# Should you lower your prices?

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Lowering prices to defend market share and utilise capacity is a natural reflex during a recession. Your competitors are doing it. So it would seem that you should follow, if not take the initiative – especially if you feel that your operating costs are lower and you have more room to manoeuvre.

But is this really a good strategy?

### *Defend market share?*

Is it worth defending market share at all costs? It is not an iconoclastic question. Some industries do not necessarily benefit from economies of scale or size advantages for covering R&D and advertising expenses. They do not all require a large market share to squeeze the most out of their sales and marketing investments.

So in industries where a large market share does not automatically yield lower costs and higher margins, why defend market share at any price?

Moreover, in industries where market share is highly valuable but a company is only a minor player with a high cost structure, why should it fight to retain a small share of the market when its margins would be even further eroded? Wouldn't it be better for the company to focus on increasing short- and medium-term cash flow?

In both of these circumstances, a sound strategy would entail maintaining prices and boosting short-term cash flow. Some market share may be sacrificed for the sake of margins, but this process will be slowed if products are strongly differentiated, customers are small and dispersed, and competitors' products are dissimilar.

On the other hand, a company with low costs operating in an industry where market share is highly coveted would be wise to defend, and even seize, market share. Competitive pricing is *just one of several* tools available to achieve this, and not necessarily the best.

A company cannot implement an effective pricing policy during a recession unless it has a clear strategic vision.

### *Capacity adjustment*

Regardless of a company's strategy, the most pressing problem in the near-term is to use existing capacity. An intelligent pricing policy will not work if most of the company's assets are sitting idle, especially if variable costs make up a small percentage of its total costs.

In situations of excess capacity, plant managers, sales representatives, CEOs and other constituents tend to unite behind the same rallying cry – we must slash our prices! But how low? Down to the level of cash costs? Or all the way down to variable costs?

Therefore, a capacity adjustment is the first step in an effective pricing policy. But again, this must be done within the framework of a broad strategy. A sharp capacity reduction may be needed in industries where market share is not very important, or when a company is not competitive or likely ever to become so.

A more moderate reduction might suffice in industries where market share is valuable and a company is cost-competitive, so that it remains well-positioned for the eventual market recovery.

High-growth businesses may want to invest in additional capacity during the low point of an economic cycle, and have this capacity ready to come on-line as soon as a recovery begins; this strategy would enable them to gain market share at the lowest cost.

***A differentiated pricing policy***

Only one intelligent pricing policy exists for any given strategy and capacity level, based on the value and positioning of a company's product or service, the competitive environment, and customers' price sensitivity.

Price sensitivity varies depending on the industry. Factors such as product quality and functionality, image, sales and marketing efforts, localisation, and related services often carry just as much weight – if not more – as price in customers' purchasing decisions. Within a particular industry, the percentage of customers who are sensitive to price alone (vs. product features, locations, competitors, etc.) rarely exceeds 30%.

Therefore a knee–jerk reaction to competitors' price cuts or demands from sales representatives to slash prices is counterproductive; a well-conceived strategy must be used to avoid the risk of widespread contagion.

Price sensitivity can be measured. It varies significantly based on the nature of the product or service, the type of customer, and the competitive environment. More specifically, it is a function of the following seven factors, some of which are interrelated.

