Kamikaze Pricing

When penetration strategies run amok, marketers can find themselves in a dive-bomb of no return.

by Reed K. Holden and Thomas T. Nagle

Price is the weapon of choice for many companies in the competition for sales and market share. The reasons are understandable. No other weapon in a marketer's arsenal can be deployed as quickly, or with such certain effect, as a price discount. The advantage is often short-lived, though, and managers rarely balance the long-term consequences of deploying the price weapon against the likely short-term gains.

Playing the price card often is a reaction to a competitor and assumes that it will provide significant gain for the firm. Usually, that's not the case. Firms start price wars when they have little to lose and much to gain; those who react to the initiators often have little to gain and much to lose. The anticipated gains often disappear as multiple competitors join the battle and negate the lift from the initial reductions.

Managers in highly competitive markets often view price cuts as the only possible strategy. Sometimes they're right. The problem is that they are playing with a very dangerous weapon in a war to improve near-term profitability that ends in long-term devastation. As the Chinese warrior, Sun Tzu, put it, "Those who are not thoroughly aware of the disadvantages in the use of arms cannot be thoroughly aware of the advantages."

If marketers are going to use low prices as a competitive weapon, they must be equally aware of the risks as well as the benefits (see "The Prisoner's Dilemma"). They also must learn to adjust their strategies to deploy alternatives when pricing alone is no longer effective. Failure to do so has put companies and entire industries into tail spins from which they never fully recover.

Pricing Options

Marketers traditionally have employed three pricing strategies: skim, penetration, and neutral. Skim pricing is the process of pricing a product high relative to competitors and the product's value. Neutral pricing is an attempt to eliminate price as a decision factor for customers by pricing neither high nor low relative to competitors. Penetration pricing is the decision to price low relative to the product's value and to the prices of similar competitors. It is a decision to use price as the main competitive weapon in hopes of driving the company to a position of market dominance.

