HOW NON-LOW COST COMPANIES REACT TO THE LOW COSTS

SUMMARY

The low cost strategy has been part of the European scene for ten years. It began when a number of low-cost companies used the liberalisation of air traffic in Europe to enter the market. The strategy then spread to other tourism-based enterprises like hospitality and vehicle hire. Joining forces with the existing price discrimination movements, mainly in the commercial distribution and food sectors, less than ten years later the low cost strategy phenomenon now spans almost all sectors of the economy.

The birth of low cost has led traditional companies to fight back. This study analyses the attitude of a sample of 200 non-low cost companies involved in air transport, hospitality, food, banking, domestic appliances and fashion to competition from the emerging low cost firms. These are the first results of the main study which looks at the non-low-cost companies' reaction to the emergence of the low-cost phenomenon. The final objective of the study lies in non-low-cost companies adopting low-cost companies' success strategies.

Results show that in spite of the success of the low-cost phenomenon, traditional companies in general are highly resistant to changing the traditional price concept, although they are emulating the low-costs in some of their competitive strategies. This research tracks these differences by sector and company size.

KEY WORDS

Low cost, price discrimination, dynamic prices, pricing, price sensitivity.

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1. INTRODUCTION

The low cost phenomenon appeared ten years ago with the liberalisation of air travel. At first it was limited to the airline sector, but it soon spread to other tourism–related areas like hospitality, car rental, theme parks, restaurants, trains and buses, cruises, sporting, cultural and musical events and events in general, sports centres and spas. Shortly afterwards, encouraged by the effervescence of the sectors most involved in price discrimination including commercial distribution and food, many others joined in. It became a global phenomenon, embracing areas like banking, electronics, telecommunications, fashion, telephone services, printing, record production, publishing, advertising agencies, legal services, cars, personal services like massage, hospitals, wholesale petrol sales, second hand goods, consultancy services, domestic, office and business cleaning etc. It was not now just companies with a high percentage of intangible products and excess production capacity, intensive use of capital and a heavy fixed costs burden that were trying out the low cost model. As the above list of sectors shows, the model was penetrating beyond the service sector even into industrial manufacturing processes.

For low cost to flourish, several factors must converge. The first is economic globalisation, which increases the number of products and services on the market, hastens their obsolescence and uses price wars as a penetration or growth strategy. The second is development of the new technologies, which over the last ten years has facilitated experimentation with radically different ways of negotiating with consumers. The low cost phenomenon as one effect of all this seems to be entrenched in a continuous price war, alternating between specialising in differentiation and cost leadership as strategies. This dialectic has ended up offering simultaneously the superb combination of low prices and high quality (Frank, Jeffrey and Laxman Narasimhan, 2004).

A further factor is the existing tradition of price discrimination, already in place in several sectors, including most distribution and other sectors that are used to offering lower prices at certain times and under certain circumstances. With the coming of low cost, this tendency to discriminate prices has taken off to such an extend that it can now be found right across European society. Progress has been assymetrical, depending on the sector (food, furniture, books, tyres etc.) and the companies concerned, and we also need to differentiate here between 'low cost', 'low price' and 'hard discount'.

Price fixing has added a new logic to traditional reasoning. Prices are adjusted to fill trough periods, in the search for customers who are prepared to pay a particular price. This new dynamic in price setting has forced a step change in the business concept of companies engaging in low cost practices.

Their business model, success based on low prices, comes from applying the following contents (Valls, Vila, 2006):

- focus is on offering one basic product, relegating all lesser complementary products; if these complementary items continue to be offered they are turned into new sources of income (for example, the 'frills' offered by low cost airline companies)
- costs are cut in all business areas - staff, processes, technologies, production times, reducing the commercialisation chain, components and raw materials, etc. Company structure is pared down to the minimum, externalising processes and departments, leaving it only with what is considered to be 'core business'.
- production prices are substantially lower.
- dynamic prices are established to identify the price customers are prepared to pay at any given time.
- strategic alliances are formed with channels, mostly through the Internet, to be able to compete on better terms than the competition.
- the lowest prices available at any time are advertised.

The most important aspect of the phenomenon is the way it turns the historic concept of price on its head. Price is no longer a key aspect in positioning a product or service or indicating its quality. For most of the consuming public, it now serves as an autonomous element in their decision making. This is how the low cost companies work. To set competitive prices you must know the competitive situation of the sector (Porter, 1985); the elasticity of price reaction to competition, in other words, the overall capacity for reaction of the competition to the lowering of prices; the elasticity of price variation on the margin, in other words, the effect this factor could have on turnover; the selection of competitive strategies that are not only based on price, in other words, higher value at lower price; the long-term price strategy to be maintained for competitive advantage, since the lowest prices may not be profitable if there are no other marketing variables in place. (De Jaime Eslava, 2007).

This redefinition of the company breaks away from the classical model of price setting based on costs, allowing for adjustment based on demand and competition. The new value-based model puts the customer first; then the perception of value and price sensitivity of each segment; it next sets the price from the two previous points; and finally, it identifies the costs and creates the product or service (Kotler, 2002). This means that until prices have been set in relation to customer demand and perceived customer value, neither the company's cost structure nor its production are finalised. The benchmark is obviously the rival's prices, bettering them by a substantial percentage, and demand positions will obviously be studied and adjusted to suit specific times or circumstances. What has happened is that the logic behind producing and selling has changed substantially. Now it is necessary to learn a customer's consumption profile/setting the price he/she is prepared to pay at any time/structure costs and create the product or service to satisfy them. For low cost companies, this whole process means that price has changed its function.

Two movements are happening at great speed. The first a movement by product and service producers, who are being forced to set low prices, basically in the form of dynamic prices, to survive in the market. This is a new version of the old practice of price discrimination (Krugman, 2001). It is nothing new; the only novelty is that the Internet gives new companies new opportunities for setting and adjusting prices (Zhang, 2007) and for tailor-made pricing. Managing dynamic prices entails understanding and anticipating consumer behaviour to maximise yield or profit. "Yield management" is an intricate and complex relationship between demand, supply and marginal cost. It is based on the premise of ensuring maximum possible profits due to the variation in price elasticity as a result of consumers' varying attitudes and ability to pay" (Edgar, 2000: 29). It also allows data to be turned into information, information into knowledge, knowledge into wisdom, and wisdom into yield (McCaskey, 2006). The second movement involves the customers, who have got used to finding lower prices everywhere, and they like it. This is varying their price sensitivity tremendously. Consumers are becoming increasingly price sensitive, and are not prepared to spend a penny more than they have to, even if it means visiting several shops or consulting more than one service (UniversiaKnowledgeWharton, 2008). Customer price sensitivity has changed. Price must be in line with the value perceived by consumers. If the price is very high, they will not be prepared to buy something that in their judgement has a lower value. But if it is too low, they still may not buy (Kotler, Bowen and Makens, 1997) and (Santesmases,1998). Krishnamurthi (2006) explains that the higher the value a product has for customers, the lower their sensitivity to its price. He also claims that value is idiosyncratic, relative and not absolute, and this means that price is as much an art as a science. It may seem that consumers are unanimously behind low cost, but the travel market has shown a very clear dichotomy that we predict may also exist in other sectors. A study conducted with a sample of one thousand Spanish travellers (Valls, Vila, Sureda, 2007) indicates that there is bipolarisation around two large groups. In the first are consumers who are not prepared to pay more than they have paid (low cost trend); and in the second, those who appreciate the quality, exclusiveness and prestige of a good brand.

