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RESPONDING TO CUT-PRICE RIVALS IN A DOWNTURN

IN DOWNTURNS CUT-PRICE RIVALS GROW FASTER THAN PREMIUM BRANDS

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In downturns, cut-price rivals with "good enough" products and services often gain market share at the expense of the premium brands. In 2008 as the UK fell into a deep recession two of the fastest growing retailers were Aldi and Lidl, the two German hard discounters (see Figure 1). Tesco, the dominant grocery retailer in the UK, actually lost market share during this period, as did Waitrose and Somerfield. A similar pattern occurred among airlines where Ryanair and easyJet clearly outpaced their full-service rivals in term of passenger growth in Europe in the final three months of 2008 (see Figure 2).

Much the same seemed to be happening in the business-to-business space. IBM and some other companies were anticipating that more corporations would replace desktop PCs with Microsoft operating systems and Microsoft Office software with lower cost thin-client solutions where Linux operating system and IBM office applications on a backroom server provide the same functionality to the user.

Some companies comfort themselves by thinking that these losses of market share are a temporary customer response in a recessionary environment. They often are not. Cut-price rivals seldom fully relinquish their gains when the good times return. Many customers find during the downturn that the "good enough" solution does fit their needs at some times and in some situations. Therefore, they continue to use the cut-price supplier under these conditions, even when they could afford to return to the premium supplier.

Cutting prices and costs may not be the best response to cut-price rivals

The temptation that many premium brands fall prey to in a downturn is to cut back, cut costs and try to compete more aggressively on price with their low cost rivals. Occasionally this might be the right approach, but often it is very shortsighted and can be disastrous long term.

As the competition from the cut-price rivals increases and some customers begin to defect, the temptation is to shave prices. This invariably leads to a squeeze in margins, which causes the company to try to either reduce costs by cutting back service levels, whether it be the number of staff in a call center or the number of technical support engineers in the field, or

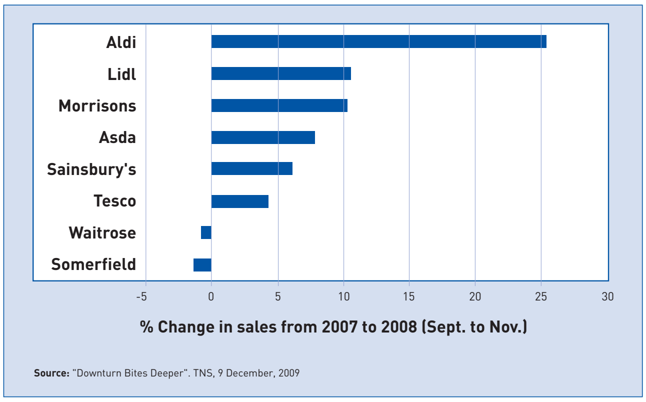
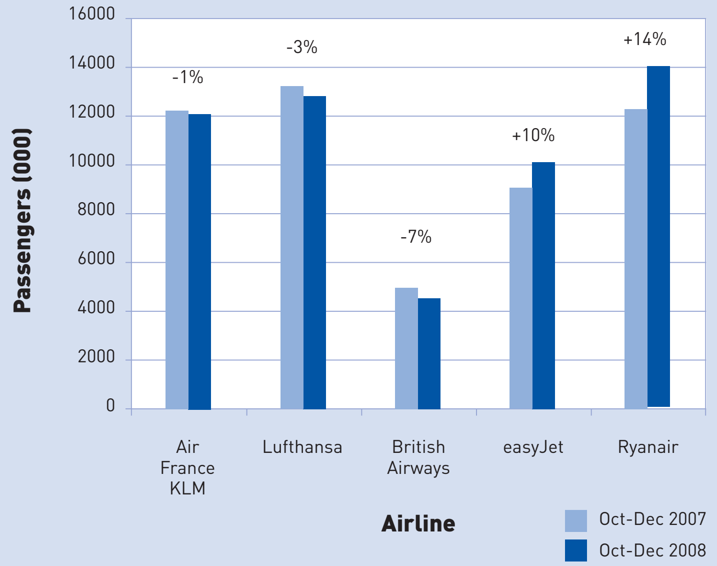