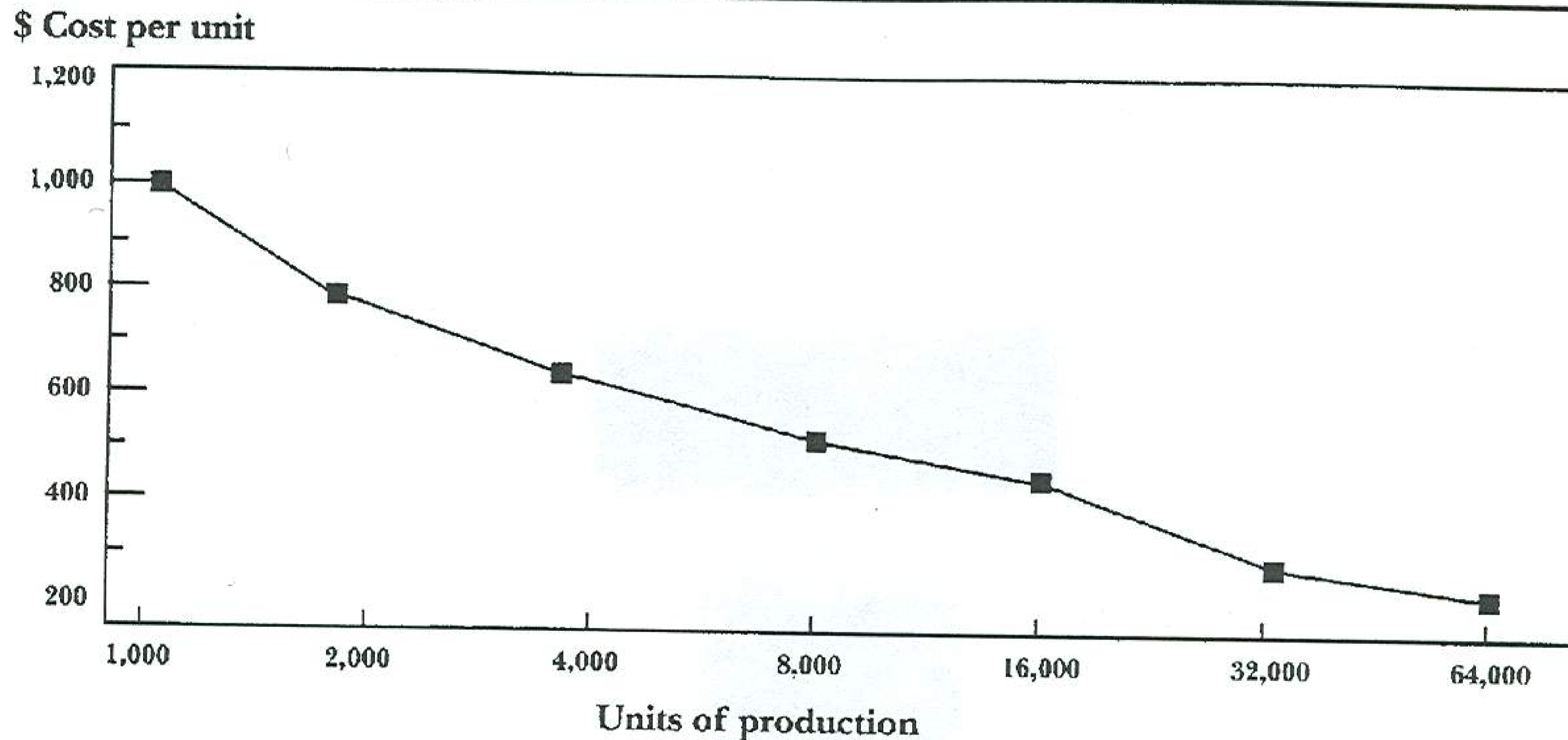
EXECUTIVE BRIEFING

Penetration pricing is perhaps the most abused pricing strategy. It can be effective for fixed periods of time and in the right competitive situation, but many firms overuse this approach and end up creating a market situation where everyone is forced to lower prices continually, driving some competitors from the market and guaranteeing that no one realizes a good return on investment. Managers can prevent the fruitless slide into kamikaze pricing by implementing a value-driven pricing strategy for the most profitable customer segments.

All three strategies consider how the product is priced relative to its value for customers and that of similar competitors. When Lexus entered the luxury segment of the automobile industry, the car's price was high relative to

EXHIBIT 1

Experience curve effects



standard vehicles but low relative to Mercedes and BMW. The penetration strategy was defined not by the price but by the price relative to the value of the vehicle and to similar competitive products.

> The main ingredient to successful penetration pricing is a large segment of customers for whom price is the primary purchase motivation.

Any of these strategies can be associated with a variety of cost structures and can result in either profits or losses. To understand when each strategy is likely to be successful, managers should evaluate their current and potential cost structure, their customers' relative price sensitivities, and their current and potential competitors. All three areas must be carefully considered before employing any pricing strategy.

Penetration Strategies Can Work

If a firm has a fixed cost structure and each sale provides a large contribution to those fixed costs, penetration pricing can boost sales and provide large increases to profits—but only if the market size grows or if competitors choose not to respond. Low prices can draw additional buyers to enter the market. The increased sales can justify production expansion or the adoption of new technologies, both of which can reduce costs. And, if firms have excess capacity, even low-priced business can provide incremental dollars toward fixed costs.

Penetration pricing can also be effective if a large experience curve will cause costs per unit to drop significantly. The experience curve proposes that, as a firm's production experience increases, per-unit costs will go down. On average, for each doubling of production, a firm can expect per-unit costs to decline by roughly 20%. Cost declines can be significant in the early stages of production (see Exhibit 1).

The manufacturer who fails to take advantage of these effects will find itself at a competitive cost disadvantage relative to others who are further along the curve. This is often the case with new technologies and innovative products, where relatively small increments in units sold yield substantial decreases in unit costs. This is also the case for many new entrants to a market who are just beginning to see experience curve cost reductions.

However, the main ingredient to successful penetration pricing is a large segment of customers for whom price is the primary purchase motivation. This can be the case in business markets where original equipment commodities are sold to the production process of a customer's business, but it rarely occurs in consumer markets where image is an important part of the use of a product.

When Omega watches—once a brand more prestigious than Rolex—was trying to improve market share in the 1970s, it adopted a penetration pricing strategy that succeeded in destroying the watch's brand image by flooding the market with lower priced products. Omega never gained sufficient share on the lower price/lower image competitors to justify destroying its brand image and high-priced position with upscale buyers. Similar outcomes were experienced by the Cadillac Cimarron and Lacoste clothing.

