

# The growing challenge from low cost competitors

Every year at the International Motor Show in Geneva, automotive companies like BMW, Audi, Lamborghini, General Motors, Toyota and many others present their new cars. In 2007, executives from these companies saw a potential new competitor presenting its cars at the show for the first time. The new competitor was a Chinese company called Brilliance. Its initial sales goals for Europe were modest – 150 000 cars over five years but it also planned to enter the US market in a few years. Few Europeans or North Americans had heard of the company or the brand. The company's pricing in Europe looked quite attractive – the price for one of its models being almost 40% less than that of a 5-series BMW with similar specifications.

Many automotive executives might have been tempted to dismiss this threat. Brilliance had just opened its first significant production facility in 2002 with an annual capacity of about 100 000 units; clearly, it lacked the decades of experience of its major Western and Japanese competitors. Complacency might also have been encouraged by a lukewarm review in a UK automotive magazine when the first Brilliance car was launched in Europe. This low cost competitor, however, probably represented a much bigger threat than these indicators would suggest. Brilliance was BMW's joint venture partner in China producing 3- and 5-series cars, initially from knockdown kits; they later utilized more and more locally produced parts. This experience undoubtedly helped Brilliance learn about high-quality manufacturing and quality control. It had also entered into a technology transfer agreement with Toyota. For the cars it manufactured and sold under its own brand, the company used the design services of Italian designers such as Giugiaro, who has designed cars for Ferrari.<sup>1</sup> One of its engines was manufactured

by a joint venture with Mitsubishi, a Japanese company with decades of experience in the automotive industry. Johnson Controls – a world-class player in car interiors – manufactured the car seats. And, the cars’ air bags and safety systems were developed in cooperation with TRW, a North American-based company with extensive automotive experience. With this kind of support and a very low cost structure, given its base in China, Brilliance could become a world-class manufacturer and a formidable low cost rival for European, North American, Japanese and Korean manufacturers.

However, there were some initial setbacks. Brilliance’s largest sedan, the BS6, disastrously failed a crash test in Germany in June 2007. Brilliance, with the help of a leading European engineering company, rapidly redesigned the car body and it performed acceptably on a second European crash test in late 2007. Perhaps more worryingly, the Brilliance BS6 was targeted at a market segment that was declining in sales in Europe. In addition, the car lacked a diesel engine option and a station wagon model, both of which were important selling points in this segment.<sup>2</sup>

Even if Brilliance does not achieve its initial objectives, the executives at the European, American, Japanese and Korean automotive companies can be sure that more than one of the dozens of low cost players that are developing automobiles in China and India will be a serious challenge to the industry titans. Perhaps one of these companies will be Tata, an Indian company with formidable engineering skills. Tata launched its 100 000 rupee (US \$2500) Tata Nano in India in January 2008, with plans to start selling variants of it in other countries in the future. Perhaps another will be Chery, a Chinese manufacturer that had some early successes in peripheral markets, such as Russia and Eastern Europe.

Similar developments are occurring in industry after industry in many parts of the world. And these low cost or value competitors that offer “good enough” products and services at low prices represent a large and growing challenge for executives and managers in a variety of traditional companies – those companies that tend to compete more on the basis of the performance, quality, fashion or style leadership, or on the basis of the close and intimate relationships they have built with their customers. The emergence and growth of these low cost competitors suggest that there is a tremendous appetite for low cost products and services that are good enough – something traditional companies in many industries have often been slow to recognize and to capitalize on.

In this chapter, we will begin by looking at some examples of low cost competitors in a variety of industries. While many low cost competitors are based in developed countries, an increasing number can be found in developing countries like China, India and Brazil. We will argue that it is these competitors in developing nations that represent a particular threat to Western, Japanese and Korean companies in many industries. Yet, companies that compete in the very high end of their markets sometimes feel insulated from the threat this type of competitor poses. We will discuss how low cost competitors can threaten the profitability – and even the survival – of traditional companies while at the same time actually creating new opportunities for the high-end players by opening up markets. Some executives believe the myth that the products and services provided by low cost competitors are inferior and will therefore never appeal to their customers. As we will see, this complacent and even arrogant attitude often does not coincide with the perception of many customers who see the low cost offerings as meeting their needs, although perhaps only in certain applications or for certain uses.