Consumers' replies are divided almost exactly 50-50. This shows that while consumers prefer low cost prices for certain purposes and in certain situations, they have by no means lost interest in quality, exclusiveness and prestige brands, where they would certainly not be influenced by the price factor. In spite of the results of other studies on the subject, the two trends seem destined to clash but coexist.

In this changing scene, traditional companies are reacting to competition from the new low cost enterprises. This study will explore the attitudes of some traditional companies to the competition caused by low cost presence in sectors where they already have strong penetration. It investigates the importance of the price variable in the strategies of traditional companies, how they behave in the face of possible changes in the price sensitivity of their customers, and whether they are in any way emulating the competitive strategies of their low-cost rivals. Also analysed are the differences found, by sector and size of company.

2. METHODOLOGY

To respond to the proposed objectives, a focus group was first set up including experts in pricing to determine the most important aspects to look at, and a study was made of the sectors most affected by low cost companies. Secondly, 200 companies were chosen by direct allocation. These were large, medium-sized and small companies operating in Spain, taken from the sectors hardest hit by low cost companies: air transport, hospitality, food, banking, domestic appliances and fashion. Thirdly, managers in charge of pricing, marketing and general management in the Spanish headquarters of these companies were identified.

A questionnaire was designed with a mix of 19 open and closed questions. Those surveyed were asked how important they throught the price variable was for their customers; what current changes there were in price sensitivity; the effects of the presence of their new low cost competitors; what price discrimination strategies were being practised. The questionnaire was then sent to the entire sample between the 1st and 25th of March 2008, and the information was collected via the Internet. Given the objective of the study, from among the surveys received, 54 companies with complete replies were selected (27% of the total), representing proportionally each of the sectors chosen (9 companies per sector) and the size of the companies (47.1% large, 41.2 % middle-sized and 11.8% small).

Due to the fact that we are in the first phase of data collection, the sample's small size only allows us to obtain a univariate and multivariate descriptive analysis, supported by bar charts showing the percentage responses in each case.

3. RESULTS

3.1 Indication of the prices of the sample companies

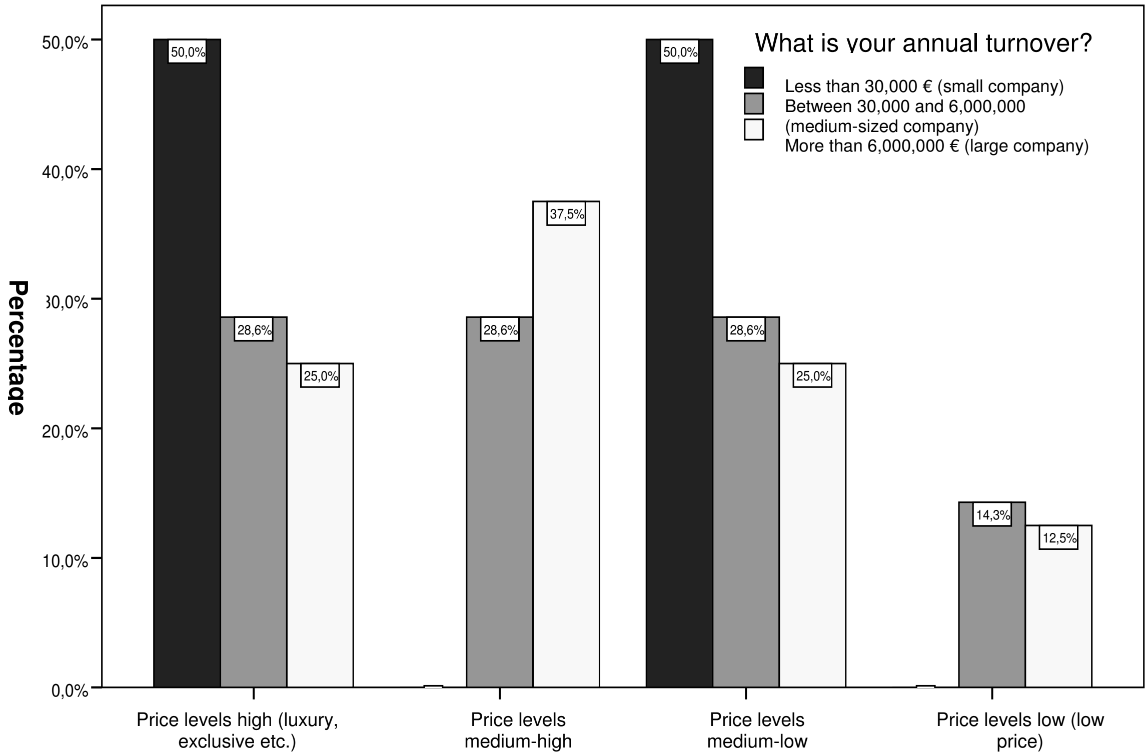
Prices of the sample companies fall largely within the reference areas: 72.22% match the reference price, compared with 22.22% below and 5.56% above it. These are companies with little interest in competing on price.

Price levels of sample companies are as follows**:**

- High (26.32%)
- Medium-high (36.84%)
- Medium-low (26.32%)
- Low (10.53%).

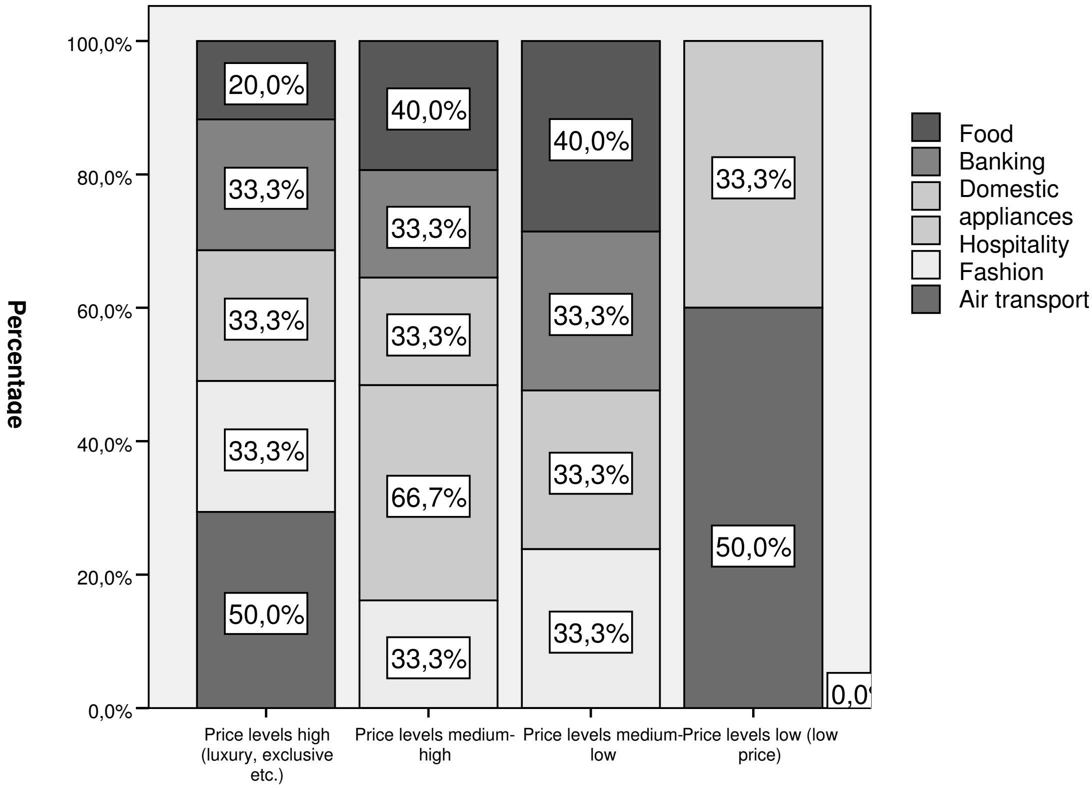
If we cross the size of the sample companies with their price levels, it seems that the small sample companies specialise in high and medium-high prices, while the medium-sized spread their prices over high, medium-high and medium-low (28.6% each) and the rest, low (14.3%)**;** and the large companies over the medium-high (37.5%), high and medium-low (25%) and low ranges (12.5%) **(Table 1)**

