Price wars and the managers who start them

Price wars are a fact of business life. Research by **Marco Bertini** sheds new light on their instigators.

Benjamin Franklin famously said that only two things in life are certain: death and taxes. But I would like to suggest a third certainty: price wars. While customers clearly relish the opportunity to save some money, most companies see no-holds-barred price competition as an unwelcome, unwarranted hazard that is best avoided. Yet, despite the apparent downside for business, price wars are surprisingly common. So what is going on? Who exactly is to blame? Ask a range of senior executives and the answer is resoundingly clear: someone else. For example, in its 2014 Global Pricing Study, pricing consultancy Simon-Kucher and Partners showed that where a firm was engaged in a price war, 88 per cent of respondents believed a competitor initiated the offensive. But, while businesspeople may be quick to point the finger elsewhere, my research suggests that the cause of price wars can also be found much closer to home. Many of the companies I have worked with treat price as a tactical afterthought, a necessity that is secondary to decisions about products and markets, rather than a core competence with important strategic implications. The work of management consultants and price optimisation specialists is partly responsible for this narrow view. Consultants, for example, try to sell their

services by pointing to the profit potential of uncontested price increases. Raise the price by just one per cent without the customer noticing or the competitor reacting, says McKinsey and Company, and the average company on the S&P 1500 list will fatten its bottom line by roughly eight per cent. While it pays to make sure that prices reach their optimal level, improving economic efficiency is only part of a broader, more interesting story.

In just about any market, price plays several roles. To start with, it reflects the economic sacrifice of a purchase. This basic point underscores the consultants' sales pitch, is described at length in any marketing or economics textbook, and is obvious to most managers.

But a price tag can also shape the value of a product or service by motivating customers to better understand the additional value they are being offered for a reasonable premium or, conversely, the benefits they need to forego in order to save some money.

IKEA's notion of "low prices with meaning" is a good example: the company is careful to articulate that pursuing the lowest possible price point on furniture comes at the expense of convenience and some quality. IKEA's value proposition is not for everyone and it wants the market to realise whether this trade-off is acceptable. Similarly, Amazon's Jeff Bezos once explained the $79 launch price of Prime, the successful shipping membership, as a number that could change people's mentality – "large enough to matter to customers but small enough that they would be willing to try it out".

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Third, price can be used to convey information to those who are uncertain about what they want or are getting. When Belgian brewer Brouwerij Artois confidently told you that Stella Artois was "reassuringly expensive," or when the Swedish engineering giant SKF proudly advertised its bearings as "the most expensive in the world," they were attempting to communicate the quality of the product. Similarly, many luxury fashion houses refuse to entice customers with price discounts, no matter how strong the temptation. Sales events can be interpreted as a desperate act to move inventory, a problem that a powerful brand really should never face.

Finally, a price can evoke powerful emotions. Consider again a company's decision to ban sales promotions. In 2011, the popular US department store JC Penney was struggling, more addicted to coupons and in-store deals than any of its peers. To turn things around, the board of directors ›

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Take a hike Ron Johnson (below left) adopted a John Lewis-style everyday-low-price policy at JC Penney, with unforeseen results

lured Ron Johnson away from Apple. Johnson, who masterminded the Apple Store concept, decided to make pricing the cornerstone of his company's strategic rejuvenation. Surely these high-pressure sales tactics were a source of frustration and anxiety, thought Johnson. All discounts were suddenly halted and replaced by an everyday-low-price "fair and square" policy. Unfortunately, Johnson misjudged the emotions of the average retail customer; many people in fact thrive on bargain hunting and cherish the smart-shopper feeling that comes from finding the best deals. Patrons started spending their money elsewhere and JC Penney's sales and share price dipped sharply. Johnson left a little over one year after the strategy was implemented, succeeded ironically by the person he replaced in the first place. The discounting returned with a vengeance.

In comparison, the UK retailer John Lewis has performed remarkably well with "never knowingly undersold," its own take on everyday low prices. Although at its core this policy is equivalent to the one trialled by JC Penney, John Lewis carefully integrated it with the company's core proposition of customers come first and its 90-year heritage as a partnership (the employees own the organisation), associating this otherwise neutral pricing tactic with positive emotions of trust and goodwill.

The proud manager

Understanding that price can play different roles in a market can help managers realise that they may inadvertently play a part in encouraging or sustaining price competition. To my mind, there are at least two problems.

The first is linked to psychology and in particular to a common trait of individuals: they like to think well of themselves. Indeed, research in social psychology shows that people evaluate themselves more positively than the average peer on nearly all socially desirable dimensions. They are overly optimistic and overconfident and grossly exaggerate perceptions of control.

More importantly, people tend to distort reality, attributing positive outcomes to personal skills or effort but blaming negative outcomes on external forces or agents.

Managers are obviously susceptible to the same self-serving tendencies that afflict the average citizen. But why would this matter? In research conducted with Daniel Halbheer and Oded Koenigsberg, we consistently found that managers interpret positive market outcomes, such as surprisingly high sales or profit, as evidence of superior product quality rather than a low price relative to competition. Managers feel that product quality is central to the organisation, stable and under their control; therefore linking success to this variable is psychologically rewarding.

Conversely, surprising negative market outcomes are typically attributed to uncompetitive prices, not inferior product quality. Managers feel that pricing decisions are more peripheral, less enduring over time and harder to control; therefore linking failure to price is comforting — it frees the manager from criticism.

These behaviours are seldom in the best interest of the organisation as most responses to market events require some adjustment to price and quality simultaneously. Instead, when self-serving managers encounter success their response is to invest further in the product, perhaps innovating to excess, while they respond to failure by driving prices much lower than necessary, all in an attempt to stay in the game. Because price is blamed for the bad stuff but never credited for the good stuff, the probable result is increased competitive pressure.