The threat from low cost competitors is real, and it creates a very depressing picture for some executives about the future of their companies. In many industries, however, the traditional companies are fighting back, quite successfully in some cases. Some have found effective ways to stay ahead of their low cost competitors – at least for now. The final section of this chapter features a flowchart to help the reader think through the challenge that low cost competition presents, as well as deciding how to respond to that challenge. This flowchart provides a useful introduction to the organization of the rest of the book.

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## **THE CHALLENGE IS REAL AND IT IS HERE TO STAY**

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When McKinsey surveyed almost 3500 executives around the world in 2006, 85% of the respondents described the business environment in which their companies operated as “much more competitive” (40%) or “more competitive” (45%) than it was five years previously. “More low cost competitors” was singled out as being the most important factor contributing to this increased competitiveness by 23% of the respondents. In several industries, such as consumer products, heavy industry and telecommunications, it was identified as the single most important factor (see Figure 1.1).<sup>3</sup>

**What single factor contributes most to the increasing competitive intensity in your industry today?**

	Industry of respondent's company							
	Business services	Consumer	Banking, finance	Healthcare	Heavy industry	IT	Telecom	Other
Improved capabilities of competitors (e.g. better knowledge or better talent)	27	21	27	18	25	30	18	20
More low-cost competitors	25	15	11	18	36	24	27	14
More competitors	18	13	15	10	9	11	9	18
Growing size of competitors	7	13	14	10	8	10	9	8
Growing number of innovative market entrants	10	9	9	9	3	10	17	10
Regulatory changes (e.g. market or industry deregulation, trade agreements)	4	4	12	22	8	3	17	10
Rising consumer awareness and activism	3	5	5	7	3	4	1	14
Growing number of attractive, accessible markets	3	4	5	5	6	5	2	2

% of respondents who describe the business environment of their companies as "more" or "much more" competitive than five years ago (n = 2963)

**FIGURE 1.1** McKinsey survey of business executives indicated that low cost competition was increasing competitive intensity in many industries

Source: McKinsey Quarterly Global Survey of Business Executives, March 2006.

## Retailing

Wal-Mart, the second largest company in the world in terms of revenue, is a low cost retailer that dominates many retail product categories in the US, Canada and Mexico, with a smaller presence in a number of other countries. However, for almost a decade, Wal-Mart struggled to establish a strong position in Germany and finally withdrew in 2006. One of the reasons for its failure in Germany was the entrenched position of the so-called German “hard discounters”. The major players Aldi (actually two separate companies Aldi Sud and Aldi Nord) and Lidl, and some minor players, had captured over 40% of the retail grocery market in Germany. These hard discounters, and other similar low cost competitors, had significant and growing shares of the retail grocery market in almost every European country. Across the whole of Western Europe, their market share in 2004 was 18% and they were growing much faster than the more traditional retail formats in many markets, including those outside of Europe.<sup>4</sup> Hard discounters are not only a threat to other grocery retailers in their markets but they have become a thorn in the side of fast-moving consumer goods (FMCG) manufacturers such as P&G, Nestlé and Unilever. The hard discounters carry almost no, or a limited range of, branded products. Their own private label products account for most of the inventory in their stores. Given the high market share of hard discounters in several countries, many FMCG manufacturers have lost a significant degree of exposure to their potential consumers. Even worse, in some respects, has been the response that these hard discounters have provoked in the other retail customers of FMCG companies. Many of these other customers have introduced a range (sometimes more than one range) of their own private label products in an attempt to be more competitive with the hard discounters. This has resulted in the FMCG companies facing a private label challenge from a majority of their customers.

In many clothing categories, the low cost retail chains such as Zara and H&M are competing effectively with traditional, higher end manufacturers of fashion clothing like Liz Claiborne. These low cost competitors have been expanding rapidly and many are reporting very good financial results. To compete more effectively with the well-known and more expensive fashion brands promoted by Liz Claiborne and others, the low cost retail chains are increasingly introducing exclusive lines endorsed by such celebrities as Madonna and Kylie Minogue.

In all these segments of the retail market, executives and managers at the traditional retailers must figure out how to respond effectively to this low cost competitive threat. It is also a major issue for the branded manufacturers like

Nestlé, P&G and Nike that supply traditional retailers and, in some cases, their low cost competitors.