Table 1
Volume and price level



If we cross price levels with the sectors analysed, food stands out slightly in medium-high and medium-low prices; air transport is equally divided between high and low; and hospitality is medium-high **(Table 2)**

Table 2
Sector and price level

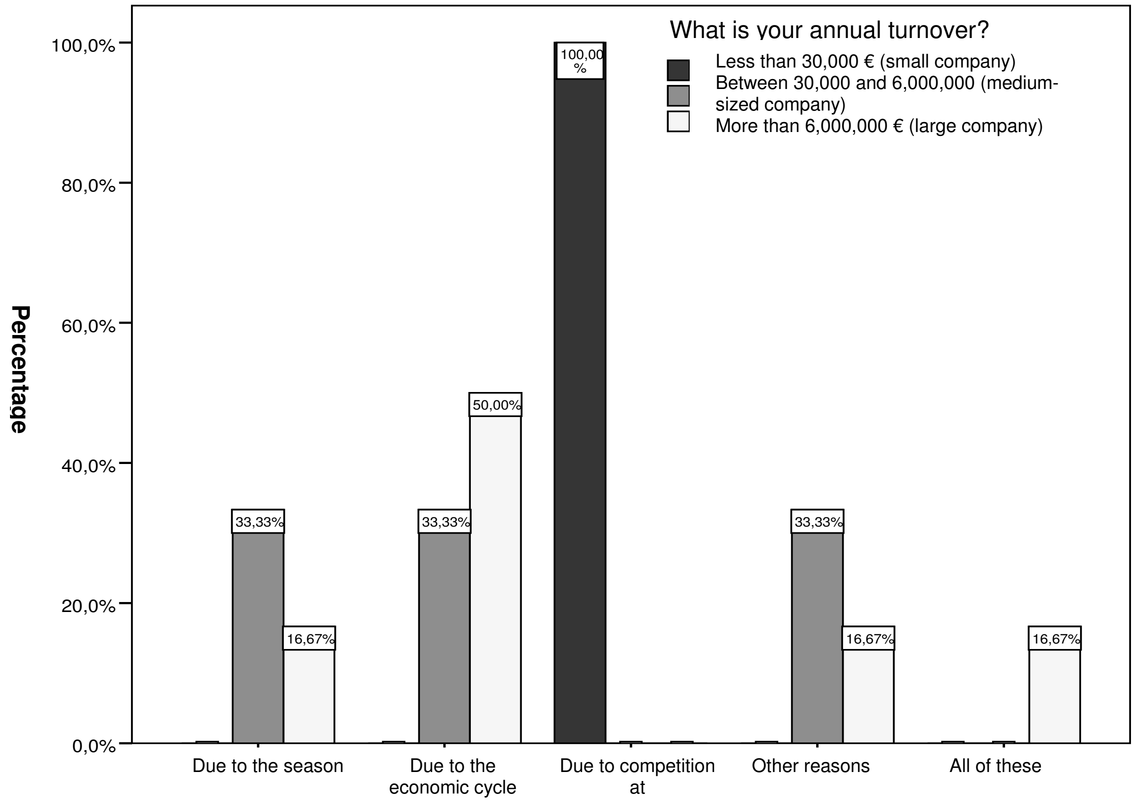


There is strong resistance to moving away from constant prices: 47.37% say that their prices are static, compared with 52.63% who claim their price levels are subject to some degree of dynamism. Price variations can occur for the following reasons:

- 27.27%, due to the season
- 36.36%, due to the economic cycle
- 9.09%, due to current competition
- 18.18%, other specific reasons
- 0.09%, all the above

If we cross size of company with reasons for price variation, medium-sized companies are divided three ways: due to the season, due to the economic cycle and other reasons; small companies concentrate on competition at the time (100%); and large companies discriminate prices due to the economic cycle (50%). **(Table 3)**

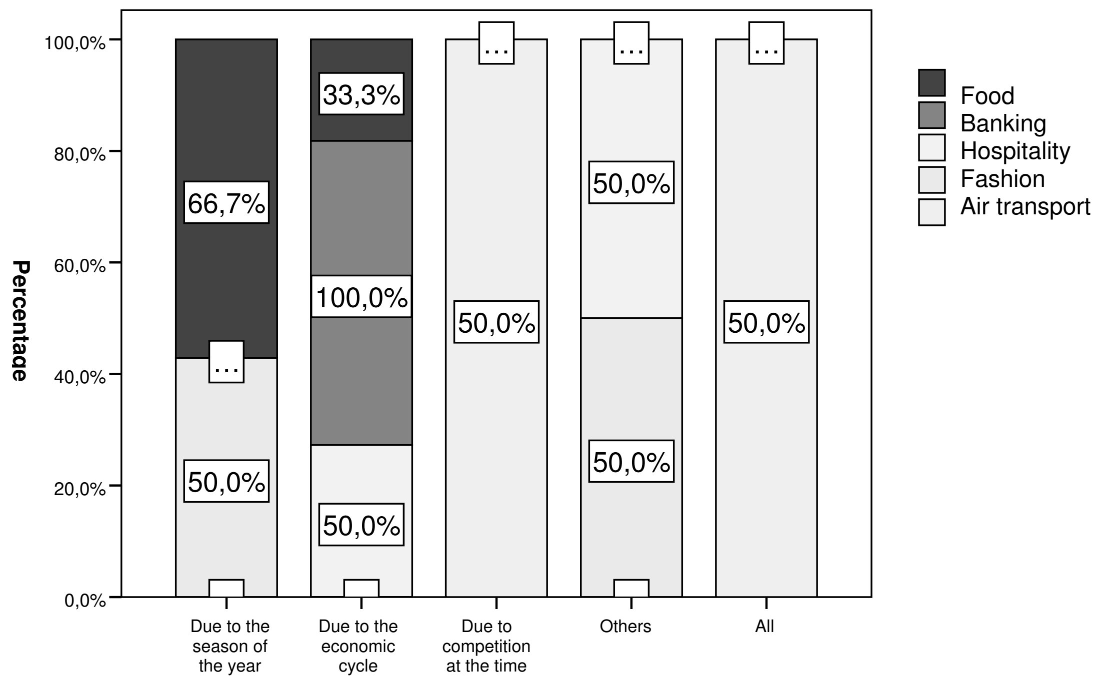
Table 3
Size and reason for price discrimination



As regards channel, price does not vary significantly in 52.9% of cases, compared to 47.06% who state the opposite.