A better strategy would have been to introduce a totally new brand as a flanking product, as Heublein did with the Popov, Relska, and Smirnoff vodka brands and Intel did with microprocessors in 1988. After the introduction of the 386 microprocessor, Intel adopted a skim price strategy for the high value and proprietary 386 chips. It also wanted to market a circuit in the 286 market that could compete with AMD and Cirrus on a nonprice, value-added basis. The 386SX was introduced as a scaled down version of the 386, but at a price only slightly higher than the 286. The net result was to migrate price sensitive customers more quickly to the proprietary 386 market with the 386SX, while still capturing increased profit from the high value users with the 386.

In its marketing of the 486, Pentium, and Pentium Pro circuits, Intel continues this flanking strategy with dozens of varieties of each microprocessor to meet the needs of various market segments.

For penetration pricing to work, there must be competitors who are willing to let the penetration pricer get away with the strategy. If a penetration price is quickly matched by a competitor, the incremental sales that would accrue from the price-sensitive segment must now be split between two competitors. As more competitors follow, smaller incremental sales advantages and lower profits accrue to both the initiator and the followers.

Fortunately, there are two common situations which often cause competitors to let penetration pricers co-exist in markets. When the penetration-pricing firm has enough of a cost or resource advantage, competitors might conclude they would lose a price war. Retailers are beginning to recognize that some consumers who are unconcerned about price when deciding which products and brands to buy become price sensitive when deciding where to buy. They are willing to travel farther to buy the same branded products at lower prices. Category killers like Toys 'R' Us use penetration pricing strategies because they are able to manage their overhead and distribution costs much more tightly than traditional department stores. Established stores don't have the cost structure to compete on this basis, so they opt to serve the high-value segment of the market.

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The second situation conducive to penetration pricing occurs when large competitors have high-price positions and don't feel a significant number of their existing customers would be lost to the penetration pricer. This was the case when People's Express entered the airline industry with low priced fares to Europe in the 1970s. The fares were justified with reduced services such as no reservations or meal service. People's also limited the ability of the high value business traveler to take advantage of those fares by not permitting advanced reservations or ticket sales. This was a key element of their strategy: Focus only on price sensitive travelers and avoid selling tickets to the customers of their competitors.

Major airlines didn't respond to the lower prices because they didn't see People's Express taking away their high value customers. It was only when People's began pursuing the business traveler that the major airlines responded and quickly put People's out of business.

The same strategy is being repeated today by Southwest Airlines in the domestic market far more skillfully. Southwest has a cost and route structure that limits the ability of major airlines to respond. In fact, when United Airlines, a much larger competitor, did try to respond with low-cost service in selected West Coast markets, it had to abandon the effort because it couldn't match Southwest's cost structure.

Penetration or Kamikaze?

An extreme form of penetration pricing is "kamikaze" pricing, a reference to the Japanese dive bomber pilots of World War II who were willing to sacrifice their lives by crashing their explosives-laden airplanes onto enemy ships. This may have been a reasonable wartime tactic (though not a particularly attractive one) by commanders who sacrificed single warriors while inflicting many casualties on opponents. But in the business world, the relentless pursuit of more sales through lower prices usually results in lower profitability. It is often an unnecessary and fruitless exercise that damages the entire dive-bombing company—not just one individual—along with the competitor. Judicious use of the tactic is advised; in as many cases as it works, there are many more where it does not.

Kamikaze pricing occurs when the justification for penetration pricing is flawed, as when marketers incorrectly assume lower prices will increase sales. This may be true in growth markets where lower prices can expand the total market, but in mature markets a low price merely causes the same customers to switch suppliers. In the global economy, market after market is being discovered, developed, and penetrated. High growth, price sensitive markets are quickly maturing, and even though customers may want to buy a low-priced product, they don't increase their volume of purchases. Price cuts used to get them to switch fail to bring large increases in demand and end up shrinking the dollar size of the market.

A prominent example is the semiconductor business, where earlier price competition led to both higher demand and reduced costs. But in recent years, total demand tends to be less responsive to lower prices, and most suppliers are well down the experience curve. The net result is an industry where participation requires huge investments, added value is immense, but because of a penetration price

The Prisoner's Dilemma

A popular exercise in seminars and executive briefings we hold is to ask executives to participate in a prisoner's dilemma pricing game. Each team must decide whether to price its products high or low compared to those of another team in 10 rounds of competition. The objective is to earn the most money; results are determined by the decision that two competitors make in comparison with each other.

