

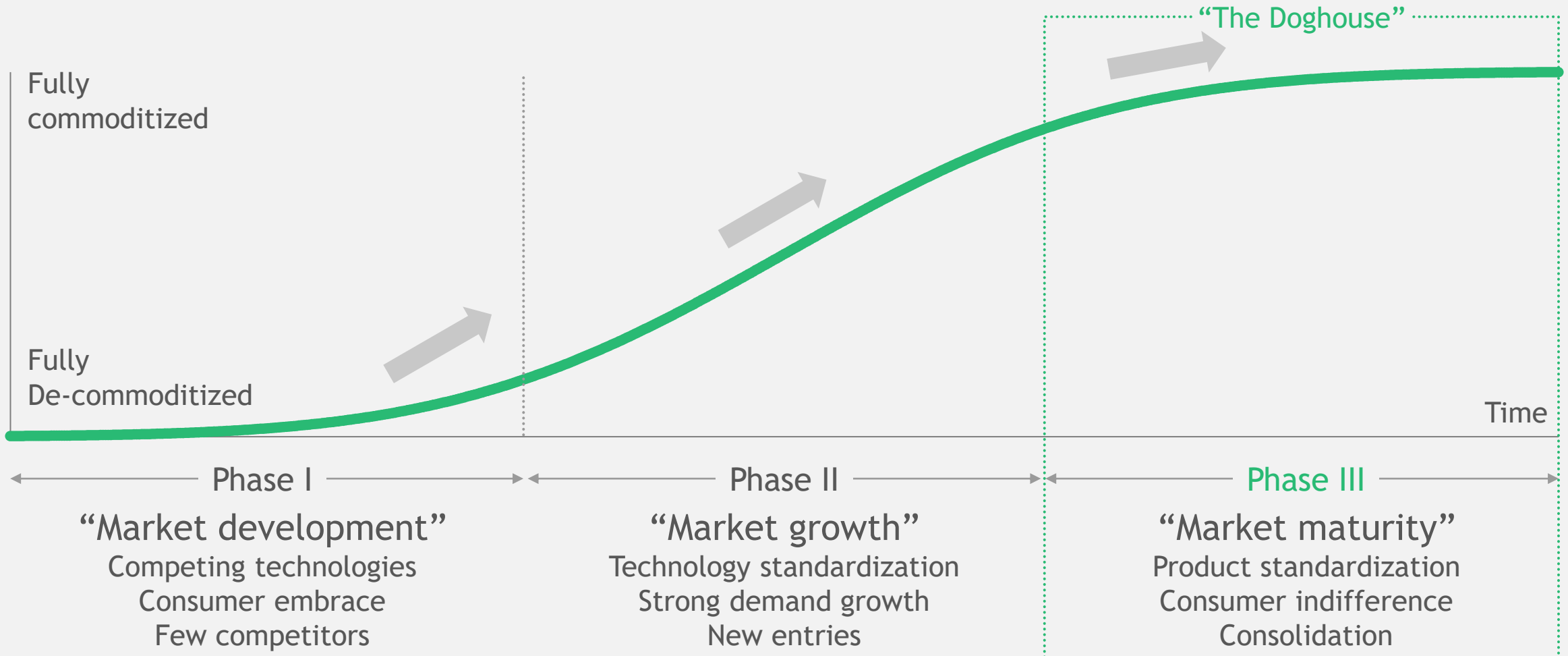


Competitive strategies in commodity oligopolies

L 03: Typology of strategies in commodity oligopolies

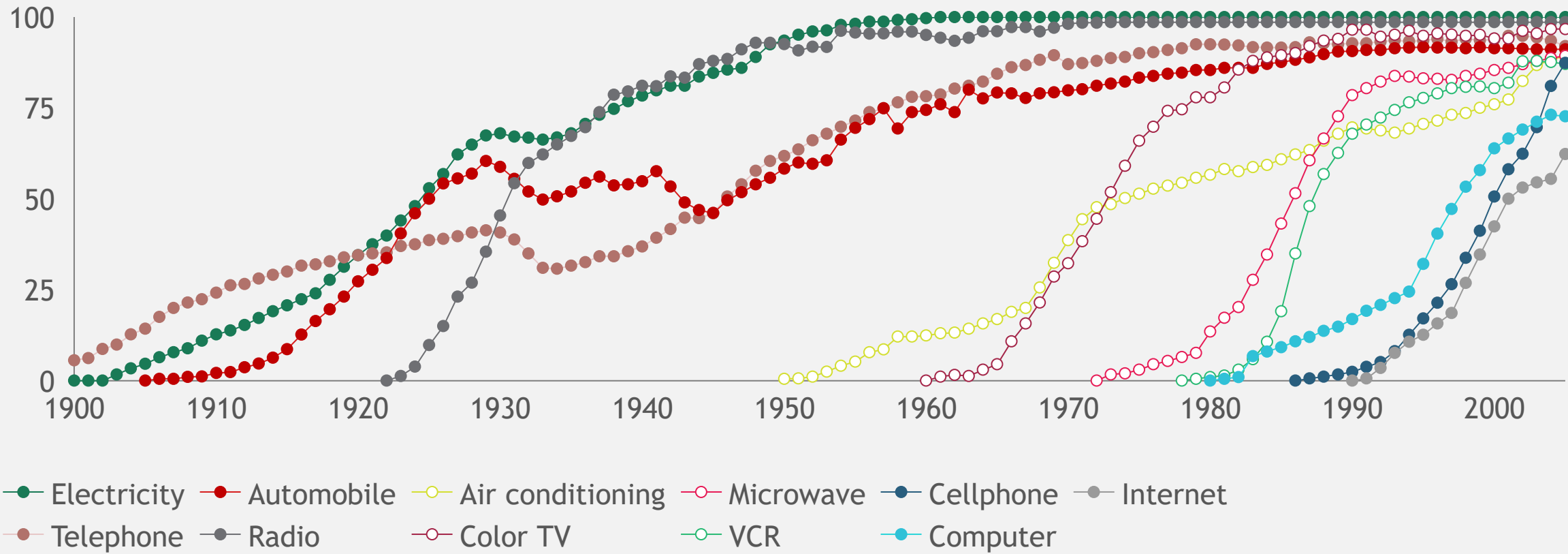
Prof. Dr. Ulrich Pidun

Three main phases of the product lifecycle



Product lifecycle times are shortening

Historical diffusion of technologies
[Percent of US Households]



Source: Wall Street Journal, BCG analysis

Commoditization changes the playing field

Commoditization



Increasing standardization

- Products perceived as interchangeable (neglecting brand value)
- Few parameters drive purchasing decision



