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When companies underestimate low-cost rivals

Attackers are threatening premium players in market after market—and not only at the low end.

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When low-cost competitors appear, one of the toughest decisions facing executives in companies with premium products and brands is whether to respond. Should the company or business unit adjust its strategy to meet the low-cost threat or should it continue business as usual, with no change in strategy or tactics?

As these established companies attempt to define the nature and magnitude of the challenge, they often underestimate it. Sometimes executives are so focused on their traditional competitors, they don't even recognize the threat developing from low-cost rivals. What executive isn't familiar with the case of the low-cost airline Ryanair and its hugely successful entry into the European market at the expense of the region's traditional carriers? Likewise, were the world's leading telecommunications companies too busy competing with one another to recognize the threat from the Chinese low-cost competitor Huawei, now a leader in fixed-line networks, mobile-telecommunications networks, and Internet switches? Then there was Vizio, a little-known LCD TV supplier that overtook the premium brands in five years to become the North American market leader in large-format TVs. Complacency and arrogance produce blind spots that delay a response and leave incumbents vulnerable.

But our study of low-cost competitors suggests that they also build momentum in slower-moving and more subtle ways—factors that established players might do well to pay closer attention to. At times, low-cost challengers build their presence stealthily by competing in undeveloped segments of a market. Or they can narrow capability gaps by tapping the look, feel, and suppliers of bigger rivals. In other cases, competition between low-cost entrants can produce unintended second-level effects that escape the notice of incumbents until it's too late to prevent a severe erosion of their market position.

Taking time to gain momentum

If the new low-cost challengers are competing in undeveloped segments on the fringe of the incumbents' market, the initial sales impact may be muted. In these cases, even though the incumbents' share of the overall market is falling, they often continue to grow, sometimes quite rapidly, lulling them into a false sense of security. This dynamic is a particular issue for companies operating in developing markets, especially in second- and third-tier cities or in rural areas, where market data are often much less transparent than they are in more mature markets. In some cases, low-cost players tap segments that take time to develop; they may require significant changes in behavior and new infrastructure to support growth. Typically, these types of changes do not happen overnight. They certainly didn't for low-cost airlines.

As a result of the dramatically lower prices that companies such as easyJet, Ryanair, and Southwest Airlines have brought to the air travel market, customers have quietly adopted new forms of behavior that in turn rewrite the rules of the market. More people in Europe take weekend breaks in countries that are farther afield; before the rise of the low-cost

airlines, these passengers would have traveled locally or regionally. Many workers in one part of Europe take advantage of job opportunities hundreds of miles away. Some doctors who live in continental Europe have part-time practices in the United Kingdom to help meet a practitioner shortage in certain regions. Even people with relatively low incomes, such as construction workers, “commute” between their homes and families in central and eastern Europe and their jobs in western and northern Europe. As prices fall and new kinds of behavior are established, growth accelerates rapidly.

Filling resource and capability gaps

Some low-cost competitors rise more quickly than premium players anticipate by finding clever ways to overcome capability gaps. For example, when low-cost attackers get under way, they may copy the products of premium companies, sometimes matching designs, colors, model numbers, and promotional materials. (One Chinese manufacturer of textile machinery even helped its customers identify the product they should choose by indicating, in its own model numbers, both the premium brand and the model being copied.) In many industries, intellectual property can be licensed and used for a modest fee. Also, low-cost competitors have acquired interests in companies with access to desired technology, distribution channels, and customer relationships.

Sometimes, low-cost competitors close quality and performance gaps with their premium rivals by taking advantage of support from customers and suppliers that are trying to protect and further their own business interests. Customers are often quite keen to have more competition among suppliers and in some cases help low-cost suppliers upgrade their offerings by providing information and support. Suppliers of capital equipment and parts used to manufacture products are eager to see low-cost competitors buy the latest equipment and components. Often, this material incorporates information from the suppliers’ premium customers and represents a transfer of knowledge and experience that may have built up over decades.

