How to Win a Price War

Price war! How can you win without destroying your own profitability? Fire a bigger weapon? Outlast your competitors?

Any way you look at it, a price war is the ultimate in self-destructive, lose-lose behavior – but it is one of the most common of all management problems and concerns.

Paradoxically, not only is a price war devastating for you and your competitors, but it is very bad for your customers as well. When a customer forces its suppliers to focus on price competition, it loses the opportunity to work with its suppliers to increase its real long-term profits in two crucial ways: (1) by reducing the joint costs of doing business together, and (2) by helping the suppliers to find creative ways to turbocharge their customer value proposition.

In short, the real win strategy – for both customers and suppliers – is to turn the price war into a value war.

Powerful tactics

When confronted with aggressive competitor pricing, the instinct is to respond with a price cut.

After all, why lose the business? Even worse, if you lose those customers by failing to respond, you could be in danger of losing them permanently, sacrificing the lifetime value of the relationship. This concern pushes managers to respond even more aggressively, and before long the pricing discipline of the competing businesses collapses, and with it goes the company's profitability.

What can a manager do?

The best tactical answer is to attack the hidden assumptions that frame the price war.

For example, if a competitor quotes an uneconomically low price, why not suggest to the customer that it demand a five-year contract. After all, the price certainly will rise back to former levels once the incumbent is out of the picture. This demand will force the attacker to back down because the losses would be too great over a multi-year period.

Another effective tactic is to rein in the instinct to respond where the attack takes place. In most price wars, the attacker aims at your most lucrative accounts and products – your Islands of Profit. By responding where you are attacked, you effectively do the most damage to yourself – and often the least damage to the attacker.

In fact, in most price wars, the attacker is funding the price war by maintaining a very lucrative, protected portion of its business – its Islands of Profit – as its core source of cash flow and profitability.

The answer? Strike back at the competitor's source of cash flow.

A classic example comes from the airlines a few decades ago. Some carriers, like United and American had very lucrative east-west routes (e.g. NY-LA), while others, like Delta, had very lucrative north-south routes (e.g. NY-Miami).

When an east-west carrier tried to enter a north-south route with low prices, the incumbent's most common response was to match the price reduction, thereby losing a huge amount of money in its lucrative north-south routes – routes in which the attacker had little to lose but much to gain.

Instead, the smart response was to strike back by entering the attacker's prime east-west routes with low prices – attacking the source of cash flow that supported the price war. This very quickly ended the price war. (*Remember that it is illegal in the US to actually conspire with a competitor to set prices.*)

Preventing price wars

These tactics are effective in framing an effective response to a price war. But how do you actually prevent one?

I was asked this question a few weeks ago by a writer who was working on an article about distributor branch pricing.

She asked how much "wiggle room" branches have when it comes to differentiating themselves from the competition based on price, and whether there is an argument for price matching if a customer comes in demanding a cheaper price they may have received down the road.

The answer is that there is a progression of three increasingly effective ways to respond to a price war – match the price, lower the customer's total cost, or increase your value footprint.

Price. The seemingly obvious, and instinctive, way to respond is to simply to match the competitor's low price.

This is an invitation to lose your profitability for two reasons: (1) your competitor probably will up the ante with another price cut, setting off a vicious cycle, and (2) you are essentially training your customers to hammer you on price at every turn. After all, you're showing them that you will fold under pressure.

The more effective counter-tactics mentioned earlier – shift the time frame or shift the locus of attack – are much more effective than simple price matching. But it is even more effective to proactively act to prevent a price war. You can do this in two ways: reducing total cost and turbocharging your customer value proposition.

Total cost. The second – and much more effective – way to respond is to systematically find ways to reduce the cost of doing business with your most important customers. By reducing costs for both your customers and for your own company, you can create real new value that will endure in the long run. Smart customers will strongly gravitate toward this process.

You can take measures to reduce your customer's direct cost. I outline and discuss these profit levers in my book and in many of my blog posts. They range from operations cost reductions (e.g. flow-through supply chains) to product/category management (e.g. product rationalization).

Conversely, customers can create surprisingly big cost reductions for the supplier. For example, by helping the customer smooth its order pattern, you can reduce your supply chain costs, often by 25% or more. Better forecasting offers similar gains, as does a limited but well-aimed product substitution policy. These profit levers benefit both the supplier and the customer – by much more than a simple, temporary price cut.