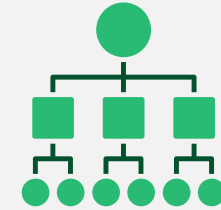
High price-elasticity

- Customers react strongly to price differences



Low switching costs

- Low actual costs
- Low perceived risk of switching

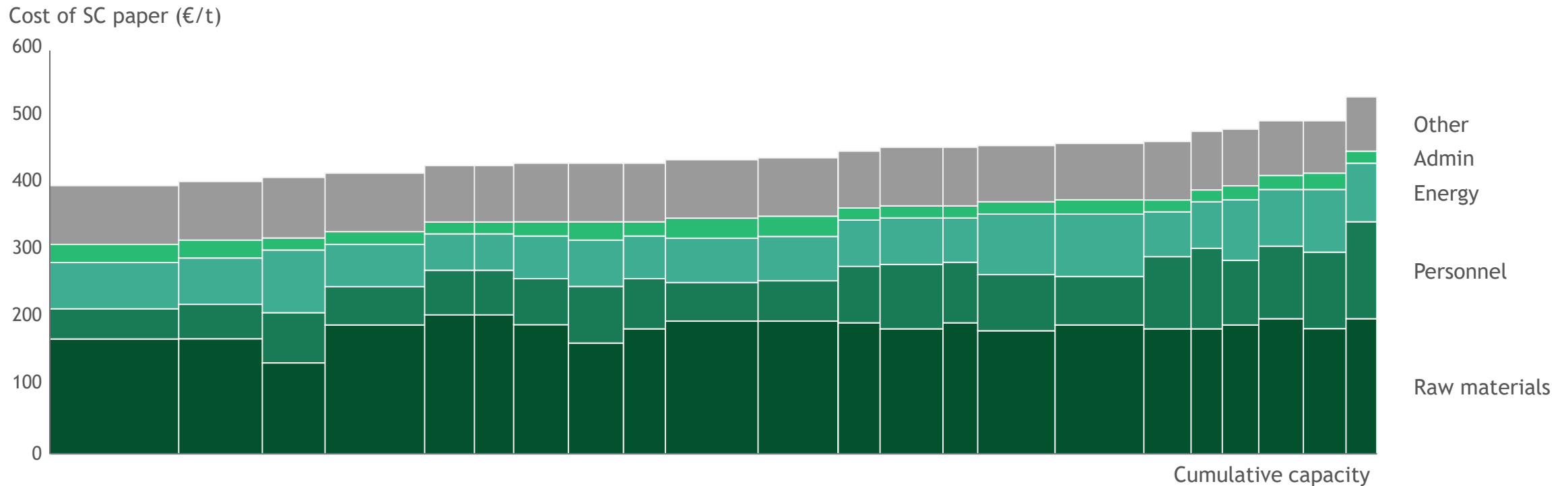


Competitive industry structure

- “Rule of 3 and 4” structure
- Established dominant business model

Intense competition will only leave efficient market players

Example: Paper industry



All players with fairly the same cost level

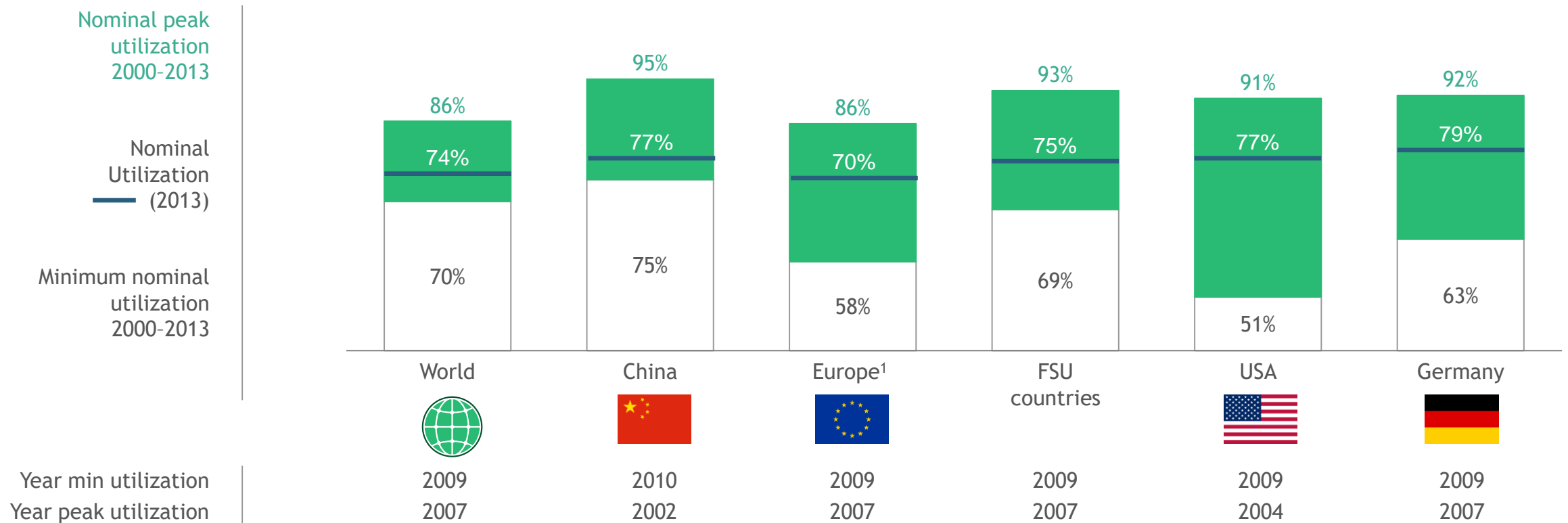
Inefficient players exit the market or become takeover candidates

Efficiency gains of the industry are passed on to customers

Note: European locations only. Cost excl. maintenance, depreciation, and interest payments
Source: EMGE; CEPI; BCG analysis

Barriers to exit may lead to persistent overcapacities

Example: Steel industry



Exit cost resulting from recultivation commitments, personnel reduction, etc.