## **Airlines**

The first major low cost airline, Southwest Airlines, was launched in 1971. Two key elements of Southwest's operating model were the use of only one type of aircraft (the Boeing 737), which simplified many aspects of its operations, and the use of a "point-to-point" system rather than the "hub-and-spoke" system favored by many major airlines. Southwest also preferred secondary airports that often had lower charges and less congestion, which allowed planes to be turned around more quickly. Since that time, Southwest's concept has spawned numerous airlines that have copied key elements of its business model. Today there are over 50 low cost carriers in Europe including such giants as Ryanair and easyJet, several in India and many others in major aviation markets worldwide. In Europe, where the low cost airlines have been particularly successful, well over 100 million passengers per year fly with them, accounting for about 30% of all scheduled intra-European traffic.<sup>5</sup>

The leaders among the low cost airlines are some of the most profitable airlines in the world, and they have created significant shareholder value. Southwest has been the most consistently profitable of all the large US airlines, and by at least one measure – net margin – Ryanair has been in several recent years the most profitable major airline in the world.

Executives at some of the traditional carriers have now been struggling for more than a quarter of a century to find an effective way to deal with this threat. Some approaches have been more successful than others, but the low cost carriers keep growing and expanding into new market segments, thereby increasing the pressure on the traditional players.

## **Banking**

Modern direct banking first appeared in Europe in the late 1980s. In the UK, Midland Bank launched its 24-hour, seven-days-a-week telephone banking service (with its toll-free phone number 0800 24 24 24) in 1989. In the late 1990s, the Internet became an additional channel and, ultimately, the main channel for customers to access their direct bank's services. ING Groep, the large Dutch bancassurance group, has been most successful in capitalizing on the interest of many consumers in a bank that offered high interest rates on savings and low interest

rates on mortgages and loans. From a successful pilot of ING DIRECT in Canada in 1997, the bank rapidly expanded its direct banking service into a number of other countries. By 2008, the bank had operations in nine countries in Europe, North America and Australasia. In many developed banking markets, such as the US, Canada and several countries in Western Europe, there are now a number of direct banks in operation.

Direct banks have had a significant impact on the industry's competitive dynamics in several markets. Traditional "bricks and mortar" banks, such as Citibank and HSBC in the US, have been forced to open their own direct banking services with competitive offerings to prevent further erosion of their customer bases. For ING, its aggressive entry into direct banking resulted in about €700 million of before tax profit in 2006. One investment bank valued the ING DIRECT bank component of ING Groep at €10 billion in 2007<sup>6</sup> – not bad for a business less than ten years old!

### **Fast-moving consumer goods**

In a wide variety of consumer product categories, the traditional branded manufacturers are facing serious low cost competition. As mentioned in the discussion above about retailers, the hard discounters put a heavy emphasis on their private label products. Often, these private label grocery products are of high quality; in many cases, the companies that have the number three-, number four- or number five-ranked brand in a market produce them. These manufacturers have come under increasing pressure as many traditional retailers have decided to allocate their limited shelf space to the number one and number two brands and perhaps their own private label brand or brands. Many of the producers that have lost their position on traditional retailer shelves are mid-sized manufacturers in desperate need of orders to keep their manufacturing plants operating at high levels of capacity utilization. This makes them very receptive to the hard discounters who promise very high and predictable volumes on a very small number of stock-keeping units (SKUs). Some industry observers estimate that Aldi sells about 150 times the volume per SKU that Wal-Mart does giving it, and the other hard discounters, tremendous purchasing power. The quality of these products is often excellent. In independent product testing, they often match or even outperform the brands of the leading FMCG companies. While the hard discounters demand high quality and very low prices, they are usually relatively inexpensive to serve because they buy centrally on long-term contracts, need little support, want delivery in

truckloads and are not interested in promotional activities. Many of the hard discounters are also loyal to manufacturers that live up to their commitments.

### **Consumer electronics**

In Switzerland, the market leader in units for fixed line telephone handsets sold to consumers in 2007 was not Swisscom (the leading Swiss telecommunications company), Panasonic, Siemens or Sony but a small Swiss company called Telgo – operating under the brand name of Switel. Telgo was launched in 2001, and it soon became a leading supplier in Switzerland of both fixed line handsets and a variety of other related consumer telecommunications products; it also began expanding into other European markets. The company takes advantage of new technology and has been quick to enter new emerging product categories such as Voice over Internet Protocol (VoIP) telephone handsets. It is a low cost competitor and, according to its CEO, it is perceived as the market leader in its home market in terms of “value for money”.<sup>7</sup> It has strong relationships with a number of major retailers, and the Switel product is often their “value” line in the product categories in which Switel competes. While its sales and product line have expanded quite rapidly, Switel has been able to accomplish this with only about a dozen employees. Most of the development and all of the manufacturing is outsourced to partners in Asia. We will discuss in Chapter 2 how the appearance of focused companies that specialize in innovation, product design and infrastructure activities, such as manufacturing and logistics, has allowed small companies like Switel to focus on building relationships with customers. Sometimes these small players have grown into significant forces in the markets in which they compete. The extensive outsourcing has allowed Switel to grow very rapidly, and in the product categories in which it operates, it is a significant competitor for large global companies such as Philips, Panasonic, Sony and Samsung.