The game fairly accurately simulates a typical profit/loss scenario for price competition in mature markets. The objective is to impart several lessons in pricing competition, the first being that pricing is more like playing poker than solitaire. Success depends not just on a combination of luck and how the hand is played but also on how well competitors play their hands. In real markets, outcomes depend not only on how customers respond but, perhaps more important, on how competitors respond to changes in price.

If a competitor matches a price decrease, neither the initiator nor the follower will achieve a significant increase in sales and both are likely to have a significant decrease in profits. In developing pricing strategy, managers need to anticipate the moves of their competitors and attempt to influence those moves by selectively communicating information to influence competitive behavior.

The second lesson is that managers must adopt a very long time horizon when considering changes in price. Once started, price wars are difficult to stop. A simple decision to drop price often becomes the first shot in a war that no competitor wins. Before initiating a price decrease, managers must consider how it will affect the competitive stability of markets.

Philip Morris discovered this when it initiated a price war in the cigarette business by cutting the prices of its top brands. Competitors followed, and the net result was a $2.3 billion drop in operating profits for Philip Morris, even as the Marlboro brand increased its market share seven points to 29%. The manufacturer of Camels experienced a $1.3 billion drop in profits.

The third lesson from the prisoner's dilemma is that careful use of a value-based marketing approach can reverse a trend toward price-based marketing. This is accomplished through signaling, a nonprice competitive tactic that involves selectively disclosing information to competitors to influence their behavior. The steel and airline industries provide prominent examples of the signaling strategy's use. They often rely on announcements that conveniently appear on the front pages of the Wall Street Journal to signal competitors of pending price moves and provide them with opportunities to follow. The strategy takes time to implement, but it provides a far better long-term competitive position for marketers who employ it.

Most managers who play the prisoner's dilemma adopt a low-price strategy. This mirrors the real world, where 63% of managers who adopt an identifiable strategy use low price, according to an ongoing research project in which we are engaged. In the game, low-price teams fail to earn any profit in a majority of cases. The strategy works in round one, but competitors quickly learn to respond and both parties end up losing any chance for profit.

Executives rationalize that, if their firm can't make money, competitors shouldn't, either. Managers quickly forget that the objective of this game—and the game of business—is profit. Price cuts in the real world can be devastating. A current example is the personal computer business, where Packard Bell sets the low price standard that many competitors follow.

Packard Bell's management is less concerned with profit than with achieving a volume of sales and market share in a growing industry. But unless the company has operational characteristics that distinguish it from competitors and permit Packard Bell to deliver a quality product at those low prices, its ability to leverage market share will be limited. Analysts estimate that Packard Bell has only made $45 million in net profit over the past 10 years and is staying afloat through loans granted by suppliers and massive cash infusions from its Japanese and European co-owners.