High political pressure to retain existing structures

Temporary capacity reduction (mothballing) sometimes expensive and risky

1. Including Turkey

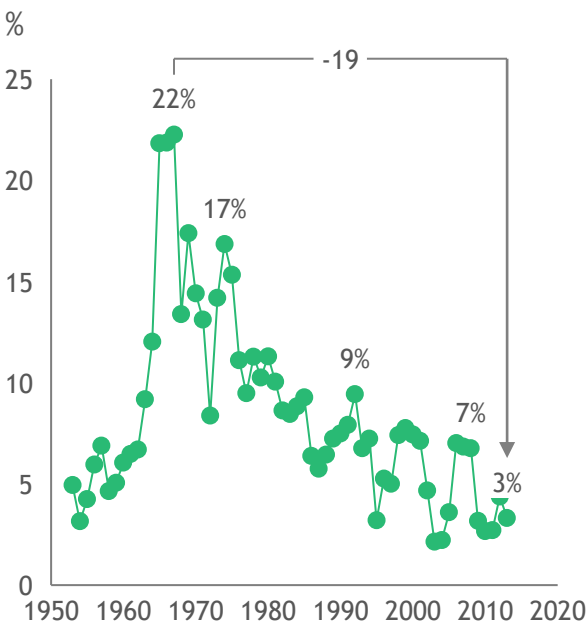
Source: BCG analysis, World Steel Association, Wirtschaftsvereinigung Stahl (German Steel Federation)

Commoditization has negative impact overall

Illustrative data from U.S. Retail Industry

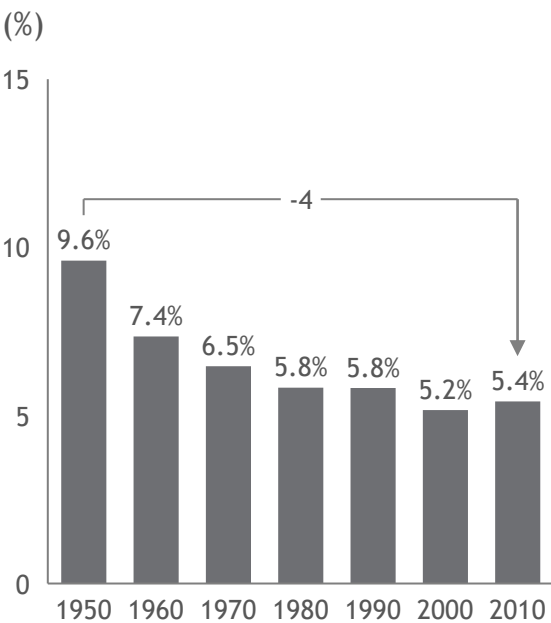
Slowing Growth

Growth in cumulative sales
(3-yr rolling average)