In North America some of these same leading consumer electronics companies are being challenged with regard to LCD flat-panel TVs by another competitor Vizio. In early 2004 Vizio was a six-person company with sales of less than \$20 million per year. By the last quarter of 2007 Vizio had annual sales of almost \$2 billion and had captured 12.4% of the US LCD TV market, just behind Sony’s 12.5% and Samsung’s 14.2% market shares. Again, Vizio managed to do this by working very closely with a focused manufacturing partner in Asia, who had also bought an equity stake in the company.<sup>8</sup>

## **Business-to-business products and services**

The threat posed by low cost competition is at least as strong in many business-to-business product and service categories as it is in business-to-consumer categories.

One industry being threatened in a number of product categories is the chemical business. Not surprisingly, for many of the commodity chemical products the low cost challenge is coming out of the Middle East and other regions with access to very low cost energy and feedstock. But the challenge is also strong, and growing, in specialty chemicals and pharmaceuticals, which have traditionally been dominated by European and North American manufacturers as well as those from the most developed Asian economies. These companies have invested heavily in research and development to create unique, patented products. In some cases, considerable process expertise is required to produce these products efficiently and to meet the demanding quality standards of their customers. However, some of these companies are now finding themselves challenged, often by companies based in China and India. In some cases, the companies have been surprised at how quickly their Asian competitors have been able to catch up to them. In one case, a European specialty chemical company had a major product for which the patent had expired. One of its leading European competitors tried to copy the product but failed to develop something that fully matched its offering. A few months later, an Asian competitor was successful in copying the product and was meeting the demanding quality standards of key customers. And it was selling the product at half the price of the original European player. The challenge for executives in the chemical and pharmaceutical industries is to come up with effective responses as some of these low cost competitors strive to offer products that provide more and more value to their customers.

IT services is another area where low cost competitors have been making major inroads, for example Indian companies such as Tata Consultancy Services, Wipro Technologies and Infosys Technologies. Initially, they capitalized on the low cost and wide availability of well-educated, English-speaking workers in India. Their first big opportunity was rewriting legacy software to cope with the new millennium. A lot of the software written in the mid- to late-20th century had not anticipated calendar dates after 1999 and much of this software needed to be repaired, rewritten and tested. This was a major challenge for many companies, and was very labor intensive and not very exciting work for software developers. The Indian companies were willing and able to undertake the work and many

performed well at the assigned tasks. Having established credibility with their Western customers, they were soon given assignments that were more challenging.

As their labor costs have risen, and as they have developed even closer relationships with customers in other parts of the world, these companies are expanding rapidly outside of India and are increasingly providing services that are more advanced. The growth rates for Indian IT service companies in the last few years have been very high, bringing them into increasing competition with the major global IT services companies such as IBM Global Services, HP and Accenture, both in India and around the world. As they continue to build up their local presence in global markets, they pose an increasing challenge for the global leaders.

Open source programs like Linux and MySQL are another increasingly important low cost threat to such leading software companies as Microsoft and Oracle. Initially these kinds of open source software were little more than a nuisance to the mainstream software vendors. However, the threat grew as both start-ups like Red Hat and large traditional companies like IBM and Sun threw their support behind some of the open source software. Some of the largest young corporations like Facebook and MySpace were reported to use no traditional commercial software in their information technology infrastructures.<sup>9</sup> By 2008, IBM was also working actively with a number of partners to make it very easy for corporations to deploy “Microsoft-free” PCs in their organizations.<sup>10</sup>

The examples above are only the tip of the iceberg. Low cost competitors occupy a large and growing part of many industries. Some of these companies are very profitable, and they have created tremendous shareholder value. It seems that almost no industry is safe from low cost competitors. Even the large commercial aircraft market is threatened by low cost competition. In mid-2007, Jim McNerney, the CEO of Boeing, said that he expected a third player to emerge to challenge Boeing and Airbus and he suggested that the challenger would probably be Chinese.<sup>11</sup> As McNerney pointed out, China has developed a formidable supply chain to support the Chinese automobile industry – something nobody thought possible in the late-1990s. If China made similar progress in the aviation manufacturing industry, it certainly would not need the almost 30 years it took Airbus to challenge Boeing for leadership in that business.