Figure 1 – *Discounters are growing fastest among UK grocers as the recession bites (12 weeks to 30.11.2008 versus previous year)*



Source: Based on public traffic data provided on airline websites

Figure 2 – *Year-on-year passenger growth for major European carriers (intra European flights only)*

Customer-friendly cost cutting requires a deep understanding of customer needs by segment. The customer needs to understand in-depth what aspects of the product and service solution are creating value and how much value.

charging fees for services that were previously "free." If the downturn lasts long enough there may be two or three rounds of these kinds of cuts or fee increases. In some cases this leaves the company "stuck in the middle" – its prices are still significantly higher than those of its cut-price rivals so price sensitive customers are not tempted to choose it. Moreover, the customer segments that valued a high level of service and were willing to pay for it, now see service levels declining or niggling fees being added. Neither group is happy. At some point some premium customers start asking themselves why they are continuing to buy from the high-price premium supplier, because they don't see the value they are receiving for the higher prices they are paying. Some decide to move to one of the cut-price players, since they no longer see the premium player is adding enough value to justify its higher price. Others who want, and value, the additional services, start looking for another premium player, who will provide the more complete solution they are seeking.

We have seen this scenario in the airline industry in both Europe and North America. Ryanair has aggressively being lowering its non-fuel costs through cost innovation and by stripping out more and more elements of the traditional airline package and charging fees for each component of the unbundled package, whether it be food, checked baggage, or airport check-in. As the gap between Ryanair's fares and those of the traditional airlines widened, a number of airlines responded by imitating some of Ryanair's moves, in effect reducing the level of service, and adding less visible fees, such as fuel surcharges (that were often more than the Ryanair fare!). This caused an increasing number of customers to question whether they were getting value for their money. Some began defecting to Ryanair or the more business-friendly low-cost carrier easyJet. Others who wanted and were willing to pay significant premiums for a higher level of service started looking at corporate jets or air taxi services. As the downturn began to bite and travel budgets were slashed, more and more business and leisure travellers began switching to the low-cost carriers for short intra-Europe flights.

Customer-focused cost-cutting may work

This does not mean that cost cutting should not be entertained – clearly it must, and not just in downturns. However, customer-friendly cost cutting requires a deep understanding of customer needs by segment. The company needs to understand in-depth what aspects of the product and service solution are creating value and how much value. The company must invest its resources in those product and service features that are valued and eliminate those that are not. This is particularly difficult to do in an environment where a company is selling a complex bundle of products and services, and most companies are. Every company that uses a call center needs to have a sense about how perceived customer value is influenced by such things as "one touch only touch" (where the associate who first answers the call must deal with the request/issue and never transfer it to another associate for resolution) or the average time to answer the phone. If the company has a policy of "one touch only touch", such as ING Direct Bank in the US, it has to have a sense of how much value this creates for its customers. Having the person who answers the phone being able to deal with any issue requires on average a more sophisticated, better trained and better paid group of call center associates. In one study the average time to answer the phone was found be non-linearly related to customer satisfaction.[1] A very quick pick up made customers more willing to recommend the mobile operator's service and a very long wait led to increasingly lower customer satisfaction ratings. However, in between there was a range of wait times where customer satisfaction did not decline. The company's target service level was well within this range, Therefore the operator might well have been able be increase the average wait time and thereby reduce costs, while not having any noticeable impact on customer satisfaction.

Moving beyond cost-cutting – Recognize the segmentation in the market and respond to it

Other more customer-focused options go well beyond intelligent cost cutting and can generate better returns and leave the company much better positioned for the future.