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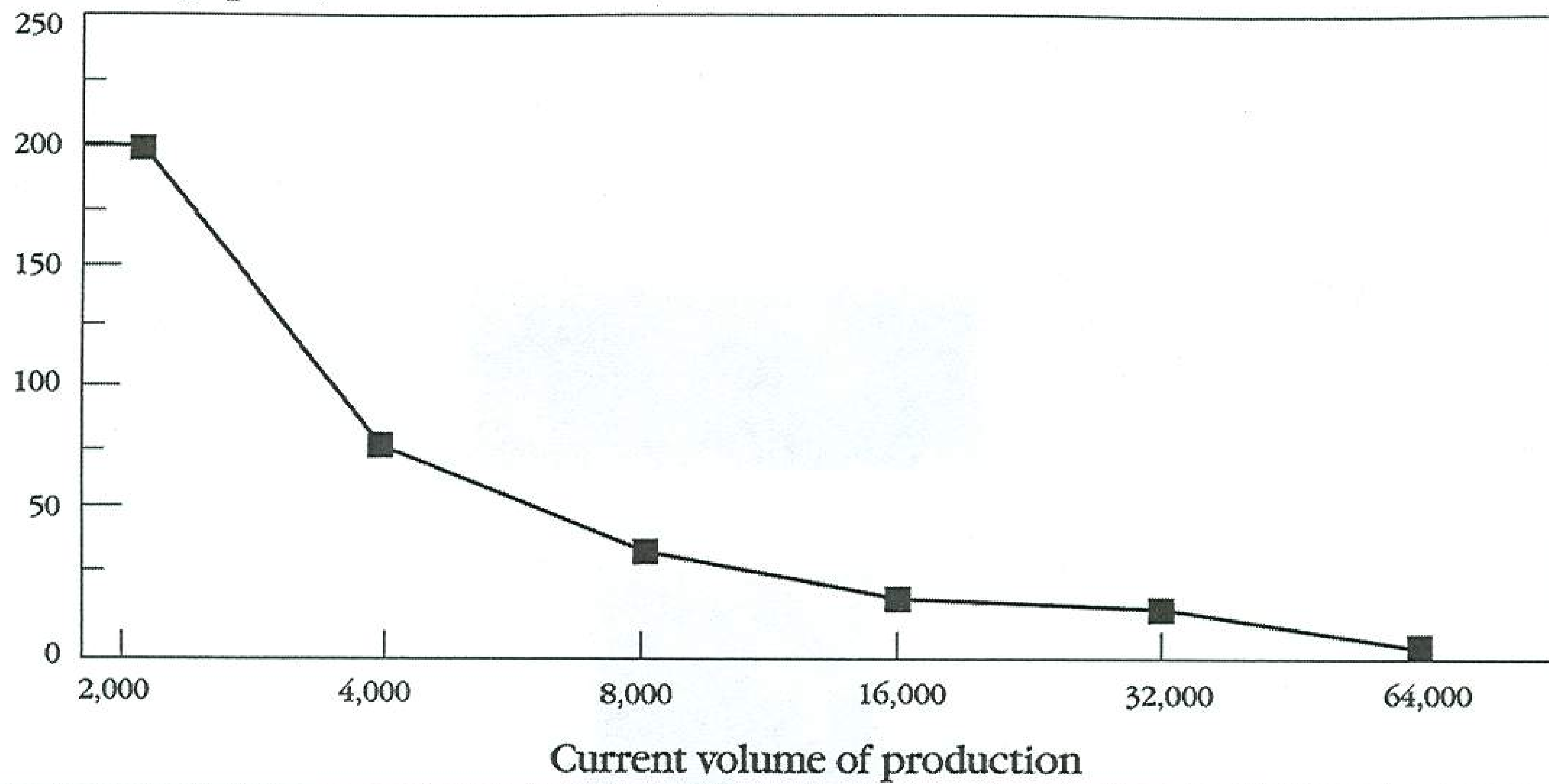
mentality, suppliers can't pull out of the kamikaze death spiral.

There was a time when large, well-entrenched competitors took a long time to respond to new low-price competitors. That is no longer true; domestic automobiles are now the low priced brands, and even AT&T has learned to respond to the aggressive price competition of Sprint and MCI. The electronics, soft goods, rubber, and steel companies that ignored low-price competitors in the 1970s and '80s have become ruthless cost and price cutters. The days of free rides from nonresponsive market leaders are gone.

Another risk comes in using penetration pricing to increase sales in order to drive down unit costs. Unfortunately, there are generally two reasons managers run into trouble when they justify price discounts by anticipated reductions in costs. First, they view the relationship between costs and volume as linear, when it actually is exponential—the cost reduction per unit becomes smaller with larger increases in volume. Initial savings are substantial, but as sales grow, the incremental savings per unit of production all but disappear (see Exhibit 2). Costs continue to decline on a per-unit basis, but the incremental cost reduction seen from each additional unit of sale becomes insignificant. Managers need to recognize that experience curve cost savings as a percentage of incremental sales volume declines with increases in volume. It works great in early growth phases but not in the later stages.

Exhibit 2

Disappearing savings



Many managers believe that sales volume is king. They evaluate the success of both their sales managers and marketing managers by their ability to grow sales volume. The problem is that their competitors employ the exact same strategy. Customers learn that they can switch loyalties with little risk and start buying lower priced alternatives. Marketers find themselves stuck with a deadly mix of negligible cost benefits, inelastic demand, aggressive competition, and no sustainable competitive advantage. Any attempt to reduce price in this environment will often trigger growing losses. To make matters worse, customers who buy based on price are often more expensive to serve and yield lower total profits than do loyal customers. Thus starts the death spiral of the kamikaze pricers who find their costs going up and their profits disappearing.