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## IN MANY INDUSTRIES THE MAJOR THREAT IS COMING FROM ASIA

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Boeing is not the only company that is watching carefully what is happening in Asian countries such as China and India. As suggested in some of the previous examples, the threat is either a direct Asian threat, such as specialty chemicals or IT services, or is an indirect threat, such as those low cost products marketed under the brand names of Switel and Vizio – produced, and in many cases designed, in Asia.

These Asian challengers, particularly the ones based in China and India, represent a very serious threat, in part because they are based in countries with huge domestic markets for numerous products and services. For example, some 45–50% of the world's cement is currently sold in China. China is also the largest market in the world for telecommunications equipment and mobile phones; it is the number two market in the world for aircraft. In 2006, it accounted for 25% of the elevators and 50% of the escalators installed in the world. India is also rapidly moving up the global rankings for many products and services. It is, for example, the largest market in the world for tractors.

If players in developed countries wait until some of the domestic companies in China and India emerge onto the world stage, they could face competitors with unbeatable economies of scale. Additionally, the competition among the local Asian players in some of these industries is fierce; there are sometimes dozens of players competing furiously for market leadership. In China, the large number of players in some industries is the result of different provinces, or other government entities, encouraging and then protecting local companies to create jobs and economic growth. In 2007, many local Chinese entrepreneurs and companies sensed there was a good opportunity in the wind turbine market. Wind power generation was rapidly becoming a major market in China as the Chinese government set ambitious goals for renewable energy. The number of local competitors went from about a dozen to more than 50 in less than a year. Goldwind, one of the local Chinese players that had produced almost no wind turbines prior to 2004, was the market leader in China with a 35% market share by 2007. This was no mean feat in the world's second largest wind turbine market where most of the world's leading global players, including Vestas, GE Wind, Gamesa and Suzlon, were also competing.

Japan and Korea provided protection for many of their industries in the early stages of their development. This meant that their companies did not have to compete head-to-head with leading multinationals in the home market before they were well established. This has been much less the case in China and some of the other more recent emerging economies. Their companies have often had to battle not only with many other domestic competitors but also with leading multinationals right from the start. This intense competition has sometimes resulted in deep, highly innovative and very flexible infrastructures that have driven costs down rapidly and improved quality. One good example of this has been the motorcycle industry in China that is centered around the city of Chongqing.<sup>12</sup> China has over 100 companies that assemble motorcycles. The privately owned assemblers rely on a network of companies that provide components and subassemblies. These suppliers take collective responsibility for the detailed design of these components and subsystems to meet the broad design parameters set by the motorcycle assemblers and brand owners. They are free to innovate to achieve the design targets and they do. The result has been a dramatic fall in costs, much of which has been passed on to their customers in the form of lower prices. By 2006, China was producing 18 million motorcycles per year, accounting for 50% of the world production, and over 60% of this production was exported. In some markets, such as South Vietnam, Japanese motorcycle manufacturers have lost most of their market share to the much cheaper Chinese bikes.

Many Western companies, sometimes belatedly, have recognized the opportunity afforded by the large and rapidly growing Asian domestic markets for many products and services, particularly in China and India. In many cases, they have established a manufacturing presence in Asia to try to tap into this growth opportunity, as well as the lower costs. At first glance, some of these manufacturing operations are quite successful with rapidly growing sales as additional capacity is being added. However, on closer examination the results are not always as positive as they first seem. For some companies, almost all the output is being exported back to their home markets, or to other export markets around the world, but very little is actually being sold in China or India. Thus, while the companies are taking advantage of the low cost manufacturing opportunities in Asia, they have not always been able to capture significant market share in local markets. So, if part of the objective of establishing a presence in China or India was to contain the local players by challenging them on their home turf, they have failed. When Chinese or Indian competitors appear on the world stage, some are

doing it from a relatively secure base in their home market. The Western companies, on the other hand, are missing out on the learning opportunities that would have been available if they had gone head-to-head in the Chinese and Indian domestic markets against the local players.

When we hear companies bragging about their success in Asia, we should always look carefully at their claims. Yes, it is very useful to build a successful manufacturing presence in Asia, but it is often strategically much more important to build a fully-fledged business there with a significant market share in the region's major domestic markets.

