Sometimes never compete on price

"Never compete on price" · Low price as a strategy

"Never compete on price."

So we are told. But customers want lower prices, and it worked for Amazon, Costco, Vanguard, and many others, so why are we told not to use a low-price strategy?

"NEVER COMPETE ON PRICE"

When two products are fundamentally different—in features, integrations, and complexity—customers often have no real choice between them. An Enterprise must use software with single-sign-on, security controls, compliance features, and scaling to thousands of users with roles and permission and myriad needs.

"Due to recent economic conditions, picture worth has dropped to an all time low of 842 words."

credit [1]

For a small business, those same features make the system harder to use. They don't want to pay for things they don't need. So Enterprise- and SMB-targeted products compete on capabilities and user-experience, not price. The Enterprise cannot use the cheaper SMB version.

But consider two products that are functionally identical. They solve the same problem in the same way, with mostly the same features. The sales teams highlight minor differences that matter to maybe 10% of users. Because they're essentially the same, price is only differentiator left. They are two gas stations across the street from one another; the main difference is the big sign with numbers on it.

When one drops prices by 20%, they start winning market share. The other, having no other way to compete, does the same. This continues through "special offers" and permanent cuts until there's no profit left. Both companies end up poor, unable to invest in product development, marketing, or customer service. The products and companies deteriorate, which in turn degrades the customer experience. Low prices come at a price after all.

The math makes it even worse. A 20% price cut needs a 25% customer increase just to maintain revenue.* It's asymmetric and working against you.

Worse, the loss of profitability isn't an issue only for shareholders. It means the company cannot fund things like product development, or better marketing, or talent in tech support. In short, it means the product is worse, the service is worse, and the company is worse. Ultimately this is bad for customers as well as shareholders.

So, is it true? "Never compete on price?"

Well, not exactly. We have counter-examples.

Of course it can be an excellent strategy to have the lowest prices. Walmart, Amazon, Costco, Southwest Airlines, Vanguard Funds—there are many examples of wonderful companies, with amazing products and happy customers, and even happy shareholders, where "low prices" is critical to the successful strategy.

Jeff Bezos famously quipped: "Your margin is my opportunity." Meaning, while a competitor is making a profit off some product, Amazon will sell it cheaper, which either means stealing market share (if that competitor stubbornly maintains its price) or destroying the competitor's profit (if that competitor matches Amazon's price).

* Making 80% of the money off 120% of the customers multiplies to 96% of the revenue you had. Percentage losses always require even-larger-percentage gains just to get back to where you were. This effect applies everywhere, such as how to become more productive.[2]

But isn't this just restating the problem we just outlined? Why is this smart for Amazon, but dumb for that other competitor?

LOW PRICE AS A STRATEGY

The difference with each of those companies who successful competed using low prices, is that the price was part of a **comprehensive strategy to win**, with unique, interlocking, self-reinforcing decisions, where "lowest price" was an *outcome* of the *decisions*, not a tactic thrust upon them by the competition.

Those same decisions created products that were *actually great*, that consumers *actually wanted*, as opposed to weak, undifferentiated products where price was the only dimension left to compete on.

Finally, those decisions created *negative consequences* also. They are trade-offs. While they create greatness in some areas, they create weaknesses in others. Not all customers want that trade-off; those will not buy, or at least not willingly, and will be happy to switch to a competitor who makes a different set of trade-offs. That's OK; that's the price of a great strategy, and a great product; the alternative is a weak product that no one is excited to buy.

Some case studies:

Costco
By coupling higher quality products with higher quantities in each purchasable package, the *unit price* is lower than grocery stores. Consumers would be thrilled to get a deal for something "this good."

credit[3]

A store that caters to bulk-buying could also get away with a "warehouse" feel, and not stock all the goods that a daily grocery store might; this gives them more inventory flexibility and they can spend less on the interior; lower costs yields lower prices while also yielding profit. Because other grocery stores couldn't match it, their stores were unique. Then they added the requirement of an annual membership; pure profit, and increases how often a consumer comes back to the store.

Thus, interlocking decisions about quality, package-sizes, inventory, store-constructions, and membership, yields "low prices" as a result.

credit[4]

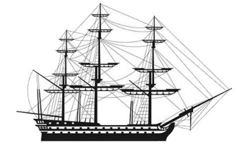
Southwest®

Southwest Airlines

Southwest Airlines has been a powerhouse for 50 years, remaining profitable even during the US terrorists attacks of September 2001 and throughout the Great Recession of 2008, surviving COVID, across a period where every other major US airline filed for bankruptcy at least once. Yet they have the cheapest tickets.

Like Costco, there are interlocking product and operational decisions that makes their offering unique. They run back and forth many times per day along the same few, short routes. Already there's a negative trade-off—no long routes, not international—but also positive ones—frequent flights means consumers have better schedules and it's easier to "catch the next flight" if you miss on. Other airlines have many kinds of airplanes for many kinds of routes, but Southwest uses only one type of airplane; this gives them pricing power over the supplier (due to large orders), and is cheaper to maintain (mechanics need only a single set of tools, trained on only one type of airplane), naturally reducing costs that can be passed on as lower prices. They have no amenities—no 1st-class seating, no meals, no baggage transfers, no connections to other airlines—which again is a negative trade-off for consumers, but lowers costs and therefore allows lower prices.

Vanguard Funds



Vanguard®

credit[5]

Every large mutual fund conglomerate in the late 1970s had a business model with hefty operational fees that paid the salaries of fund managers and analysts, who actively researched stocks, picking when to buy and sell. Consumers were paying around 2% per year to have these managers vigilantly understanding and picking stocks on their behalf. So, if the fund increased in value by 5%, the consumer would receive only a 3% increase. It really hurts if the fund decreases in value.

Vanguard realized that many people might want a completely different product: One that simply tracks indexes like the S&P 500, or automatically (i.e. without human judgement) tracks well-defined sets of stocks like "Large American companies." Without teams of human beings, they could eliminate sales 2% charge, replacing it with *de minimus* fees from the automatic trades. For consumers who believe that fund managers outperform the market, this new product was silly. But for customers who believe that managers don't out-perform the market in the long run—especially after removing the compounding effect of fees—the Vanguard funds were uniquely low-cost. Again, "low cost" was an outcome of a unique product, that made different trade-offs, that was appealing to a subset of the market.

When the only differentation a product has is "it's cheaper," that's worse than a bad strategy—it's no strategy at all. The result is commoditization and a race to the bottom. That's why you mustn't compete *only* on price.

That's a product that's *cheap*, as opposed to *affordable* or *a good deal*.

When lower prices are *a result* of strategy—business structure, cost structure, product trade-offs (which ICPs[6] love but others hate), and other decisions that competitors can't or won't make, then low-prices are a powerful, winning strategy.

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