If we cross price discrimination with the sectors analysed, the air sector tends towards acting due to competition at the time, at all times; banking, due to the economic cycle; and food, due to the season **(Table 4)**

Table 4
Sector and reason for price discrimination



3.2 Importance of the price variable

In 50% of cases, customers of the products of the companies surveyed are guided by the price variable, compared to the remaining 50% who are guided by other factors:

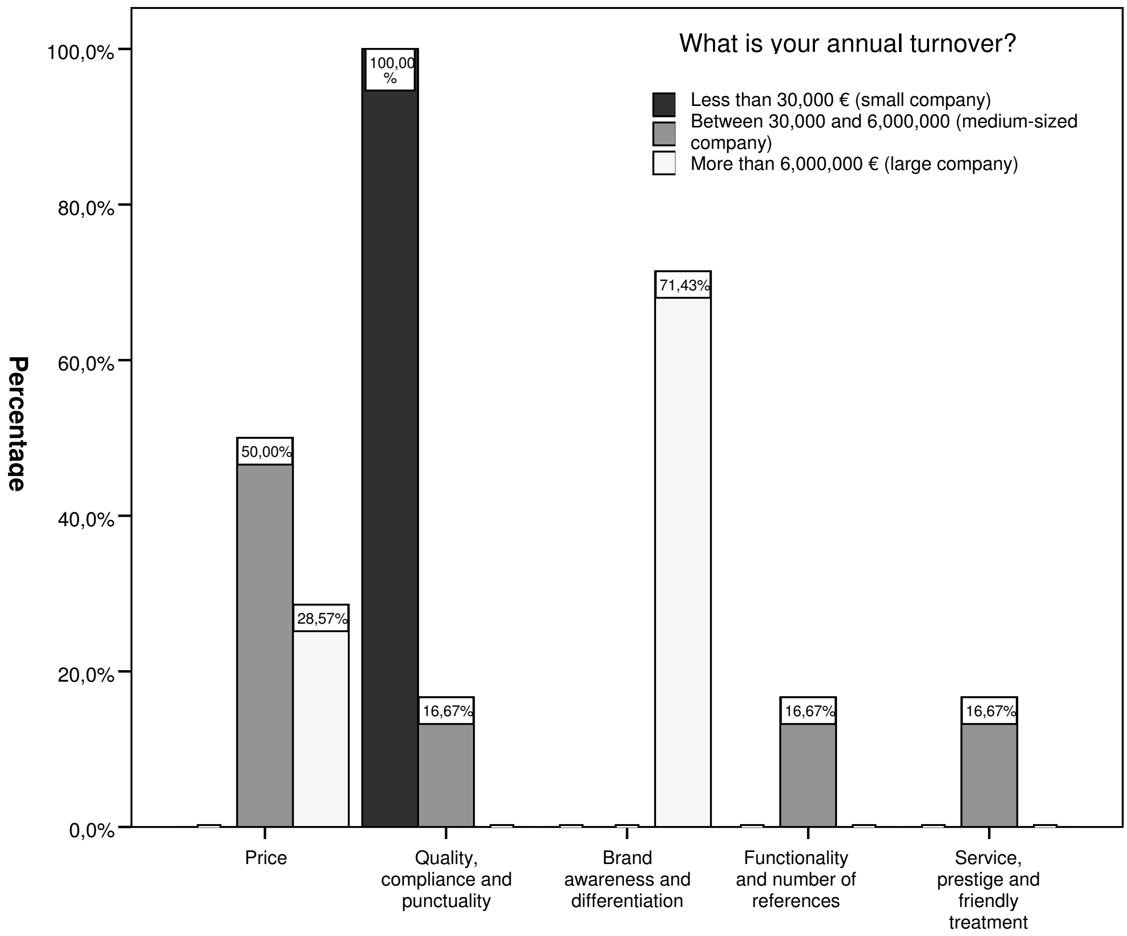
- Brand awareness and differentiation (13.6%)
- Compliance and punctuality (13.6%)
- Service, prestige, quality and friendly treatment (9,1%)
- Nearness, time saving (9.1%)
- Functionality and number of references (4.6%)

While price motivates half of the sample, the other half buys without taking it into account, basically buying on brand, compliance with certain requirements, service, and also time saving and functionality.

Aspects other than price that influence 50% of company customers' decisions to buy have been directly or indirectly identified by the sample as linked to quality, exclusiveness and prestige. At another point in the survey, 83.33% of the sample identified this whole group as brand effect, as the main source of differentiation from the competition, and as what effectively conditions price levels. Only 16.67% disagreed with this.

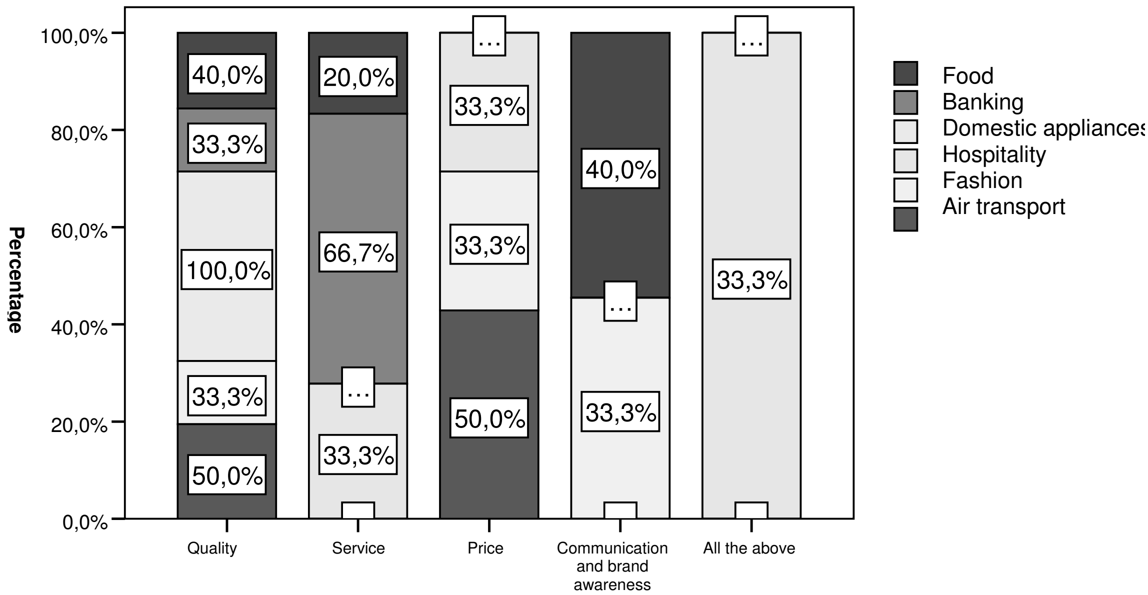
If we cross company size with purchasing attributes, it seems that small companies stand out in quality, compliance and punctuality (100%); middle-sized companies in price (50%); and large companies in brand awareness and differentiation **(Table 5)**