Penetration pricing is overused, in large part, because managers think in terms of sports instead of military analogies. In sports, the act of playing is enough to justify the effort. The objective might be to win a particular game, but the implications of losing are minimal. The more intense the process, the better the game, and the best way to play is to play as hard as you can.

This is exactly the wrong motivation for pricing where the ultimate objective is profit. The more intense the competition, the worse it is for all who play. Aggressive price competition means that few survive the process and even fewer make reasonable returns on their investments. In pricing, the long-term implications of each battle must be considered in order to make thoughtful decisions about which battles to fight. Unfortunately, many managers find that, in winning too many pricing battles, they often lose the war for profitability.

Value Pricing

To avoid increasingly aggressive price competition, managers must first recognize the problem and then develop alternate strategies that build distinctive, nonprice competencies. Instead of competing only on price, managers can develop solutions to enhance the competitive and profit positions of their firms.

In most industries, there are far more opportunities for differentiation than managers usually consider. If customers are receiving good service and support, they are often willing to pay more to the supplier, even for commodities. A client in India produced commodity gold jewelry that was sold into the Asian market at extremely low penetration prices. Because of the client's good relationships with wholesale and retail intermediaries, we recommended a leveraging of those relationships to increase prices to a more reasonable level. Despite much anxiety, the client followed suit and major customers accepted the increases.

Opportunities to Add Value

Marketers often fail to recognize the opportunity for higher prices when they get caught up in kamikaze pricing. To avoid this, they need to understand how their customers value different product and company attributes. The objective is to identify segments of customers who have problems for which unique and cost-effective solutions can be developed. Sometimes it's as simple as a minor adjustment in packaging.

Know what customers want. Loctite Corp., a global supplier of industrial adhesives, introduced a specialty

