Hitting back: strategic responses to low-cost rivals

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By the late 1990s, global network manufacturer Cisco Systems was sitting pretty in China. Offering hardware, software and services for internet solutions, the firm had a 60 percent market share for high-end equipment there. But as Cisco was being lauded in cover stories in the world’s leading business publications, Huawei Technologies, a little-known Chinese start-up, quietly entered the networking industry. Beginning in 1998 by importing and developing PBX telephone products, Huawei was unencumbered by inherited costs, was able to hire newly minted Chinese engineers at starting salaries of $8,500 a year, and enjoyed a multi-billion dollar credit line from the Chinese government. Huawei took full advantage of its competitive strengths, reducing networking equipment costs 70 percent compared with Cisco, its much larger rival. Through partnerships with 3Com and Siemens, Huawei entered new markets, and in the United Kingdom, it won British Telecom’s business, ultimately forcing the domestic incumbent Marconi Corporation onto the selling block. From 2001 to 2005, Huawei’s revenue rose from $2.3 billion to nearly $6 billion, and it cut Cisco’s market share in China to less than 40 percent.[1]

Huawei’s brashly competitive move was built around low costs. But successful low-cost competitors don’t just sap margins incrementally. What makes them so dangerous is their ability to redefine the entire competitive landscape. The low-cost competitor transforms its value chain to reduce prices drastically. With low costs as a pivot, it shifts the ground beneath larger, less flexible opponents and turns their mass and momentum against them. Responses often come too late to be effective, and are hampered by strategic assumptions that no longer apply. Larger rivals soon find they are fighting a war on the new competitor’s terms. Wanting to move quickly, they often cut back on prices to retain customers. If they do so before performing a thoughtful analysis, this action may punish them further. Meanwhile, the Huaweis of the world thrive and continue to gain market share.

The way to beat low-cost competitors that have the potential to become serious competitors is to identify and deal with them early, before they get a foothold in a market.

Sting like a bee

As Cisco learned, even high-tech firms with strong brand identities are not safe from low-cost rivals. Nimble competitors exploit their offshore advantage, partnerships, and inexpensive technologies to break down barriers and rewrite the rules of competition, almost overnight. Following widely different strategies, these firms succeed for one reason: they redesign their value chain to cut costs substantially in an established market.

Exhibit 1 highlights some of the attributes of low-cost competitors, which can be seen in a variety of different companies. Consider Nike’s face-off with Steve & Barry’s, a discount clothing chain that captured a niche market in athletic shoes. At under $15 a pair, its Starbury One basketball shoe is leading a full-court press on the youth market for budget-priced...
athletic shoes. Three million pairs of Starbury sneakers have sold since their August 2006 debut. Meanwhile, Nike’s footwear inventory is 15 percent larger than a year ago.[2]

Then there is Southwest Airlines. Although known for its no-frills service, the most overlooked aspect of Southwest’s profit-winning strategy is its superior asset utilization. By structuring flight schedules to return planes from the gate to the air in as little as 20 minutes, Southwest flies its planes 20 to 30 percent more hours than the other major airlines. By deploying a point-to-point route network, instead of the hub-and-spoke approach used by most major carriers, Southwest minimizes the domino effect of flight delays and gains maximum use of its assets.

Even Wal-Mart and Ikea, low-cost competitors in their own right, must constantly be on alert for their next threat. While these firms compete on price rather than product differentiation, their retail model is now being challenged by Japanese retailer, Muji. Its stores combine low prices with a high-concept minimalism so that customers don’t have to sacrifice status for cost. The retailer, well established in Europe and Asia, is now moving into the US market.

Low-cost competitors can be right under your nose. A current partner, a supplier or even a contract manufacturer can walk away with key elements of your value chain, establishing its own operations on a modest scale and positioning itself to take more value later by moving upstream or increasing its leverage. That same contract manufacturer may cross boundaries to apply what it learned in one industry to break into another. Case in point is Huawei’s challenge to Cisco.