The role of second-order effects

The initial impact of low-cost players on incumbent companies may not be the most important consideration. In many markets, if they are relatively easy to enter, a number of low-cost competitors may do so. There might be enough business for everybody at first, with little direct competition between the low-cost players. But as direct competition intensifies, one or two of the low-cost companies—sometimes “losers” in price wars in the market’s lower tiers—may try to escape it by differentiating their offerings and moving up in the market. The strategy of these losers often poses a much more direct and formidable threat to the traditional players than the original low-cost strategy, since the attackers typically offer an enhanced product or service built on a low-cost base.

A good example of second-order effects is occurring in the airline business in Europe. The intense battle between Ryanair and easyJet raised both their games, with Ryanair

dominating the truly low-fare market and easyJet moving upmarket to compete much more directly with the full-service carriers in both airports served and services offered. The full-service carriers now face withering competition and cost pressure on most of their European routes.

Sometimes second-order effects derive from the interplay between a low-cost competitor's offers and the behavior of customers over time. One Indian chemical producer initially sold only a narrow range of offerings, but high volumes and low changeover costs allowed it to undercut a US rival in the European market and to capture a high share of sales. However, the US company did not immediately realize that the low prices would lead customers to rethink how they could formulate a broader range of their products to take additional advantage of the Indian producer's relatively inexpensive chemicals. More volume shifted to the Indian producer, leaving the US company with an increasingly less economic mix of products.

Fighting back

Premium-brand companies have a few options for responding to these subtler attacks on their market position. The possible responses range from directly confronting a low-cost competitor in its market segment by launching competitively priced products to adjusting strategy in an attempt to isolate the business from the low-cost threat. Such a strategy might include shifting from the segments most vulnerable to attack by low-cost competitors. A customer focused primarily on product quality and reliability, for instance, may switch to a low-price offering if its producer can show that it is good enough in these respects. By contrast, customers attracted to a premium brand because it offers a total solution—for instance, financing, very high levels of technical support or service, and strong personal relationships—may be much less likely to switch. Premium players could therefore focus on selling solutions rather than physical products.

One company that successfully dealt with a challenge from low-cost rivals was Nokia, which faced a particular threat in China.¹ Motorola was the first mobile-phone handset manufacturer to set up operations there, in the late 1980s. It was soon followed by Ericsson and Nokia, and later by Samsung and Siemens. These foreign players dominated the small but growing market. In 2002, Motorola (the leader) and Nokia still controlled almost 50 percent of the Chinese market. Yet 18 months later, their combined share was down to less than 35 percent, and local players, such as Ningbo Bird and TCL, had captured more than 40 percent. These local companies offered low-priced phones designed to meet the needs of domestic consumers.

¹The information in this example comes from publicly available sources, including *Bloomberg BusinessWeek*, IBS Case Development Centre, *McKinsey Quarterly*, *Shanghai Daily*, and *Wired*.

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Nokia responded rapidly to the threat. By 2005, it had introduced a number of new entry-level phones, including two designed just for China that enabled users to enter Chinese characters with a stylus. To counter the local rivals, which were particularly strong outside the major cities, Nokia revamped its distribution structure. The company had been relying on several supposedly national distributors that in reality provided good coverage only in the top ten cities. Nokia dropped several of these distributors, replacing them with about 40 provincial ones, and built a sales force of more than 1,000 people, with an additional 4,000 paid promoters at retail sites. (In peak periods, the promotional force could grow to more than 20,000 people.) By 2009, Nokia had about 90,000 sales outlets and 1,000 customer service centers.

The company rapidly regained its lost market share. In recent years, it has captured about 35 percent of China’s mobile-phone market, despite stiff competition from the other leading global players and a large number of low-cost Chinese ones. Nokia is now the globally dominant competitor in the entry-level mobile-phone market.



Executives always regret it when they don’t anticipate the scope of a low-cost threat and respond forcefully. To be sure, a failure to see competitors is an example of the forces of “creative destruction” at work in capitalism. But companies alert enough to identify the nature and magnitude of the challenge will be in a better position to find ways to hold the new competitors at bay. ○

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