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## **MANY CUSTOMERS PREFER GOOD ENOUGH PRODUCTS AND SERVICES**

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Think about it. It is not always just about price. It is often more about the total value proposition. Many customers choose to buy good enough products from value competitors because they are cost-conscious and/or because their needs are fully met by the value player's solution. In some cases, these customers even think that the value competitor offers more value at lower cost.

Aldi and Lidl, for example, offer their customers an attractive value proposition. For some manufacturer-branded products, their prices are sometimes higher than the hypermarkets'. However, the everyday low prices of their private label products are often significantly lower than prices in other grocery stores. For many hard discounter customers, a very important aspect of the value proposition is the combination of store proximity and very limited choice, both of which provide shopper convenience. Some 80% of German households live within 20 minutes of a hard discounter. Hard discounters carry a very limited number of SKUs, often around 1000 versus up to 25 000 in a traditional supermarket and many more in a hypermarket. This limited range means that the customer does not have to choose between the 10 to 20 brands, product variants and sizes found in many traditional supermarkets or hypermarkets. This simplifies and speeds up decision-making.<sup>13</sup> As mentioned earlier, the quality of their products is satisfactory and, in some cases, compares favorably to leading branded products. For many customers, this combination of low prices, high quality, convenience and simplicity is a winning value proposition. This applies to both low-income consumers who rely on reduced prices and higher-income consumers who see themselves as smart shoppers. In

Germany many consumers think it is “cool” to find bargains at stores like Aldi and Lidl – and even have a saying for it, “Geiz ist geil” (stinginess is smart).

Similarly, many customers find the “service” of a direct bank totally acceptable – they do not want or value personalized service or a relationship with a bank. These customers would rather earn high interest on their savings and pay low interest rates on their loans. They may also prefer to do their transactions via the Internet at their convenience. They do not see much value in waiting in lines for teller service and having to endure what might be indifferent service, at best. In banking, as in many other industries, technology is advancing quickly and making self-service faster, more convenient and more effective. Some customers of low cost airlines, such as Ryanair, find that the smaller and less crowded airports that the carrier uses result in greater convenience, better punctuality and shorter, more predictable travel times.

## **LOW COST COMPETITION IS NOT ALL BAD NEWS**

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The emergence of low cost competition is certainly not all bad news for traditional companies. It often signals that there is a significant segment of the market not satisfied with the traditional offerings; in other words, there is a need for good enough products and services at low prices. As we will discuss later in the book, this segment may seem to be quite small initially. However, it often grows exponentially as both the demand side of the business develops and the supply side infrastructure grows to support the low cost players.

Smart executives and managers in traditional companies recognize the opportunity early and may decide to move quickly to stake a claim on the new emerging market and capture a first-mover advantage. As we discussed earlier in this chapter, ING Groep saw the direct banking opportunity before many other large financial services companies (but still several years after it had first emerged) and moved to capitalize on it in many of the major countries around the world.

After stumbling at first in the low-end segment of the Chinese mobile phone market, Nokia bounced back with handsets designed for those customers. And perhaps more importantly, they developed a distribution system that allowed the company to penetrate markets deeply in the third- and fourth-tier cities and the rural areas. Based partly on its successes in China and India, Nokia is believed to have about a 50% share of the world’s “below €50” mobile segment.

In some industries, customers first enter a market by buying good enough products and services at low prices, often from low cost players. However, as their needs evolve over time, customers may buy from a supplier that offers a more advanced product with better performance or service. In some cases, this may be from a traditional company that does not compete in the good enough segment of the market. However, in other cases, if they have been satisfied with the low cost competitor's product, and if the low cost competitor provides products and services that meet the more advanced needs of customers, they may continue to buy from the low cost player. Thus, a traditional player without a low-end offering may find it difficult to access these customers as they "move up" in the market.

Many FMCG companies are recognizing the opportunities with consumers who are further down the income "pyramid" than those whom they have traditionally served. These consumers not only represent an "upgrade" opportunity over time but can also represent an attractive market in their own right. While they lack the individual purchasing power of their higher-income, traditional consumers, collectively they represent a significant market opportunity. Additionally, these consumers often shop in traditional "mom and pop" retail channels that have much less buying power than retailers in the "organized" segment of the market, which gives manufacturers more power and control in the relationship. Several leading FMCG companies are now aggressively "tiering down" to pursue this consumer group in the developing world for both the immediate market opportunity they represent as well as the longer term "upgrade" potential. Nestlé, for example, has a major thrust to provide "Popularly Positioned Products" to consumers in the developing world. Many of its products have been specially formulated to offer these consumers nutritionally balanced products, in small package sizes and at affordable prices. Nestlé hopes that these consumers will recognize the value that is being offered and that they will become loyal purchasers of Nestlé products. This will give Nestlé an advantage if and when these consumers start buying higher-end products in the product categories in which the company competes.