As Exhibit 2 illustrates, a low-cost competitor can pursue several strategies along various points of the value chain, and rarely focuses on just one area. These competitors minimize complex and expensive activities such as R&D, product design and marketing, and focus
instead on ruthless efficiency. At each step, the new rival chooses the strategies that best deliver lower costs. It keeps the number of SKUs low, standardizes its design and products, outsources assembly to low-cost countries and forms partnerships for activities too costly to build in-house. Cutting costs across the value chain not only enhances its ability but makes it all the more difficult for larger, less flexible companies to respond.

Your hands can’t hit what your eyes can’t see

Many companies fail to recognize the significance of a low-cost competitor until it’s too late. For one reason, because they are too wedded to the status quo, they develop their strategies in functional silos and according to internal objectives without considering the entire spectrum of competitor strategies or changes to the external environment. In other words, firms make a serious mistake by benchmarking their position against competitors’ existing value chain. In a world of the extended enterprise, analyzing competitors’ capabilities is like trying to hit a target capable of rapid transformation. With more diffuse industry barriers, low-cost rivals are outsourcing some parts of their value chain and building partnerships in others. This obscures the true competitive picture and multiplies the number of benchmarking variables.

The best way to identify and thwart a low-cost rival is to adopt its mindset, anticipate its next competitive move and measure your costs against its costs. This requires digging deeper than the qualitative, theoretical approach of war-gaming or the internally focused tools of business-process redesign and lean manufacturing. The goal is to defeat the low-cost rival by compelling actions that allow you to become more competitive and grow or maintain a profitable position in your market segment.

This best practice analysis requires four steps:

1. **Identify likely low-cost rivals.** Identifying low-cost competitors early in the game is crucial. The sooner they can be detected, the less likely it is you’ll be competing on their terms, and the more time you’ll have to plan a response. What to look for? Focus on strategies that offer a cost advantage against your own, for each area of the value chain. Emerging rivals are firms that:
1. Concentrate on a cost-effective design process rather than a unique product design. Reducing complexity in design has a ripple effect on other areas of the value chain, from cost management to procurement and quality. In the 1980s, while US automakers were rolling out large, customized vehicles, Japanese competitors focused on streamlining their processes to cut down on costs and offer affordable models.

2. Involve suppliers early in the process, during initial product design and development.

3. Assemble products in low-cost countries. Companies that develop this mindset and capability give themselves a significant head start and source of advantage.

4. Standardize products to reduce testing. Effective firms also engage their suppliers in the quality process.

5. Engage consumer-to-consumer online communities (eBay and grassfire.com are good examples) and develop low-cost shipping and distribution models via third-party logistics providers.

6. Sell in large volume to developing economies. Low-cost rivals often cover their fixed costs and build up their brands and capabilities by serving emerging markets before moving into established ones. If incumbents are not scanning competitors outside their national markets, they might not spot the new rivals until late in the game.

7. Offer unique online and self-service customer support systems – or find creative solutions in call-center strategies. For example, JetBlue Airways routes customer service calls to call-center representatives who work from home, thus saving millions of dollars in real estate overhead.

Internally, consider whether your company is still as profitable as it was six months or a year ago. Because shrinking margins often indicates that a new competitor is undercutting you on price, have a process in place for an ongoing analysis.

2. **Perform a total-cost analysis.** A total-cost analysis is used to translate a likely competitor’s advantages into a hypothetical total product or service-cost analysis. This compares your opponent’s “should cost” to actual costs. Questions that should guide the analysis at this point include: How significant is the advantage? How does the cost advantage translate into pricing options? Is it sustainable over time? Most importantly, can we replicate it, and if so, how? Exhibit 3 shows what happened when a global electronics component supplier used a total-cost analysis to identify potential threats from companies with more efficient

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**Exhibit 3 Total-cost analysis reveals competitor’s advantage**

Source: A.T. Kearney
supply chains. The analysis was based on detailed plant-by-plant assumptions, which were validated against known cost structures both inside and outside the company. By employing operational best practices, regardless of location, this company could cut costs by 20 percent or more.