Table 5
Volume and purchasing attributes



If we cross purchasing attributes with the sectors analysed, air transport is the sector that leans most towards both price and quality; food towards brand and quality; and domestic appliances towards quality. **(Table 6)**

Table 6
Sector and purchasing attributes



3.3 Level of competition

The scenario in which sample companies compete has the following characteristics:

- Consumers have less disposable income
- The market has more suppliers at the same price level
- There has been a strong increase in competition
- Companies are improving technologically and creating Internet-based tools to help reduce costs and therefore prices
- Distribution brands are gathering force

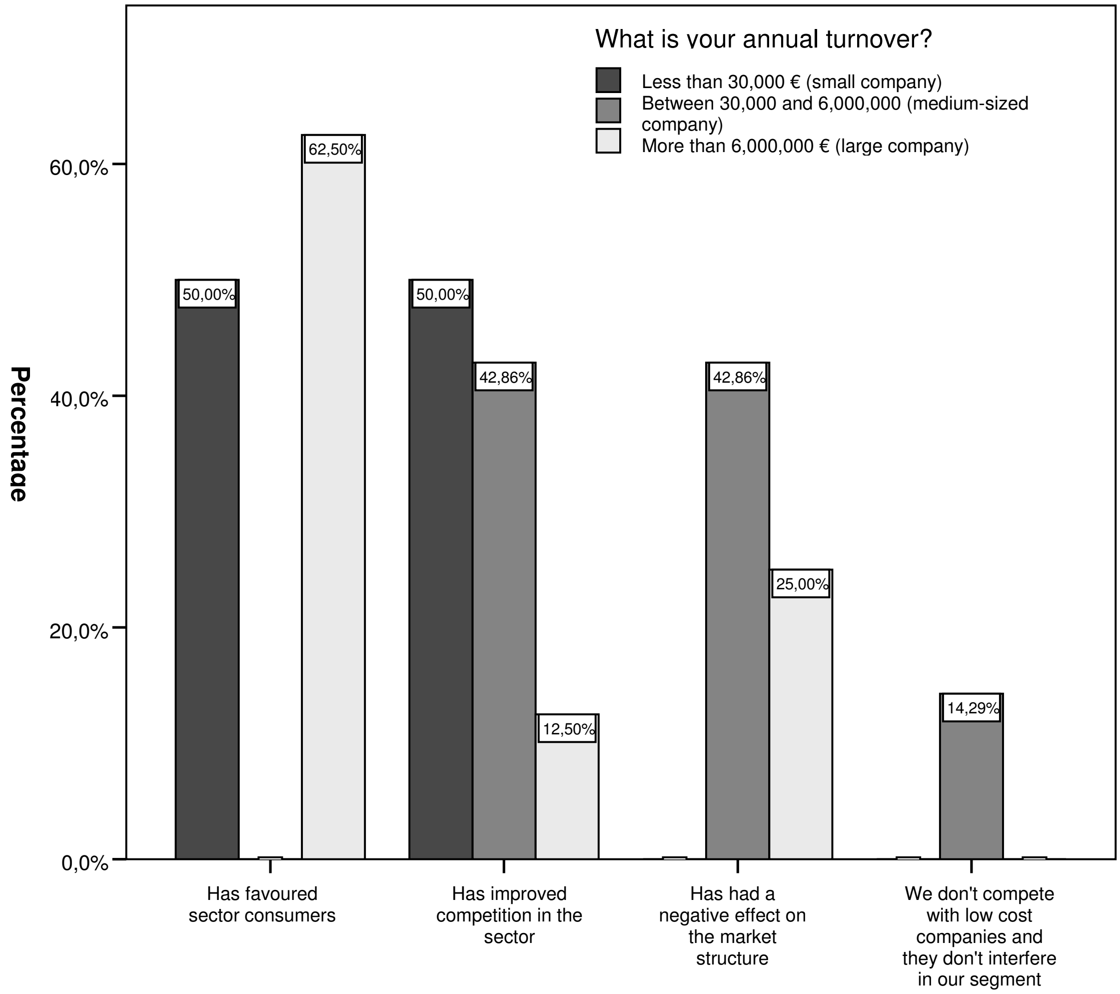
Some 75% of the sample are seeing new competitors enter their market using the low cost formula, compared to the remaining 25% who do not identify this for now. The penetration of these companies is very evident. Three quarters of the sample therefore consider that there is a high level of competition. However, when they explain how this competition is evolving, in only 26.32% of cases has it increased significantly; has increased a little or somewhat (36.84%); and has hardly changed (36.84%). This tendency towards lower prices is going to continue. This is felt by 56.25% of those surveyed, compared with 43.75% who feel that the opposite will occur.

Results on the market presence of low cost companies are as follows:

- In 30% of cases, it has favoured sector consumers
- In 25%, it has had a negative effect on market structure
- In 20%, competition in the sector has improved
- And in the remaining 15%, at 5% respectively, it does not interfere with the market, service level has gone down, and the effect of low cost companies has not been noted.