The same kind of dynamic exists in many business-to-business markets where new companies often enter a business by producing very basic or commodity products. For example, a Chinese entrepreneur might see an opportunity to enter the yarn manufacturing business. Initially, he twists cotton fiber to make coarse or medium-grade yarn. This is the easiest segment for him to enter and a basic twisting machine from a low cost local Chinese manufacturer might be totally adequate for this purpose. These basic machines are simple enough that a

local mechanic might be able to make some replacement parts for them as well as do the servicing. Because there are few barriers to entry, however, many other entrepreneurs have the same idea and the business becomes very competitive with low margins. As the entrepreneur becomes skilled and gains more experience in the business, he sees that if he were to twist fine or very fine cotton or wool, the margins might be much better since the barriers to entry are higher. To do this, however, he needs to buy more sophisticated twisting machines. He may also have to buy replacement parts from, and perhaps even get more sophisticated servicing done by, the machine manufacturer. These machines might only be available from European and Japanese suppliers (at least initially until a few of the local Chinese players can begin to match their offerings). The entrepreneur then becomes a customer for the traditional textile machinery manufacturers, focusing more on quality, performance and industry-leading technology.

## **UNDERSTANDING AND RESPONDING TO THE CHALLENGE OF LOW COST COMPETITION**

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Beating Low Cost Competition is designed to help executives and managers in traditional companies better understand low cost competitors and their strategies. Traditional companies can only hope to compete effectively with their competitors by having a deep understanding of them. This will help them to develop strategies for their business that will not only allow them to counter the threats from low cost competitors but also, in some cases, take advantage of the opportunities in some of the more cost-conscious segments of their markets.

In Chapter 2, we will introduce a simple conceptual framework that allows these executives to place their own strategy and those of their competitors, including their low cost competitors, within a common context. We will also explore some of the major reasons that low cost competition has become such a major challenge for companies in a variety of industries. The chapter discusses the three core value propositions – performance, price and relational value – that companies use to appeal to their customers. We will argue that many product categories, if not whole industries, are moving more quickly than ever before from the introductory phase, through the growth phase and to maturity. This leads to relatively rapid commoditization of the core product or service and results in players emphasizing price value emerging more quickly and more vigorously than we have seen

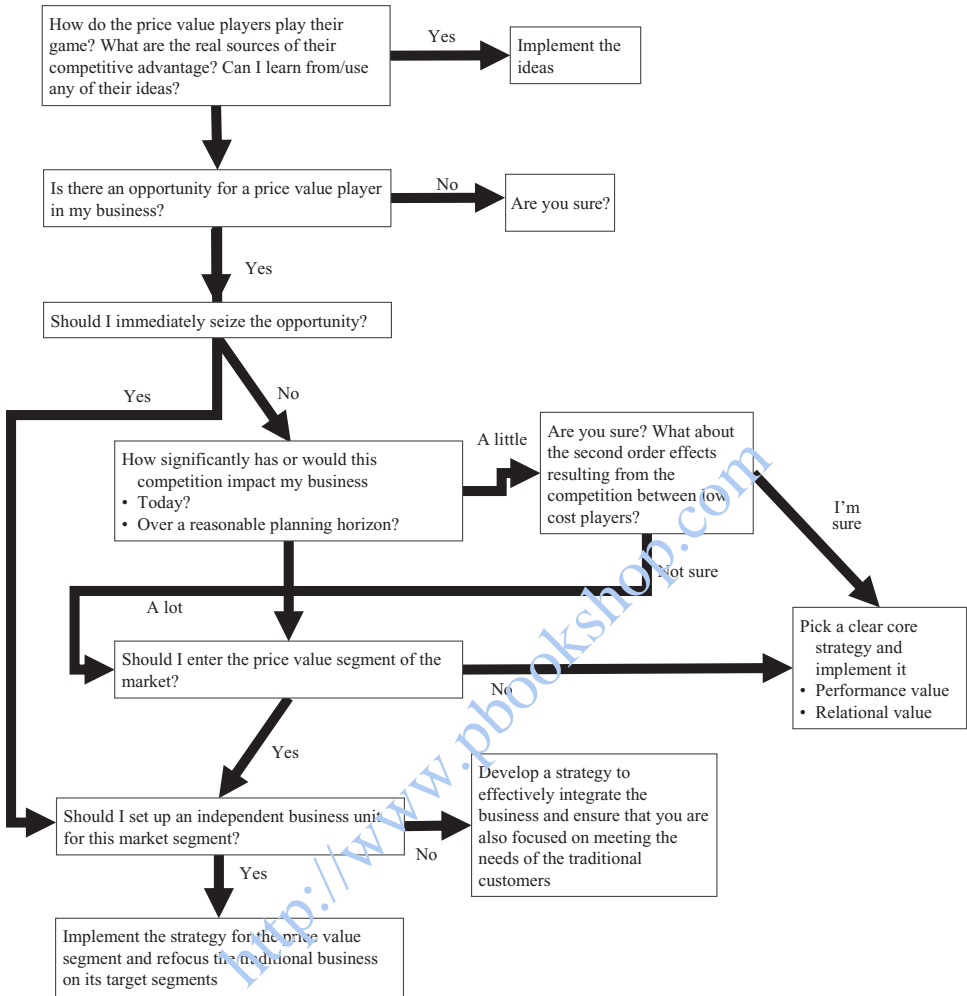
previously. We will discuss some of the reasons why there seem to be more low cost competitors than ever before and why they are appearing more quickly. As we shall see, fundamental changes in the business environment in many industries have contributed to this. The growth of price value players has been actively encouraged in some industries, by both the suppliers and customers of traditional companies. Additionally, in many consumer product categories, the consumers themselves have become much more receptive to good enough products and services at low prices.