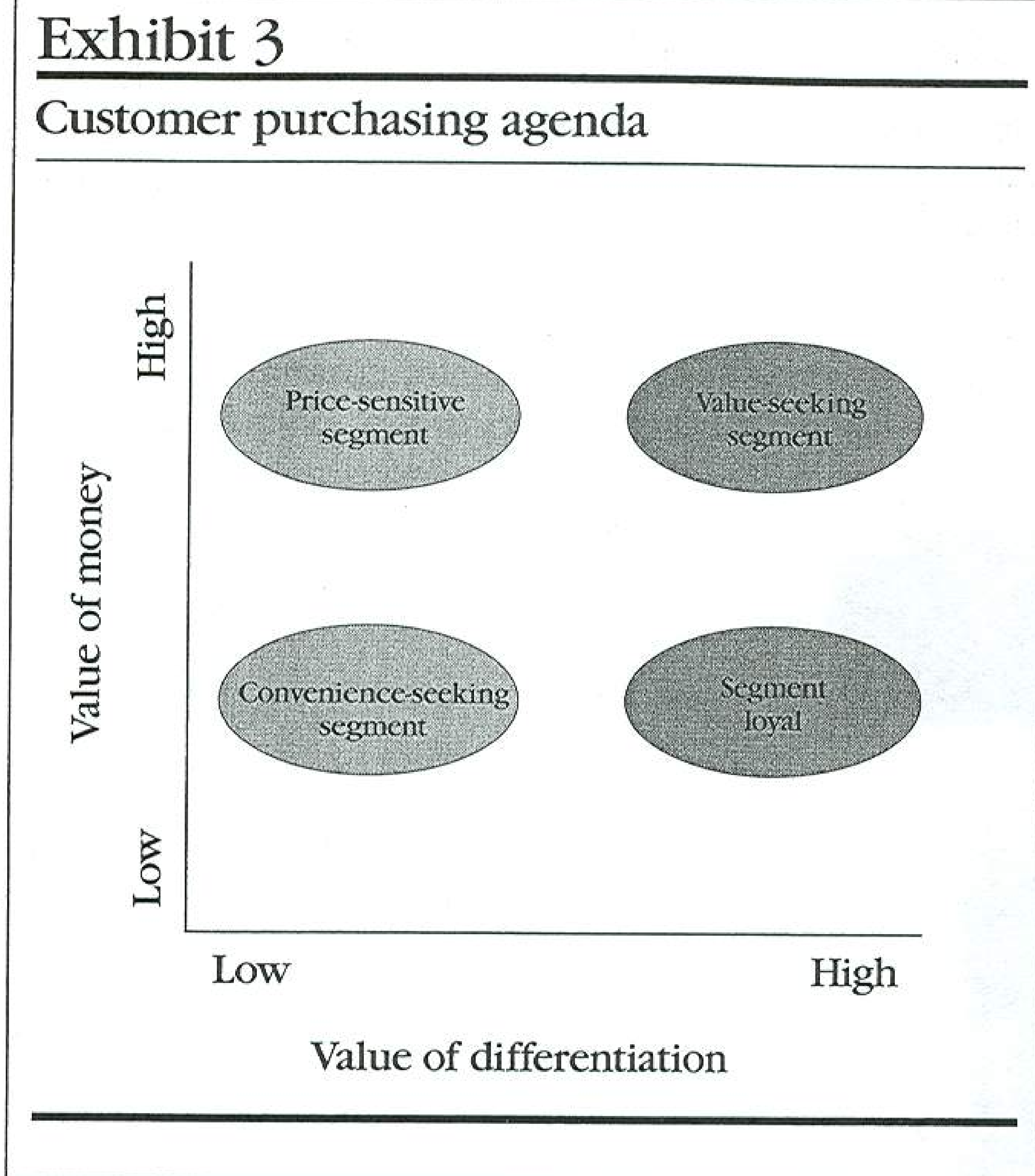


Exhibit 3
Customer purchasing agenda

liquid adhesive in a 1-oz. bottle for use in emergency applications. Unfortunately, sales were less than spectacular. After a number of customer interviews, Loctite discovered that the liquid was difficult to apply and the bottle was difficult to carry. What customers really wanted was an easy-to-apply gel in a tube. The product was reformulated to meet these criteria and saw huge success. In the process, Loctite almost doubled the price.

> Firms that attract value customers get the loyal buyer as part of the bargain and sell to the price buyer only when it is profitable and reasonable.

Managers should identify features that they can add more cost effectively than their competitors can. IBM has been under intense price pressure in the personal computer segment. Besides introducing lower-priced flanking products (with limited success), IBM also has introduced computers with more internal memory. This feature had significant appeal because of the higher memory demands of the Windows 95 operating system. The value of this feature was greater than a price cut because IBM is arguably the most cost-effective producer of random access memory in the world. It also forced low-price competitors to incur higher relative costs to match IBM, thereby undercutting their ability to price their PCs below IBM's.

In the process of adding value to their products, firms should remember that value is achieved not only from the products themselves, but from the services associated with their use. The manufacturer of a heavy-duty truck oil broke out of commodity pricing when it began analyzing the oil from its customers' trucks to determine if there were excessively high temperatures or metal in the oil that would indicate a breakdown of the internal components of engines. The service was promoted in a mailer included with each large drum of oil. The cost of this service was minimal, and a large segment of small- and owner-operator customers placed a huge value on it. This tactic helped the firm to differentiate its product with a valued service connected to the product.

Offer complete benefits. Another way to avoid downward pricing is to offer complete product benefits, which is especially useful in the early phases of a new product's life. This tactic is not as effective when products mature and customers no longer need as much service support. However, when customers are still developing their expertise, they require complete systems to achieve the maximum benefit to their organization. This is often an expensive affair that needs to be justified by the future business and profit potential that a customer represents.

When marketers correctly assess this type of situation, they often develop a sustainable competitive advantage that makes them impervious to competitive erosion. This was the strategy that Intel employed when it introduced the 8086 microprocessor to the PC industry in the early 1980s. Although the 8086 was slightly inferior technically to Motorola's 6800, Intel adopted sophisticated customer support programs that permitted new PC manufacturers to introduce new products quickly. This and other services were backed by a strong sales and marketing program that focused on specific customer adoptions. The net result was the beginning of Intel's dominance in PC microprocessors.

Understand customer agendas. Marketers make a serious mistake when they assume that all their customers are willing to sacrifice quality to obtain low prices. A few are, but most really want to get high-quality products at the lowest possible price. The seller of a high-quality product can compete against a low-price, low-quality product by recognizing that, despite the words of the purchasing agent, pricing need not be too aggressive.

Sellers who understand why customers buy their products often find that there is a fairly uniform set of reasons underlying purchasing behavior. Price is often important, but it seldom is the sole motivation. In most business situations, there are four types of agendas with regard to the pricing of products and a buyer's desired relationship with the supplying firm (see Exhibit 3). One of the best ways for marketers to avoid the trap of excessive price competition is to develop market- and customer-level strategies that reflect those behaviors.