3. Develop all potential scenarios. Developing “what-if” scenarios allows you to ascertain likely next steps. Will the low-cost rival reposition itself? Enter new markets? Launch new products? Move into new services? Of course, effective forecasting depends on understanding where the market is going and which low-cost companies have sustainable capabilities. For example, a supplier that is not a low-cost rival today, could become one tomorrow if it develops the right capabilities or if a number of suppliers consolidate. A private-equity firm could even step in and provide funding to enable such a transformation.

These scenarios will probably cause some internal angst as the company weighs whether or not it can make the necessary changes, and if it is likely to lose its most valuable customers as a result. This leads to a crucial fourth step in our analysis.

4. Determine your best strategic moves. At this point you want to make sure the goal is to compete against a low-cost rival by using the information from the what-if scenarios to improve operations and become more competitive overall. The analysis should prompt new questions:

- Are we focusing on the right things to remain competitive?
- What can we do immediately to protect our position?
- What should we do to compete over the medium to long-term given our current strategy?
- What should we concentrate on first to remain competitive and create value?

Defeating low-cost competitors involves two separate but related tasks: First, “stop the bleeding,” and second, reposition the company for success in the new market. Leaders should break down potential moves into short-term tactics and long-term strategies (see Exhibit 4).

Short-term tactics

Short-term tactics should reinforce a firm’s existing strengths and gain time for the internal and external analysis needed to develop the long-term strategy. These tactics keep low-cost rivals at bay while the company repositions its business. For example, when first confronted

What not to do when battling low-cost competition

A key part of your battle plan is establishing what not to do when fighting low-cost competition:

- Don’t wait for the new rivals to hit you. For example, Sears, K-Mart, and other department stores were slow to respond to Wal-Mart.
- Don’t respond without first developing a plan. Otherwise, you waste resources on all potential rivals rather than focusing on those that pose an actual threat.
- Don’t focus solely on current competitors and current products. Companies that may not be direct competitors today could move in with similar products or services tomorrow.
- Don’t drop your guard against traditional competitors. Old fights don’t end when new ones begin.
- Don’t try to defeat low-cost rivals by cutting prices alone. Given your competitors’ margins, a price war will almost never work in your favor, unless the competitor can’t sustain its advantage over time.
- Don’t underestimate the extent of the change management involved. Competing against low-cost rivals is a company-wide effort. Engineering, distribution and marketing, for example, must be realigned to a new strategy, which requires managing change across all aspects of the organization.
by a low-cost rival, companies often respond by lowering prices or providing sales incentives to maintain their market share. Although there are obvious disadvantages and risks to this tactic, it sometimes works; especially if the competitor is relatively weak and doesn’t have the product mix or capabilities to sustain its cash flow. Before attempting this, an incumbent needs to assess the true likelihood that it will outlast its competition and go on to reclaim lost market share. Sometimes another way to protect market share in the short-term is through legal action. As a case in point, Cisco hit Huawei with a patent infringement lawsuit to slow its entry into American and European markets, but eventually dropped its suit when Huawei agreed to modify its products.[3]

Often the better tactic is to shift the competition away from price alone. The newer rival may be less competitive in other areas. Use product differentiation to appeal to customers’ needs for features or benefits they can’t get from the low-cost competitor. In the short-term, differentiation may be enhanced by crafty marketing. Shell Oil did this back in the 1950s when oil companies were all essentially on par. Shell decided to promote the merits of “plafomate,” a little-known mileage-boosting additive that was, in fact, used by other firms as well. The sales effort began with a television ad campaign where a car fueled by Shell gas without plafomate raced against a car powered by gas with the additive. The non-plafomate car ran out of gas and stopped while the plafomate car was shown passing the stopped car and bursting through a huge paper banner with a Shell logo on it. The ad was a visible illustration of product differentiation, and the marketing campaign is credited with launching Shell as a major player in the industry.
Finally, focus on your more attractive customers and leave the less profitable ones to your new rivals. Not all customers are equally valuable. Some are prohibitively expensive to serve and draw resources that could be directed elsewhere for bigger gains. Let new rivals take these customers off your hands, so you can concentrate on the more profitable ones. Just don’t make a public announcement of this tactic with a letter, as Sprint did recently.[4]

