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The Knowledge

Can price wars be won?

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Synopsis
Companies frequently compete on price. When things turn for the worse, they engage in price wars. According to theory, price wars have no winners; the companies involved and the public, ultimately suffer. The losers of price wars are forced out of business, and those left standing, frequently firms with significant scale advantages and cost structures, suffer long-term falls in profitability, often irrecoverable because they have effectively trained customers to focus on price. In this article, Professor Reinmoeller argues that a price war may be an effective, if risky, strategy and that winning a price war has as much to do with strategic capabilities and skills as superior cost structures.

Definition
While all practitioners and academics know that engaging in price wars is perilous, the literature knows only two strategies to deal with them; avoiding price wars altogether is seen as the preferable solution or, failing that, preparing for survival with the best cost structure for advantaged firms. While my research supports extant theory in pointing out the importance of low costs structures, it also identifies the contextual capabilities of a company that knows how to choose and wage price wars it can win.

Current thinking
Surprisingly, research documenting price war consequences is not yet rich, and not without it's limitations.

Triggers such as declining economic conditions, competitive entry, and opportunities based on weak brand loyalty and price sensitivity have shown to make price wars more likely. High exit barriers or a worsened financial situation can lead firms to initiate or engage in price wars for perceived lack of alternatives or in the hope for benefits.

The last decades of research on price wars looks mostly into"Why price wars should be avoided" rather than into opportunities to win and focuses mainly on the negative outcomes and early warning signals. The consensus that emerges shows overall price war effects, including dwindling prices, declining image and revenues, and profit erosion for all parties involved. Price wars are seen as causes of bankruptcies, great losses in terms of margins, consumer equity, competition, and ability to innovate, which can permanently alter industries` competitive dynamics. Consequently research on antecedents seeks to understand early warning signals to avert price wars, avoid unintended outbreaks and escape or limit their negatives effects. Advantages based on superior cost structures (including economies of scale and scope) were found to be the only safeguards against a price war`s negative consequences.

When I started out, I was just puzzled by the clarity of this finding. If it were so bad, why would smart people take the risk of starting a price war without any fighting opportunity to win and why are there so many of them? Against the emphasis on superior cost structure, my detailed analysis of Dutch retailer AH (Albert Heijn) subsidiary of Royal Ahold N.V. (a Fortune's Global 250 company in 2013) found that strategic capabilities and skills can matter more. In the 2000s, the Dutch retailer AH (Albert Heijn) started the fiercest price war ever known in the Netherlands even though it suffered a less competitive cost position than its rivals. It emerged as the clear winner, turning itself into the undisputed leader of Dutch retail.

I found clear choices and capabilities at work that can guide other firms to understand how to wage and win price wars and developed a process that leads to understanding whether a price war is a way forward for your company and what are the capabilities and conditions needed to win it. These steps are i) to clarify the motivation; ii) to mark the battlefield; iii) to isolate competitors; iv) to rally the support of partners and v) to enhance price actions.

Clarifying the motivation requires leaders to assess the risks of engaging in price wars, which are, as we know, not without peril. Does the motivation justify risking annihilation? Winning a price war takes a concerted long-term effort, fundamentally different from the short-term price actions we see around us in many industries. Running a marathon takes the skills of the marathon runner. If you are only good at sprinting, winning a price war may not be right for you.

Marking the battlefield is critical. Not all that matters is visible. Who is likely to be drawn into a price war, and who is allied with whom? What could the consequences of these dynamics be like? Who are you running against? Sprinters or marathon runners? How many are there? How desperate are they? Most critically, who do you want to stay out of the competitive dynamics? Often you will want to avoid price wars with cost leaders in an industry where they are strongest.

Thinking in outcomes of the price war, which of the likely participants is relatively weak? The relatively weak opponent needs to be isolated to enhance the odds of success. Winning a price war means prevailing against weaker opponents. If your research cannot find any likely loser of a price war, it may be you. Only if you are able to identify, like AH did with Laurus, a likely loser, should you go ahead.

Rallying partners to support the effort is very important. Through the right partnerships, companies can greatly boost their ability to win the price war. Generating such a supportive ecology is necessary to maximise effectiveness of the price thrusts (in the short/mid term). Without the support of suppliers and other value chain partners, even winning can hurt too much. AH aligned its partners behind its initiative and was able to protect its margin. If you are able to enlist the members of your "ecosystem" in your efforts, their support helps you and is unavailable for your adversary. Finally, whilst analysing the external environment is important, organisational processes, design, systems and culture may need to be brought into alignment with any intense price action e.g. changing your operations, organisational design and practice (as in the case of AH) or even your entire business model (like Dell in the past and Netflix in the present). Whilst taking these steps, a company must be careful not to signal its strategy before it is ready to move.

Implications for leaders

Acknowledging that price wars can be won is an important step. Price wars are suddenly no longer a no-go area. However the wider implications go deep and wide. More specifically, leaders need to strengthen three core elements of contextual capabilities. Firstly, they need to increase their awareness of their own and related industries and the broad changes engulfing societies. Secondly, they need to enhance analytical capabilities at all levels through state of the art tools and skills e.g. data analytics. Finally, successful execution requires not only close monitoring of progress but an effective combination of persistence and peace of mind.

While such actions based on contextual capabilities increase the odds of winning a price war, preparing in this way may reduce or even avoid the harmful effects of miscalculation or escalation. Through developing strategic capabilities, you can beat rivals who may rely on their superior cost structure but lack your superior capabilities. Skills can beat structure!

Further reading

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About the author

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