For example, loyal customers highly value specific things that a supplier does for them, such as technical support, quality products, and customer-oriented service agents. These customers are less concerned about the price than about the care they receive. They often have a single

supplier and have no intention of qualifying another. Understanding who the loyal customers are and keeping their loyalty is critical.

The purpose of sales is not to use a lower price to close a sale, but to convince the customer that the price of a product is fair.

Conversely, price buyers care little about a long-term relationship with a supplier and want the lowest possible price for products. These commodity buyers have multiple vendors and encourage them to dive into kamikaze price wars. For consumer marketers, price shoppers who switch allegiances at the drop of a coupon provide few incremental dollars to the retailers who cater to them. For business-to-business sellers, these tend to be the buyers who scream loudest and dictate pricing and selling strategies. Unfortunately, the profits they generate rarely justify the attention they demand.

The price buyer's agenda is to get products at the lowest possible prices, so he or she uses tactics that force marketers to employ kamikaze pricing tactics even when it might not be the wisest thing to do. For the marketer, the trick is only to do business with the price buyer when it is profitable to do so and when it doesn't prompt a more profitable customer to purchase elsewhere.

Convenience buyers don't care whose product they purchase, and have little regard for price. They simply want it readily available. This often is the most profitable market segment, provided marketers can deliver their products at the locations preferred by these buyers. Unfortunately, this group exhibits little brand loyalty and provides sellers with no sustainable competitive advantage beyond their distribution systems.

Offer the best deal. Value buyers evaluate vendors on the basis of their ability to reduce costs through lower prices or more efficient operations, or to make the buyer's business more effective with superior features or services. From a customer perspective, this is the place to be; while both price and loyal buying have unique costs, value buying comes with the assumption that these customers are getting the best deal possible, given all factors of consumption. From a marketing perspective, firms that attract value customers get the loyal buyer as part of the bargain and sell to the price buyer only when it is profitable and reasonable.

Organizations that employ kamikaze pricing have a poor understanding of how their products create value for customers. This lack of understanding results in excessive reliance on price to obtain orders. Successful marketers use price as a tool to reflect the value of the product and implement systems in the organization to assure that value is delivered to customers and captured in the pricing.

The Five Cs

"Sell on quality, not on price" was once a popular marketing aphorism. Unfortunately, while product quality can reduce the seller's rework and inventory costs, it does little for customers. Selling the quality of a product is often not enough because buyers have difficulty quantifying its value and may be unwilling to pay for it. By focusing on quality, we miss the opportunity for customers to understand the true value that quality brings to the buyers of our products. Instead, resolving to "sell on value, not on price" focuses on understanding how pricing really should work. To avoid the rigors of price-based competition, marketers should adopt the five "Cs" of the value-based approach:

- Comprehend what drives customer value.
- Create value in product, service, and support.
- Communicate value in advertising.
- Convince customers of value in selling.
- Capture value in pricing strategy.

How a product provides customer value and which value-creation efforts best differentiate a product from the competition must be understood by marketers. When there is additional value that can be created, marketers need to do a better job creating it in their products, service, and support activities. Once a firm provides differentiating value to its customers, the primary responsibility of the marketer is to set up a communications system, including the salesperson, that educates the customer on the components of that value.

The purpose of sales is not to use a lower price to close a sale, but to convince the customer that the price of a product, which is based on its value in the market, is fair. Of course, most sales compensation systems do just the opposite, rewarding salespeople for closing a sale, regardless of the price. Salespeople who lack an understanding of a product's value often bend to a buyer's wishes and match a lower-value competitor's price. Product prices should reflect a fair portion of their value, and they should be fixed so salespeople will have to sell on the basis of value.

Companies that approach pricing as a process rather than an event can effectively break the spiral of kamikaze pricing.

Penetration pricing gains ground in markets against competitors, but extended use of this offensive tactic inevitably leads to kamikaze pricing and calamity in markets as competitors respond, cost savings disappear, and customers learn to ignore value. Good marketers employ such weapons selectively and only for limited periods of time to build profitable market position. They learn how to draw from a broad arsenal of offensive and defensive weapons, understanding how each will affect their overall long-term market conditions, and never losing sight of the overall objective of stable market conditions in which they can earn the most sustainable profit.

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