company introducing the price cut, a price reduction will lead to retaliation by competitors. So dropping prices normally does not lead to an increase in market share. Instead it leads to a sharp drop in profits.

Price wars also shape customer expectations. The lowest price people pay for a product or service is often remembered the longest, and becomes their reference point. Driving down prices to unreasonably low levels, has a dramatic influence on a customer's perception of what is a "reasonable" price long after the war ends. Price wars also divert the attention of customers away from product benefits towards price. That is when the game becomes dangerous, as all smart marketers would readily admit.

Many of the justifications given by managers for entering a price war are untenable. The claim that weak competitors can be knocked through a price war is weak. Indeed, there is sufficient empirical evidence to indicate that price wars are not guided by any logic. They tend to get emotional and continue long after it has become economically unviable to offer these products at such low prices.

As Robert A. Garda and Michael V. Marn[1], point out, price wars usually occur by accident than by design. Sometimes, companies do embark on a price war, as part of a deliberate, well-planned strategy. Such a strategy would make sense if the company has invested in a new technology or developed a new process that slashes costs. The company may then attempt to lower its prices to gain share and preempt competitors. The giant retailer, Wal-Mart, with its excellent distribution and logistics capabilities is a good example. But most price wars end up in a lose-lose situation. A good example is the HLL vs. P&G detergent war in India.

How can companies avoid price wars? To start with, senior managers must not yield quickly when frontline sales people call for price cuts. When sales personnel tell them that a competitor has cut its price and plead for an immediate matching price cut, senior managers must dig further to get additional information about the price cut. Does the discounted price apply only for a few days of a festive season? Is it restricted to only some distributors and only to large quantities? An across the board retaliation under such circumstances is eminently avoidable.

There are some industries where marketers must be particularly careful, as the risk of price wars is inherently higher. In case of commodities, price is likely to be an important buying factor as the scope for differentiation is less. Similarly, in industries with low capacity utilization or in a shrinking market, the probability of price wars is higher as players feel the pressure to grab a bigger share of a stagnant cake. When there are only a few large customers who enjoy high bargaining power, there is strong price pressure on all competitors. The more fragmented the market, the greater the risk, as it is difficult to impose pricing discipline. The airline industry is a good example. If one airline cuts prices, typically others follow. Similarly, risk increases when barriers to switching suppliers are low, when price sensitivity is high, and when costs are unstable or declining. The PC industry

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[1] "*PRICE WARS*," McKinsey Quarterly, 1993, Issue 3.

is a good example. With PCs increasingly moving towards a standard or modular configuration, switching costs have reduced significantly.

Misreading competitive and market developments can trigger off an avoidable price war. This is one situation where the old saying “Discretion is the better part of valour” is well and truly applicable. Companies must keep their cool and not react until they understand the reason behind a competitor's price cut. It often makes sense to delay the response until one is sure about the need to respond. Indeed, the best response to a price cut by a competitor is usually to do nothing. Even when a response is required, something other than price must be first explored. Finally, when retaliation is justified, making it as limited as possible, such as by restricting the price cut to a small geographical region can go a long way in avoiding or at least moderating a price war.

Marketing communications have a big influence on price wars. Advertisements should not keep drawing customer attention to prices. This unfortunately is the trend today for many products in our country today. It also makes sense to gain market share, gradually. Aggressive attempts to snatch share from key rivals too quickly, often lead to sharp retaliation, igniting a price war.

The kind of signals top management sends out is also important. Price communications should be carefully drafted to minimize the chance of misinterpretation by customers or competitors. Companies must ensure their actions are not seen by competitors as price undercutting. When cutting prices, they must communicate clearly the conditions applicable e.g. The price will remain in force until the current stocks are exhausted. Companies must also proactively communicate the dangers of price competition and the virtues of benefit competition. They can write about this in magazine/newspaper articles, in company newsletters and talk about it in public forums and industry association meetings.

One way to avoid entering a price war is to sign long-term contracts with key customers. Such contracts also give suppliers more latitude to offer more value and differentiate their services and to create a sustainable barrier to future price undercutting by competitors. Another way is to pursue the strategy for which Wal-Mart is famous, Every Day Low Prices (EDLP). Keeping a consistently low price through the year is also better from the point of view of managing the supply chain efficiently by smoothening demand fluctuations.

Only in some exceptional cases, must a company immediately and publicly match the price cut. If a rival steals a major customer, the company by immediately going after one of the rival's major customers in the same market, can communicate to competitors that their price aggression will be matched move for move. Needless to say, this strategy is risky. Rivalry across the entire industry may escalate. So this step must be taken with extreme care, and after all other options have been explored and tried out.

To conclude, price wars are avoidable for many reasons. Once they start, things can go out of control. A cool headed proactive approach towards pricing will go a long way in preventing the market place from getting excessively heated. This itself will go a long way in minimising the probability of a price war.