Curiously, if those at the helm of an organisation are aware of the psychological limitations of their subordinates, they can make pre-emptive decisions that exploit the situation. For example, they can make initial decisions about price and quality that take into account the way managers are likely to react later on. This softens competition because rivals anticipate each other's actions. In particular, they understand that future decisions are based only on price or quality, but not both.

Alternatively, the company can attempt to democratise price and quality decisions, in a sense sharing the responsibility across individuals in the hope that the bias is corrected. Of course, this may imply restructuring the internal processes of an organisation, as price and quality are typically handled by different teams.

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The uninformed manager

Seeing the world through rose-coloured glasses is not the only problem. The second is education, as managers sometimes lack the necessary understanding of the factors that ignite wasteful competition.

Perhaps the most common example of this is that too many executives are unclear about the unique value their company's products bring to market. If sellers are unable to articulate a clear and concise argument why buyers should purchase their offering instead of a competitor's – an argument that convincingly demonstrates that the company understands the needs of the customer – they should not be surprised when the customer focuses on and demands a lower price. Remember, if all that customers care about is price, it's probably because you haven't given them anything else to care about. The absence of a strong value proposition only increases the temptation to use price as the reliable (and relatively effortless) means to close a sale.

The challenge for managers is that value arguments often seem "soft", wrapped in uncertainty and difficult to present in a way that is both quantifiable by the seller and verifiable by the buyer. A price concession doesn't have the same problem. The solution is first to learn the customer's business model inside out; that is to study how your offering can improve the economic benefit of the client, and then communicate the value proposition in the language of the customer, making sure to highlight the unique features and benefits of your offering in terms of its impact on the metric driving the customer's financial performance. The onus is on the seller to make the business case for a sale, not on the buyer.

The second crucial point in understanding the role of pricing is that many managers forget that, when it comes to a competitive threat, not all players in a market are created equal. Customers seldom know the exact price of all purchase options. Rather, they tend to group products in tiers: there are cheap, middle-of-the-road, expensive, and perhaps even prohibitively expensive options. Competition tends to vary across tiers: it is likely to be more intense within tiers than between them. Moreover, aggressive pricing from top-tier firms is likely to hurt all firms below, while aggressive pricing from bottom-tier firms is more likely to expand the market rather than prompt brand switching. Psychologically, however, managers tend to act as if every threat is the same when in fact they should focus on those companies that truly offer the next-best alternative for customers.

The third point is that managers have

been shown to apply crude heuristics to simple break-even analysis and often make errors of judgment when assessing the relationship between margin and volume. The classic mistake is to assume a one-to-one relationship. For instance, a ten per cent decrease in price makes sense from a profit perspective if sales increase by ten per cent or more. But this assumption does not of course take into consideration the fact that a price drop is much more damaging to a business with a razor-thin contribution margin than one with more breathing room. Instead, managers subconsciously anchor on the magnitude of the suggested price change and adjust insufficiently for the cost basis of the business. Indeed, another study by Simon-Kucher and Partners showed that 74 per cent of senior executives questioned grossly underestimate the volume necessary to cover a price reduction. The smaller the perceived implication for volume, the less threatening the proposed change in price appears, which if implemented has a high probability of spurring competition.

One way to illustrate the trade-off between margin and volume is to draw a constant profit line joining the different combinations of price and quality that yield the exact same return. This is relatively easy to do as the data lie in-house with the accounting department. Importantly, it helps change the tone of a pricing meeting by providing a real benchmark to evaluate proposed changes. When, for example, sales personnel are asked to sell 20% more product if senior management agree to a 10% price concession, they are suddenly confronted with a hard target. Offering the classically vague "we'll make it up in volume" justification is no longer sufficient, and the hope is that having to commit to a specific result weeds out requests that are overly ambitious.

Finally, managers seem to have a common blindspot when it comes to factoring in the reactions of rival firms. At a general level, they tend to forget that competition is not a static affair, but rather a series of actions and counteractions. Failure to anticipate the dynamics of a market can be devastating; in particular with respect to price actions as these tend to have the biggest impact on customer loyalty and switching behaviour. When one company lowers prices, its rivals will invariably do the same, potentially nullifying any benefit in sales that the price decrease was expected to bring. Indeed, the end result may be similar relative shares but lower profitability for all rivals.

Similarly, companies lack foresight into the competitor's reaction when they sneakily decide to hold price and instead pile on extra value to the current offering. Giving the customer more for the same is a tried and true technique to close a sale, but rivals are likely to respond to any loss of competitiveness in value-for-money by adjusting the variable that yields the quickest response: price. Unfortunately, the end result is the same.

Mea culpa

If managers realise and accept their own limitations in price competition, they can move to figure out what changes in their behaviours bring about a more favourable outcome. As outlined above, those in a supervisory role who anticipate the self-serving ways of their subordinates can act to stifle competition accordingly.

Alternatively, they can diversify the risk of biased responses to market outcomes by sharing decision-making across larger groups. In addition, managers also need to better understand and communicate to their customers the points of difference that make their offerings stand out. They need to pay closer attention to the firms that are more likely to be a direct competitor; to take more care when assessing the impact of proposed price changes; and finally they need to appreciate the interactive nature of markets.

Beyond this, senior management can make an important contribution to maximise the value obtained from the goods and services that the company provides. Pricing cannot be a simple tactical afterthought; it must assume a more strategic, longer-term position.

In the majority of cases, pricing is indeed central to the business model: it is the lever that helps the firm not only turn a competitive advantage into revenue, but also communicates and helps establish that competitive advantage in the first place. Senior managers should ensure that pricing policy is fully integrated with the broader set of corporate and marketing objectives and thought of more as a vital supporting function than a tactical lever. ■

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Resources

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