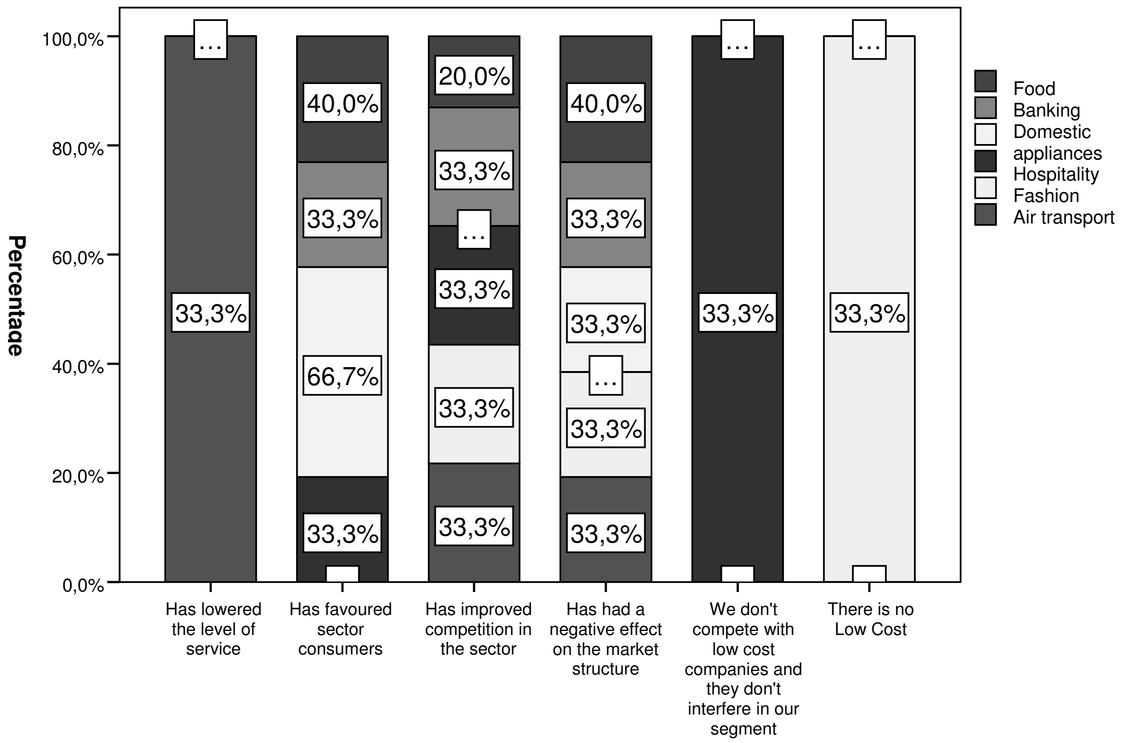
If we cross company size with effects of the presence of low-cost companies, we find the following. Small companies are evenly split between saying that it has not favoured consumers and that it has improved competition in the sector; middle-sized companies state that it has improved competition in the sector and had a negative effect on market structure (both 42.86%); large companies state that it has favoured most sector consumers (62.50%) **(Table 7)**

Table 7
Volume and effects of the presence of low-cost companies



If we cross effects of the presence of low cost companies with the sectors analysed, only food stands out with a response that while not majority, holds that while their presence has favoured consumers, it has had a negative effect on market structure; also in domestic appliances, where three quarters of the companies consider that it has favoured sector consumers **(Table 8)**

Table 8
Sector and effects of the presence of low-cost companies



3. 4 Competitive strategy

For 55% of the sample, in recent years companies have been forced to change their price strategy so as to continue competing; the remaining 45% have not. When necessary, companies have considered different strategic alternatives to deal with the low cost phenomenon. Although more than half use price discrimination, emulating the low costs by selling at low prices would not bring them any competitive advantage (55.56%), compared to those who thought the opposite (44.44%).

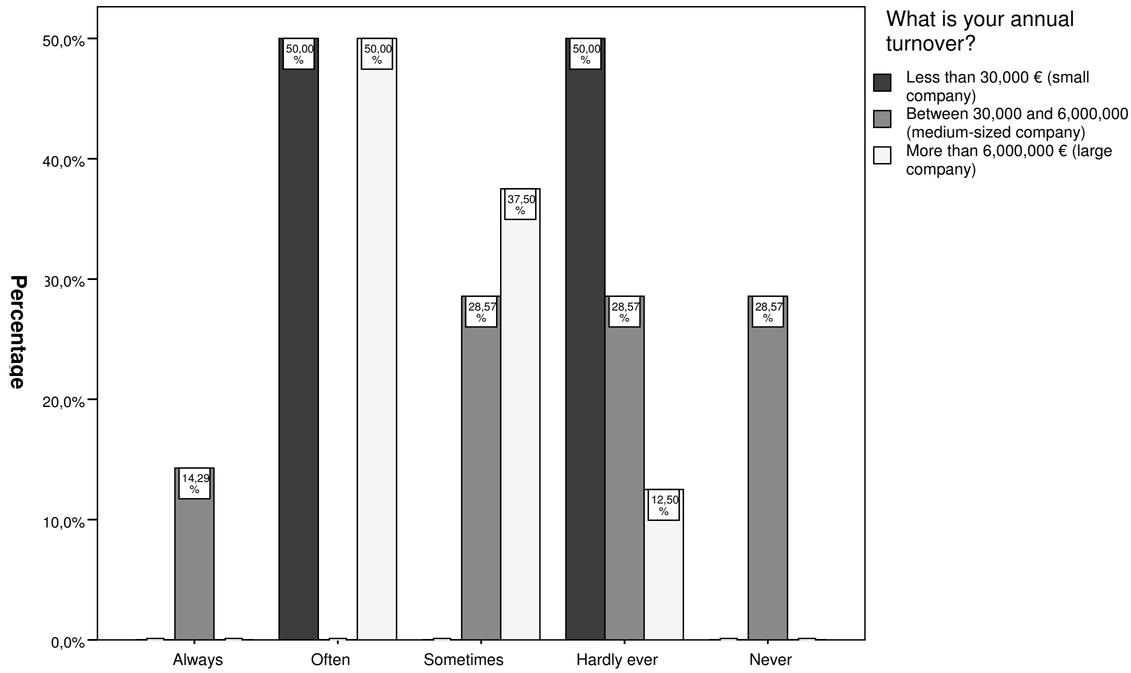
To face up to competition from the low costs, one of the strategies used is to provide offers or promotions. This has been done as follows:

- 5.26%, always
- 26.32, often
- 36.84%, sometimes
- 21.05%, hardly ever
- 10.53%, never

This means that in more than 68% of cases, companies have offered promotions sometimes, hardly ever or never, compared to 32 % always or often.

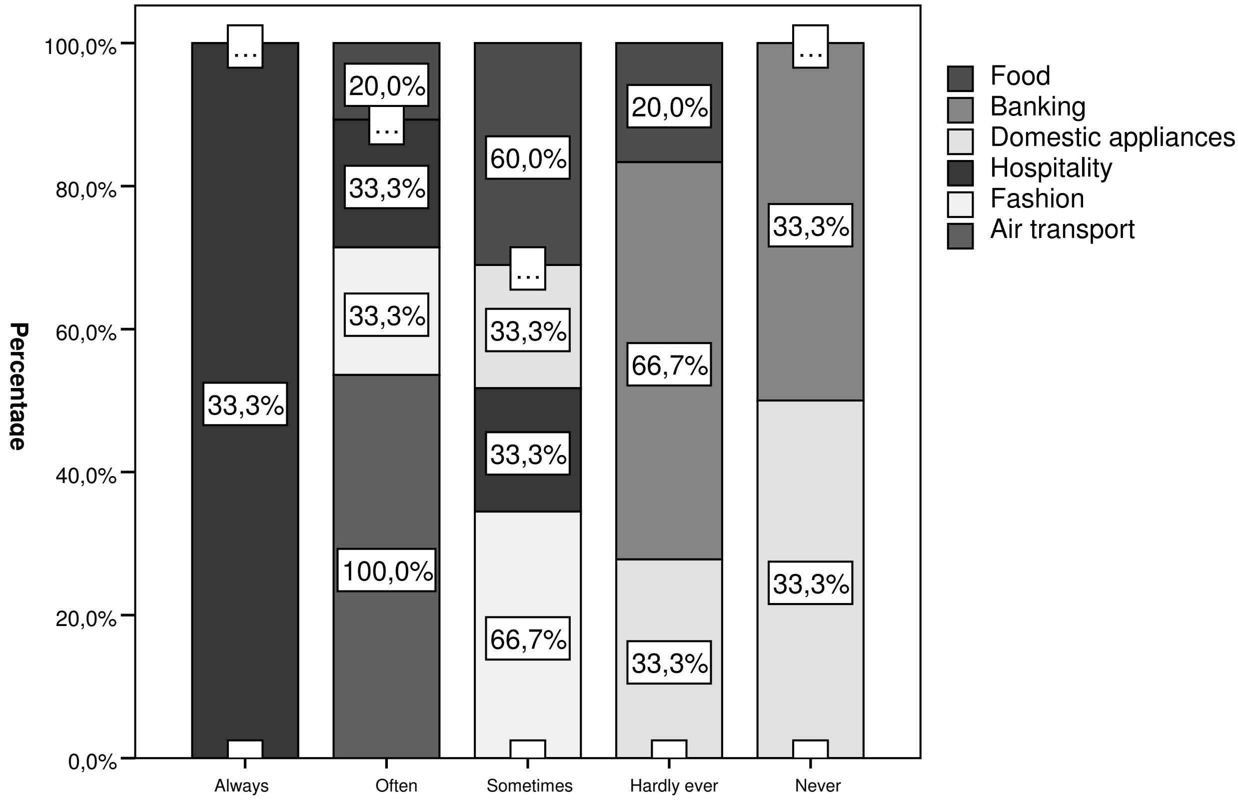
If we cross company size with frequency of promotions, small companies are divided equally between often and hardly ever; middle-sized companies come in at a third each for sometimes, hardly ever and never; and large companies are mainly often (50%) or sometimes (37.50%) **(Table 9)**