Figure 1.2 shows the overall flow of the book and the major questions that are addressed in Chapters 3 to 7. These are the questions that company management teams or business unit teams facing the threat of low cost competition should be asking themselves.

In Chapter 3, we will deepen our understanding of how some low cost competitors from a variety of different industries play their game. We will see that while these companies compete in quite different industries, they often share a number of common characteristics. Many of these companies have been quite innovative in their own ways. In some cases, traditional companies can learn valuable lessons from how these low cost competitors operate and how they manage their businesses.

In Chapter 4, we look at the fundamental challenge facing many traditional companies that are, or soon will be, threatened by low cost competitors: Should we tackle the low cost competitor in his market segments, or should we try to avoid a direct confrontation by focusing on other segments? In this chapter, we will explore why many companies fail to address this tough question in a timely manner. An important element in this analysis is developing an understanding about how the strategies of the low cost competitors may evolve over time. In only a few years, what may initially be a remote or minor threat can sometimes evolve into a direct and powerful threat to the core of a company's business. It is essential that company management think through the likely long-term evolution of the strategies implemented by their low cost competitors. Many executives in traditional companies fail to take into account the creative strategies that low cost competitors can adopt to attack their core business.

In Chapter 5, we take a close look at the issues facing a company that is seriously considering challenging the low cost competitors in the price value segment of the market. We will examine, in detail, the major arguments for and against confronting the challengers in their market space. We will also argue that



**FIGURE 1.2** Responding to an actual or potential low cost challenge – think through the key issues

if the decision to move against the low cost competitors is positive, it is much better to move quickly and pre-emptively before the low cost competitors are established in the market. After discussing these issues, we will turn to some of the major decisions regarding implementing a competitive low cost strategy. These decisions include the degree of independence that the two parts of the business should maintain, major tactical decisions such as “make versus buy”,

branding and “go to market”, and other considerations like sales and distribution infrastructure.

In Chapter 6, we show that whether or not a company decides to confront the low cost players in their segment of the market directly, some tough choices have to be made about how to strengthen its position in the other market segments. Some companies try to contain the low cost competitor in the “low end” of the market or even exploit the price value segment in markets that are remote (e.g., geographically remote) from where its traditional business competes. Other companies decide to focus on either performance value or relational value. In Chapter 6, we will look at some companies that have adopted these various approaches and examine some of the strategic and tactical decisions they have taken. We will also review how well they seem to be working.

In Chapter 7, we will step back and look at the issues facing the leadership of companies or business units that are being challenged by low cost competitors, or will be in the near future. Implementing an effective response is often an exercise of major organizational change and one that may take years to be successful. It almost always requires significant cultural change throughout the organization. And whatever direction the company takes, a flawless execution will be absolutely essential if it is to succeed.

Finally, in Chapter 8, we will look to the future and discuss some of the major issues a company’s management team should be addressing as we head towards an even more challenging world where low cost competition will play an ever bigger role.

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