**Long-term strategies**

While long-term strategies involve more risk, the rewards are often worth it. Firms build these strategies to adapt to changed conditions and seize new opportunities – which can sometimes result in a very different company. IBM was the premier manufacturer of personal computers until the 1990s, when Dell and Gateway began selling lower-priced models directly to customers. In the early 1990s it posted a nearly $5 billion loss, the largest of its kind for any American company in a single year. Undaunted, the company set about reinventing its business. By 1995, with the acquisition of Lotus, IBM had a new strategy. Instead of selling components and hardware, it began selling software and service ‘solutions,’ bundling products together for a higher-value offer.

Another example comes from the retail propane gas industry where the focus is traditionally on price. One company beat its rivals by ramping up customer service and expanding its delivery options. The gas company decided to invest in technology (global positioning systems, scheduling software, etc.) to transform its field-service operations. These efforts improved deliveries, reduced fixed costs, enhanced asset allocation, increased its ability to match supply with demand, and strengthened customer service – leading to nearly 300 new customers within nine months. The company’s investment had a short payback period and, perhaps more important, the move fundamentally altered the industry’s landscape and performance expectations by creating significant barriers to entry.

Lastly, if you can’t beat your low-cost rivals, steal a page from their playbook and form a low-cost offshoot. United Airlines, tired of competing with the likes of Southwest and other low-cost flyers, came up with its own low-cost rival, Ted.

**Low-cost rival in the ring**

To see how companies can use analysis of a potential low-cost rivalry situation to guide strategy, let’s look at the example of a copy manufacturer. Any company in this industry is either in a margin squeeze between high costs and declining prices, or its products are being commoditized by companies in low-cost markets such as China. Well aware of the challenges within its industry, this manufacturer, we’ll call it CopyCo, was looking beyond known competitors to identify potential outside threats. It found two: Huawei Technologies and its current contract manufacturer.

A company such as Huawei, well-known for moving into new industries, could readily become a competitor if it wanted – or form the low-cost backbone for yet another company. As evidence of its capability, it was already becoming a factor in the mobile phone business; in 2006, Vodafone introduced its latest branded consumer mobile phone, and announced that Huawei was its first choice to manufacture the handset. Typical of the emerging Asian white-label manufacturers, Huawei could produce the new handset at a cost 30 percent lower than Vodafone could hope to receive from a larger equipment maker.[5] From networking components to cell phones, Huawei was proving to be a flexible and formidable force.

“A supplier that is not a low-cost rival today, could become one tomorrow if it develops the right capabilities or if a number of suppliers consolidate.”
Another threat was CopyCo's existing contract manufacturer. It could use the knowledge gained in the current partnership — product designs, engineering and manufacturing specifications — to become a ruthless competitor as well.

Alert to these threats, the analysis identified a handful of other potential foes in the market — expanding on CopyCo's list to include several white-label manufacturers. CopyCo could see how potential competitors might optimally design their products, set up their value chains and manage total costs. This is where companies see the break-even point at which they can manufacture a product and where a competitor could make it for much less (see Exhibit 5).

CopyCo was already selling its smaller copiers at a loss to drive sales and encourage repeat purchases of ink cartridges — it didn't realize a profit until several replacement cartridges were sold. In contrast, its known competitors were closer to making money on the initial sale and realizing additional profits on repeat cartridge sales. A company such as Huawei would no doubt improve these prospects even further. CopyCo put pencil to paper, finding that a low-cost competitor could harm them in the following ways:

- Enter and dominate the low-cost market segment. The company could then partner with another competitor to move up the value chain and compete in the high-price/high-quality market segment. This would squeeze CopyCo out of both markets, just as Huawei did to Cisco.
- Develop white-label products to sell to CopyCo's top customers. CopyCo would lose retail channels due to white-label competition. Huawei's partnership with Vodafone is an example of such a strategy.
- Enter developing countries early, exploiting cost advantages and capturing market share. Meanwhile, CopyCo would be slow to enter, fail to gain market share, and miss planned growth projections.