Dow Corning, the world's largest manufacturer of silicone products, had achieved this position by working very collaboratively with its customers to develop silicone solutions to meet their particular needs. Over time, it had built customer-focused business units with their own marketing, sales and technical support to deepen its understanding of its customers' businesses. In some cases, it engaged in co-development of new products with its customers. In the early years its customers had shown a willingness to pay for the high level of support that Dow Corning provided, but during the 1990s an increasing number of customers began defecting to low-price rivals for at least some of their silicone requirements. This seemed to accelerate as the early 2000s recession began to bite. The company had responded by engaging in some cost cutting and price reductions that some observers felt was weakening its full-service offering. Performance declined and it was in danger of becoming stuck in the middle between cut-price, "good enough" solutions of low-cost competitors and the full-service solution that many customers still wanted and were willing to pay for. In 2001 it recognized the gravity of the situation and began a crash program to respond by March 2002. The response was a dual pronged approach: offering a lower price option for customers seeking a "good enough" offering and upgrading their traditional offer for those customers who wanted a more complete solution and were willing to pay for it. The good enough offering is delivered from the same production infrastructure by a new Xiameter business unit. Xiameter is an internet-based business which offers a limited range of Dow-Corning's more commoditized products (less than 5% of its total portfolio) without technical support and with very strict business rules about such things as order quantities, delivery time and payment terms. The price, which varied depending on spot market conditions and Dow Corning's available manufacturing capacity was generally about 10-15% lower than the price charged for the same product if bought from one of Dow Corning's full service business units. Most industry observers view the Xiameter business unit as being a very successful and profitable addition to the Dow Corning portfolio. But perhaps the most important benefit of the Xiameter business has been the fact that it has allowed Dow Corning's six other market-focused business units to refocus their efforts on the customers who want Dow Corning's full service offering.

Help customers cut costs and focus on their core business

Companies that are focussed on cutting headcount and costs in a downturn, are sometimes more receptive than usual to offers from suppliers may be able to reduce their costs by taking over non-core activities from them. They may be particularly receptive to offers, which convert an activity that has significant fixed cost elements in it, to one that can be bought on a variable cost basis. Orica Mining Services showed strong profit growth during the last recession in part by taking over the blasting activities of many mines and quarries and charging the customers for the rock "on the ground" that met the customer's specifications. This often involved the customer transferring its blasting staff and perhaps the equipment used for blasting to Orica. This helped Orica be less dependent on selling commodity explosives and more tightly linked to its customers making it more difficult for them to switch suppliers. By leveraging the tremendous range of operating conditions and experiences of its customers around the world Orica was well positioned to build intellectual property in all aspects of providing blasting solutions thus

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creating higher barriers to entry for companies trying to "muscle in" on its service business.

Invest in product and service innovation to distance yourself from the cut-price rivals

And a third group of companies recognizing that customers have unmet needs can find that a downturn is a good time to introduce new products and services that are significantly better than the "good enough" products offered by their low-cost rivals. Apple successfully launched iPod and iTunes in 2001 and with the addition of the iTunes music store in 2003 it left the other manufacturers of commoditized MP3 players in the dust. Downturns are often good times for launching new products where heavy advertising and promotion outlays must be made to build customer awareness for the new product. Advertising spending is often down as advertisers cut back to save costs, making it much easier and cheaper to find the best advertising and promotional vehicles to launch a new product and to rise above the "noise" level that exists in any market.

In some business-to-business markets, customers want to try a new product in a normal operating environment before they adopt it. For example, manufacturers considering adopting a new material or new equipment in their manufacturing process might want to run trials on their production lines under normal operating conditions to make sure that they don't run into any unexpected problems, and that they can achieve acceptable yields with the new material or new piece of equipment. When markets are booming companies are reluctant to take capacity out of profitable production for this kind of testing activity. In a downturn, production lines are often sitting idle, making it a perfect time to test new products.

Conclusion

The demand for "good enough" products and services usually rises in a recessionary period and some of the loss of market shares by premium brands can become permanent. In some cases companies can reduce the loss by reducing the price differential through intelligent cost cutting and price reductions. In some cases the best strategy for a premium player may be to enter the "good enough" segment of the market with a competitive product offering at a competitive price. In other cases there may be viable opportunities to develop service offerings that meet the customers' needs for a lower total cost solution. In still other situations the downturn may be a very good time to introduce new industry leading products or services to take advantage of lower advertising and promotion costs, or to take advantage of the fact that some customers now have the time and resources available to test new solutions. All of these options can leave the company much better positioned in the market when the good times return. Willy-nilly cost and price reductions, on the other hand, may leave the company greatly weakened and not positioned well for the future.

1 Adam Braff and John C. Devine, "Maintaining the Customer Experience," McKinsey Quarterly, December 2008.

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