Table 9
Volume and frequency of offers



If we cross frequency of offers with the sectors analysed, we see that air transport often uses promotions; fashion, sometimes or often; and banking, hardly ever or never **(Table 10)**

Table 10
Sector and frequency of offers



Promotions by sample companies are distributed as follows:

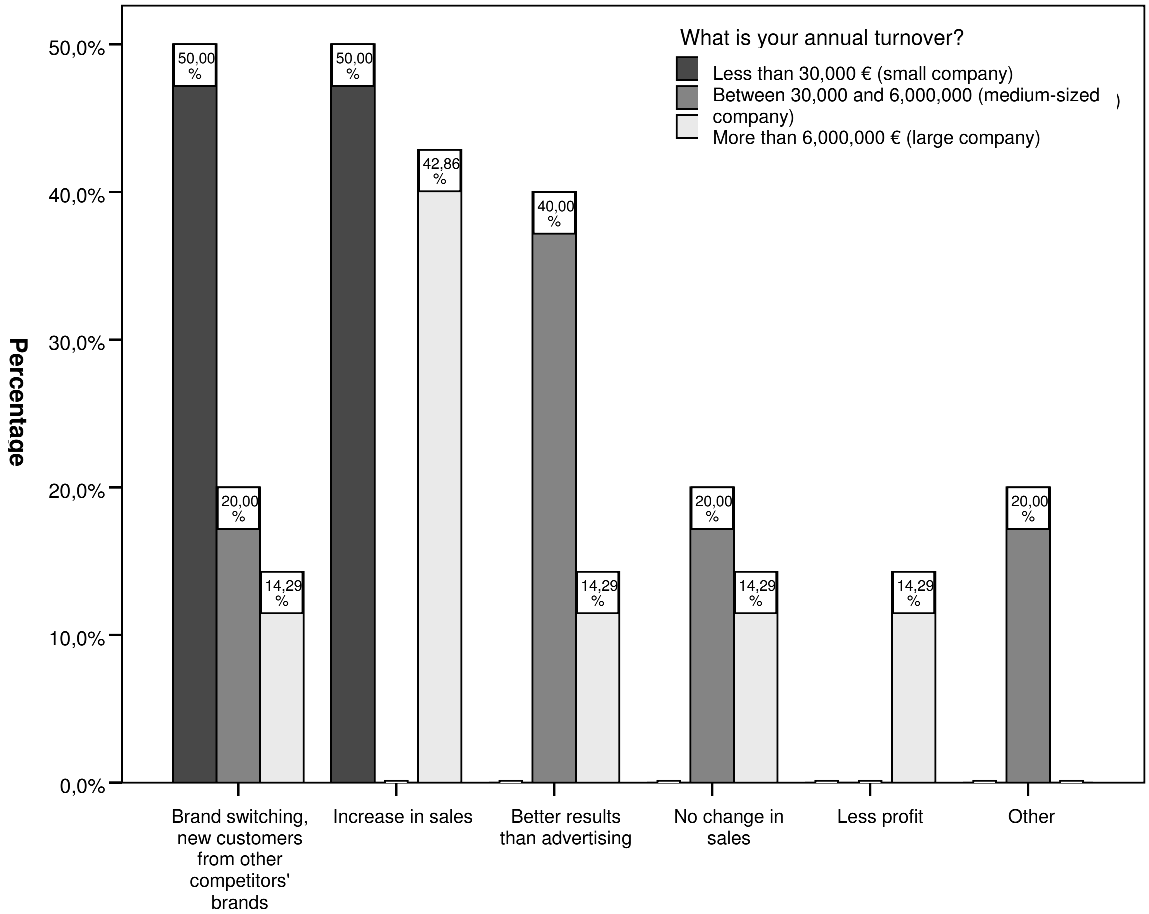
- 6.67%, through advertisements in *google, adwords, xing*
- 26.67%, direct
- 60%, indirect, through coupons, plus some cross selling
- 6.67%, through informative events

Results obtained from these promotions are as follows:

- 20%, brand switching, new customers from other competing brands
- 26.67%, increase in sales
- 20%, results are more successful than advertising
- 13.33%, no change in sales
- 13.33%, less profit
- 6.67%, other effects