Smart suppliers pass a big portion of their savings back to their customers in price reductions. Here the customers know that the price reduction is fully warranted by real savings, and therefore can endure over time.

Customer value. The third, and most effective, way to "win" a price war is to prevent it by waging and winning a *customer value war*. Yet all too many managers think of this last, if they consider it at all.

Think about the example of Baxter's Stockless business that I have often cited in my book and blog. For example, see: *Profit from Customer Operating Partnerships*.

Several years ago, Baxter was stuck in a price war, with its products like IV solutions, viewed as commodities mostly bought on price by low-level hospital purchasing staff. Baxter mapped the joint hospital-Baxter supply chain, and discovered that it could enormously reduce both businesses' costs by sending a supervisor into a major hospital to count the needed product, then picking orders into ward-specific totes, and delivering and putting the product away on the patient floor or clinic.

This was the forerunner of vendor-managed inventory, which many companies offer today. Incidentally, Cardinal ultimately bought this business from Baxter, and Cardinal's ValueLink offering is still an extremely effective business run in many of the best major hospitals.

Stepping back, Baxter developed a way to permanently "win" the price wars that raged in its business by converting them into a one-firm race to lower the total cost of the joint supply chain, passing this saving to the hospitals. And this saving was so large that it dwarfed the pennies at stake in the price wars.

However, Baxter packed even more into this business initiative. In the prior period, before the Stockless/ValueLink was developed, the hospitals were reluctant to operate a large network of off-site clinics and surgical centers. Many top hospital managers did not have confidence that their materials management staff could handle the complex scatter-site network of critical products.

The new partnership with Baxter enabled the hospital executives to gain confidence that the newly created supply chain, managed by a supply chain expert like Baxter (now Cardinal), could support the evolving network of facilities. In short, Baxter created a fundamentally new value proposition for the hospitals – enabling them to radically change the way they operated to bring huge new value to *their customers* – the patients.

The progression was incredibly powerful: from price matching, to total cost reduction that competitors couldn't match, to partnering with the hospitals to create a fundamentally new and much more effective value proposition for the patients, which again the competitors could not match.

Baxter did not just win the price war – it eliminated it.

Baxter won the customer value war.

A Lesson from GE

GE is a very insightful, innovative firm. GE managers are trained not just to compete effectively, but to relentlessly search for fundamentally new and better ways to do things – winning by changing the competitive game.

A prime example of this is the decision of the GE aircraft engine group to change its product offering. In the past, the company offered traditional but effective product centered on aircraft engines and spare parts.

However, insightful executives stepped back and reflected on what GE's airline customers really wanted: not just engines and parts, but rather, hours of engines effectively powering their aircraft. After all, they were in the business of flying passengers.

In response, GE developed a fundamentally new offering: "power by the hour". GE wisely combined its prior offerings – engines, parts, and related services – into one offering that directly addressed its customers' needs. Much as Baxter did for the hospitals.

Not only did this new "power by the hour" offering meet the customer needs much better that any competitive offering, but importantly, it combined a package of products and services that *no competitor could match*.

GE redefined its market so it had virtually no effective competitors.

Baxter did the same. So did Southwest Airlines.

The key imperative is very clear: Once you have a lead, step on the gas – and the most effective way to do this is by turbocharging your customer value proposition.

Islands of Profit

Winning the customer value war is most often surprisingly easy because your competitors rarely think about it. All too often they focus on tactics like price optimization, rather than accelerating their customer value proposition.

This is especially critical for securing your Islands of Profit – your high-revenue high-profit business. These customers are most susceptible to a competitor incursion, yet these also are the customers that are most receptive to innovations that fundamentally reduce your joint cost structure and transform your customer value proposition.

Your Coral Reefs – your high-revenue low-profit customers – on the other hand, are usually the most price-sensitive. Yet, many can be converted into Islands of Profit if you develop a compelling value proposition.

The same goes for your Minnow customers – low-revenue low-profit – especially those that are someone else's big customers and are just using you to discipline the competitor's prices.

The Essential Question

The essential question is: Are you so busy with tactical issues like price wars that you “do not have the time or resources” to systematically and relentlessly build your customer value proposition? Especially for your Islands of Profit Customers?

Winning the customer value war is the only way to permanently prevent price wars and really secure your future.