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How to Avoid a Price War

Strategy

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As most business managers know, pricing has a more significant impact on the bottom-line than any other item on a company's income statement. For the average company, a 1% drop in price can slash operating profits by up to 12% - 15%. This creates a strong motivation to avoid price wars. A price war is every manager's worst nightmare. War is an appropriate word since, like conventional warfare, it leaves lots of casualties and rarely does anybody really win. There are many ways in which a price war can get started, but often managers from different companies will have different versions of what precipitated the price war. None of them started it, yet they're all in it.
The following guidelines on ways your company can successfully avoid price wars and maintain profitability are based on our experience in helping clients deal with pricing challenges.

1. Be Careful about misreading your competitors' actions

Often price wars are started due to misreading competitors' actions or intentions. The results can be a downward spiral in prices that ruins profitability.

In the packaged goods industry, a company recently discovered the cost of not having accurate information. It misread a 10% price cut by a competitor by assuming that it was a long-term strategic repositioning of its product, but that was not the case. In fact, the competitor was responding to an FDA requirement that all nutritional information about packaged foods be reset to 6 oz. Hence, the competitor was only trying to get rid of its obsolete 6 ½ oz package before launching the 6 oz product. By misreading the intent of the price cut, the company responded with its own deep price cut. If it had not done so, prices would have returned to normal in a month or so; instead, the result was a price war that destroyed industry profits for the year.

2. Selectively communicate your strategy

By no means should an organization participate in collusive or predatory pricing. But there are situations where companies should selectively communicate their strategies to minimize the chances of a price war.

When Chrysler, for instance, was under the threat of a deluge of new minivan competitors entering the market, the president made a speech to its dealers covered by the business press. In the speech he indicated that Chrysler would be building a new very low-priced minivan but he also explained that it was something in the desk drawer in case it was needed. To make himself abundantly clear he finished by saying “If it comes to a price war in minivans, I’m convinced we can win it.” By making Chrysler’s intentions to defend its market share clear, Chrysler indicated to the competition that they would lose a lot of money by trying to build market share through low pricing.

The value of communicating your strategy at times is that it forces competitors to take off the rose-colored glasses when preparing their forecasts, and hence dampens their enthusiasm for aggressive price competition.

3. Have good information about your customer’s level of price sensitivity

Understanding customer price sensitivity is essential to any effective pricing strategy, but it becomes critical during times when new competitors enter the market place.

A client in the packaged goods industry found this out when it suddenly faced a new private label product that was positioned directly against one of its flagship brands. The company was unsure how to react in the face of this new threat. The horror stories of companies which did not effectively respond to private labels are industry legends, yet dropping prices substantially based on this fear would cost millions. To respond strategically, the company knew it had to better understand the price tradeoffs customers would make with this new private label brand in the market. By undertaking pricing research, the company was able to forecast the short-term and long-term impact of alternative pricing strategies. What the company learned was that its brand was very strongly positioned and that it could afford to charge a substantial premium and still retain its customers. The strategy chosen was to maintain the premium price, and to “add value” to the brand which would further insulate it from price wars.

4. Be consistent in your response and move quickly

If competitors perceive that they will benefit from making aggressive price moves then they will do so.

A manufacturer of lighting products recently faced aggressive price competition and was slow to respond. By the time it did respond its competitor had benefited substantially, and decided to make another aggressive price move. This pattern continued until the company which was slow to respond almost went out
of business.

The lesson is that if you want to minimize price competition, then you must be willing to respond to aggressive pricing moves consistently and quickly. This will minimize the benefits which an aggressive competitor can accrue, and this sets the stage for the understanding that deep discounting will not be to anyone's advantage.

5. Manage your company's capacity carefully

The single biggest cause of price wars is industry over-capacity. Price wars are almost unavoidable once there is significant over-capacity, since everyone is fighting to maintain critical mass.

Numerous industries have suffered chronic capacity problems – airlines, printed circuit boards (PCB's), and newsprint (until recently) are a few examples. Managing capacity correctly is a tricky issue that has many different strategic implications. However, companies often fail to account for the possibility of over-capacity. The result is that they end up in a costly price war.

Some questions to consider when assessing the ramifications of adding capacity are as follows:

- *Are our forecasts realistic?*
- *Are our competitors' forecasts realistic?*
- *How much industry capacity is being added?*
- *Can we diversify the use of our capacity to minimize risk when demand is down?*
- *How significant a cost advantage will we have over our competitors?*
- *Are there market niches that will support our requirements for profitability?*

By asking these questions you can avoid some of the painful lessons learned by companies which have not done so.

Price wars are detrimental to all involved. They destroy industry profits and rarely lead to long-term advantage for anyone. Even if a company does go bankrupt due to a price war, its capacity rarely disappears, which is evident from the U.S. airline industry. Instead, the best approach is to apply these tips and minimize your chances of a price war.

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