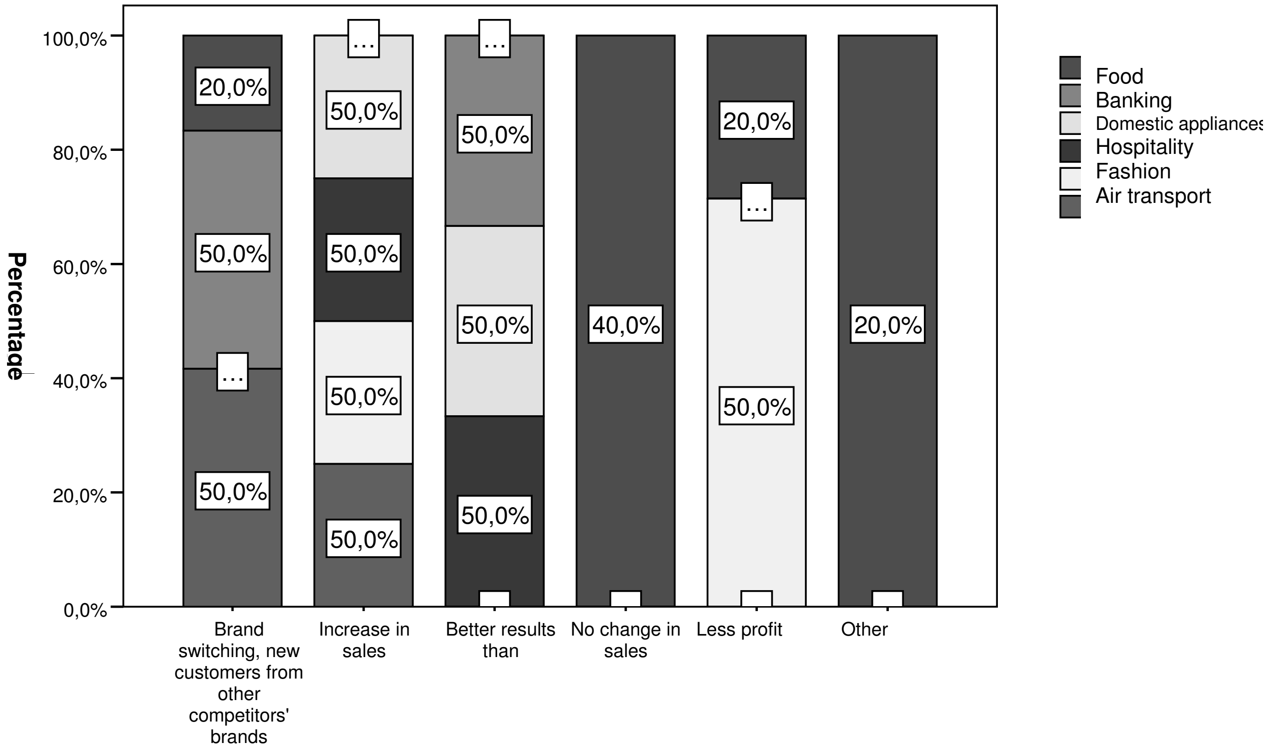
If we cross company size with results obtained through promotions, small companies experience brand switching and increase in sales in equal proportions; medium-sized companies obtain more successful results than in advertising (40%), followed by brand switching and no change in sales (20% each); and large companies mainly obtain increase in sales (42.86%) (**Table 11)**

Table 11
Volume and results of promotions



If we cross results of promotions and the sectors analysed, except for fashion which is divided half-in-half between the statements that promotions have reduced their profits and increased sales, the other sectors are mostly inclined towards increase in sales; banking and air transport opt for brand switching **(Table 12)**

Table 12
Sector and results of promotions



4. CONCLUSIONS

After analysing the results obtained from this quantitative study, a series of contributions can be made to the discussion on the issue, bearing in mind that this is an exploratory study and a preliminary approach. Depending on the number of sectors analysed, a roader sample would facilitate the application of other kinds of technique in analysing the differences between different types of company.

Some years after the introduction of the low-cost phenomenon in Spain and Europe, the companies analysed are showing strong resistance to change, and continue to adopt traditional behaviours, albeit in some cases emulating low cast competitive strategies. This transition marks an adaptation to the new environment, although none of the companies declared any interest in converting to low cost.

Non-low cost companies have not adoped low cost strategies in the following areas: concentration around a basic product; establishing strategic alliances with channels and agents to compete on better terms; advertising their lowest prices as a communications strategy. However, they are reducing costs (without considering a leaner company structure); they are also producing at lower prices. Finally, they have been timidly introducing dynamic prices. This trend is becoming generalised across all sizes of company analysed, and in general across all sectors.

The level of competition represented by low cost companies in the sectors analysed is high; only 25% of the sample have not seen new competitors with low cost strategies enter their market, compared with 75% who have noted the phenomenon. But the intensity of this emergence does not match its impact; only a quarter of the sample considers that the emergence of the low cost companies has had a negative effect on their market structure, above all among middle-sized companies. One of the sectors where it has had greatest impact is food. As regards the immediate future of prices, most (56.25%) agreed that they would continue to fall.

Although traditional companies are immersed in fierce competition with the low costs, they are mainting a strong resistance to changing the historical price concept. We might say that this is a transitional situation in the face of the emergence of low cost companies, in which competitive prices are responding to the following competitive situations (Porter, 1985): elasticity in the price reaction of the competition, the selection of competitive strategies, and competitive advantages (De Jaime Eslava, 2007). The results obtained allow us to confirm that in general across volumes and sectors, companies are resisting significant change in pricing, although they are using price to block the emerging companies who use it as their standard bearer. Since the study has not dealt with margins, no conclusions can be drawn about their evolution. Below are the data that confirm transition in the historic concept of price:

- Company prices broadly match reference prices (72.22%)
- While not majority, constant prices are holding their own (they account for a significant percentage at 47.37%) against dynamic prices (52.63%)
- Dynamic prices are used on an occasional rather than a structural basis: almost never as an immediate reaction to competition from low cost enterprises at the time (9.09%); to some extent, due to the season (27.27%); and slightly more, due to the economic cycle (36.36%)
- Price per channel does not show excessive variation (52.9%)

Price sensitivity of customers of the sample companies reproduces the bipolarisation found in the study "Evolución de la sensibilidad al precios de los turistas españoles 2005-2007" (Valls, Vila and Sureda, 2007), referred to in the introduction. Half of these customers choose on variable price, while the other half choose for quite different reasons, like brand awareness and differentiation (13.6%); compliance and punctuality (13.6%); service, prestige, quality and friendly treatment (9.1%); nearness, time saving (9.1%); functionality and number of references (4.6%). We would say that consumers are equally divided: one half make price a basic element in the purchase, and so demand that it should be as low as possible, the "low cost effect". The other half adopt other factors related to quality, exclusiveness and prestige, to the extent that 83.33% of the sample indicate that they see "brand effect" as the main source of differentiation over the competition. Sometimes customers succumb to the price factor, sometimes to the other factors mentioned. This dichotomy of consumption, the leaning of consumers towards one or the other, depending on functions or situations, needs much more research to explore customer behaviour in this transition towards low cost. The issue must still be considered very open, and the action of sample companies seen as wise, given the situation. Middle-sized companies favour price, and the air transport sector is swayed equally by price and quality. Brand is the key trend in large companies and among the food and fashion sectors, and quality is the trend in small companies and the domestic appliance sector.

Some 55% of the sample claim that they have had to change their competitive strategy to stay competitive, but a slightly higher percentage, 55.56%, say that lowering prices would not bring them any competitive advantage. We are seeing some timid moves towards presenting offers, but only 32% do so always or often, compared with 68% who do so sometimes, hardly ever or never. Large companies do so often; the middle-sized, very little (never, hardly ever or sometimes); and small companies somewhere between often and hardly ever. By sectors, air transport often makes use of promotions; fashion, sometimes or often; food, sometimes; and banking, hardly ever or never.

Promotions as a competitive strategy against low costs are applied indirectly in two thirds of our cases, using coupons, for example, compared with slightly more than a quarter who do so directly. Results obtained from these promotions are positive: increase in sales (26.67%), brand switching (20%) and obtaining better results than advertising (20%). By volume, small companies tend towards brand switching and middle-sized and large companies obtain much better results than through advertising. By sector, except for half the fashion sector which reports that promotions bring lower profits, the rest claim that they mostly increase sales.

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