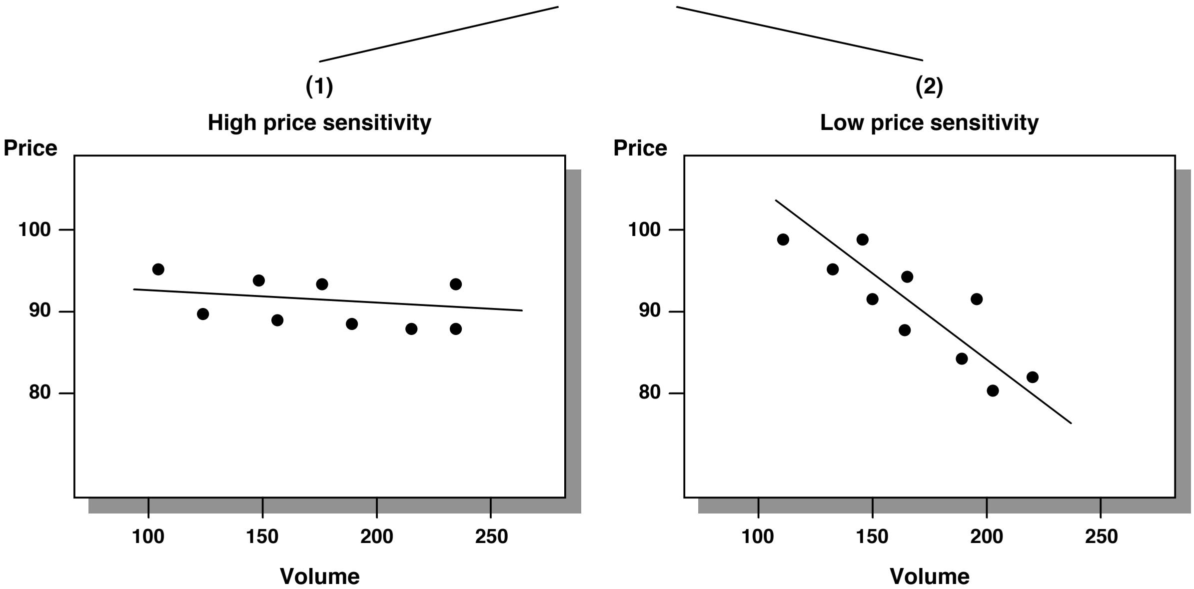
- The degree of product or service differentiation (technology content, functionality, real or perceived quality, associated image or status, the ability to make objective comparisons, etc.). The higher the differentiation, the lower the price sensitivity, all other things being equal.
- The degree of similarity among competitors' products or services (in terms of content, image, location, etc.). The greater the similarity, the higher the price sensitivity; a customer typically switches only when there is not much difference between the product or service offered by two competitors.
- Market structure. Price sensitivity to a given company's product or service depends largely on that company's market share (a fact people often forget!). The same price cut will not have the same effect on sales volumes when carried out by a company with a large market share vs. one with a small market share (the pool of additional customers that could be acquired would be different). The same holds true, asymmetrically, for price increases.
- The level of customer knowledge and sophistication (small, dispersed customers vs. large customers likely to have a purchasing department or an engineering department influencing the purchasing decision). In the manufacturing industry, the price of a product or service usually differs by 20% to 30% depending on the different types and sizes of customers, for good reasons that are understood by customers.
- The product's importance to customers and their purchasing preferences (the product's position in the customer's value chain, whether the technical improvement is limited or carries across the entire value chain, whether the selection is based purely on price, etc.).
- A customer's cost and risk of switching between two suppliers (i.e., whether the customer needs a specific product or service for its value chain).
- A supplier's cost and feasibility of switching between two customers, should one default (the relative sizes of the customers and suppliers, the type and flexibility of their respective manufacturing equipment, etc.).

Based on these factors, products and customers in just about any industry can be segmented into several groups with very different price sensitivities (see Table 1).

The relationship between price and quantity can be measured spatially and over time. By combining the seven factors listed above, we can identify, for most industries, between ten and twenty segments – each with the same type of product, service, customer, location, and competitive environment – where the price-quantity relationship is sufficiently established and predictable to serve as a basis for an optimal pricing policy. Using this approach, companies can analyse, in a simple, rational, and *systematic* manner, the two to ten thousand classic combinations of product items, customers, etc., that exist in any industry.

**- Table 1 -**

**The ranges of products / services / customers / regions vary widely within each industry**




This sort of tactical price optimisation can be used for various customer segments and product ranges in the manufacturing industry, for identical services provided to end customers in various locations, for consumer goods in different price segments and regions, etc.

An intelligent pricing policy during a recession is one that further *differentiates* pricing among customers, products, optional services, regions, and the competitors the company is confronting. Prices should be lowered when they will give a substantial boost to sales volumes and capacity utilisation; prices should be maintained when products provide genuine value to customers, and customers are willing to pay for it.

Pricing strategy is a key variable during a recession, along with managing costs and investments. As with cost cutting and CapEx optimisation, a rational, systematic analysis of pricing will give greater insight than mere managerial experience and intuition.

There is no miracle cure. Prices will go down *on average*. But between a knee-jerk reaction to sales reps' worries on one hand, and a well-designed, differentiated pricing policy on the other, companies should be able to eke out a little additional cash flow.

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*Estin & Co is an international strategy consulting firm with offices in Paris, London, Geneva, and Shanghai. The firm helps senior managers at large European and North American companies develop and implement growth strategies, and works with private equity funds to assess and value their investments.*