Exhibit 5 Average unit cost for copier: low-cost competitor versus CostCo
Leverage low-cost country research and development or exploit lax intellectual property rights protection to leapfrog CopyCo technologically, win on price and capture key market segments.

Be acquired by a separate cash-rich or debt-averse computer-hardware company.

Realizing that several firms had the potential to become rivals, CopyCo was motivated to adopt a proactive plan. While a company like Huawei was certainly a potential threat, the scenarios demonstrated that other, still unknown competitors could be just as competitive. After prioritizing its plans, CopyCo chose the strategy it was most capable of implementing quickly. In the short-term, it increased its advertising and stepped up sales efforts to maintain its share.

Long-term, it is tailoring its strategies around two different markets. For the low-end brand, it is shifting to pursue profitable customer segments that account for the largest volume of replacement ink cartridge sales. In the high-end market, it is focusing on industry-specific solutions to raise its margins and produce an offering rivals can’t emulate. Also, CopyCo executives are reevaluating their current contract-manufacturer relationships.

**Thriving against aggressive low-cost competitors**

It is unlikely and unrealistic that any company will start with a clean sheet in response to low-cost competition, but all companies can develop action plans by considering their situation along with a competitor analysis. The following are three things to keep in mind:

1. **Don’t get caught off guard.** Scour your market and others for current and future threats. Recognize that competitors can come from anywhere and attack at any time. They could be a real and urgent threat. They could come from a different industry or segment. Or they could be holding back, waiting to enter the market given favorable conditions. This competitor could also be a “best of” amalgamation of current and hypothetical competitors. Engage your top managers to identify the most likely competitors.

2. **Be action-oriented.** American automakers lost ground to Toyota because they failed not only to see the threat soon enough, but also to deploy their relevant sources of competitive advantage. They could have met the challenge when it was a potential threat rather than an actual one. Hyundai, for example, took a clean-sheet approach and came up with the car company of the future – one that avoids high fixed costs, captures the full lifetime value of a car through leasing rather than selling, outsources operations, and offers low-cost modular designs. All of these principles could have been adopted by US and EU car companies. Eventually, Hyundai’s strong quality performance allowed it to move upstream from producing low-cost to high-end cars.

3. **Develop a robust plan of action.** No company should ever underestimate its ability to outsmart the competition. Companies can turn even the toughest challenge into an opportunity to reexamine and intensify their efforts. The recent turnaround at Cisco Systems proves that it is possible to come back strong against low-cost rivals. After taking a hit in the networking business from the likes of Huawei, Cisco realized it needed a new strategic direction. While it remained committed to its traditional business, it also began expanding into new product areas, including business equipment and consumer technologies. The key was recognizing market transitions and entering at the appropriate time: Bad bets can be costly, so the company put resources into understanding markets, developing the right capabilities, and perfecting its timing. As a result, Cisco recently posted an 18 percent revenue increase from the previous year. The company expects years of steady growth from a second Internet boom (Web 2.0) as consumers upgrade to the next generation of web-based technologies such as video conferencing and Internet telephony. “Web 2.0 is an opportunity to be an instant replay of what happened to Cisco in the early 1990s,” CEO John Chambers said in an interview.[6]

For Cisco and others, the Huaweis of the world are everywhere. You may beat some and ignore some, but others will be lurking in the shadows. While no industry is impervious to
such rivals, the winner every time will be the company that identifies the genuine threats, takes on the serious competition, adapts to its tactics quickly and hits back with a well-placed blow.

Notes