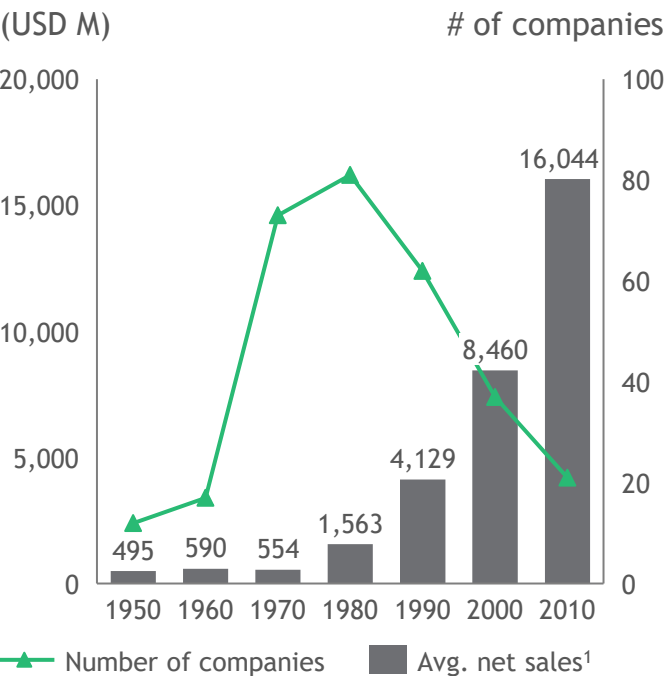


Lower Margins

Weighted average Industry EBIT margin¹



Industry Consolidation

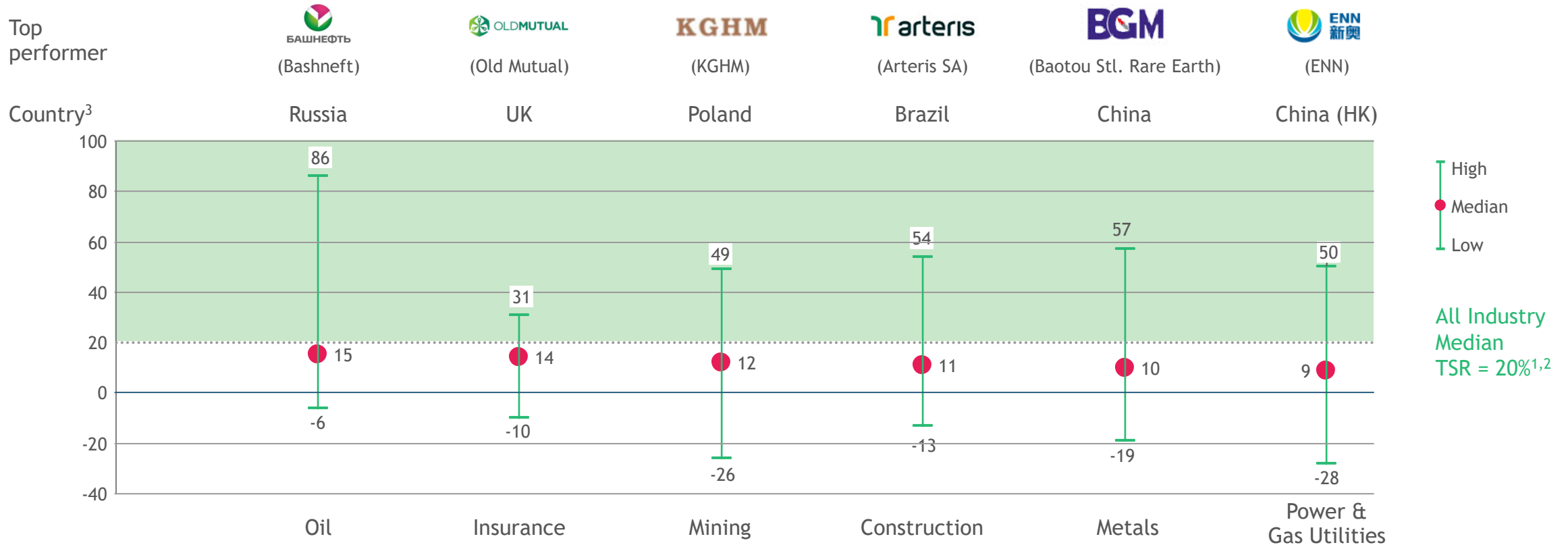


1.Excluded Wal-mart due to its big size compared with other companies
Source: Compustat company data for SIC = Retail, 1950-2013

But some players continue to flourish

Outsized returns available even in commoditizing industries

High, Median, and Low TSR in Commodity/Commoditizing industries (Annualized TSR, 2009-2013, %)¹



1. Annualized 5-year TSR from 2009-2013; 2. Including 1,620 global companies, which are the samples selected for BCG 2014 Value Creators Report; 3. Refers to the country of the primary stock exchange on which the company's shares are listed

Sources: Standard and Poor's Capital IQ ; company disclosures; BCG analysis

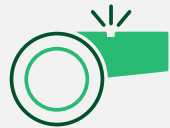
Three patterns of strategic behavior

Evasion



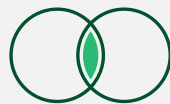
Changing the rules of the game

Hardball



Discipline through deterrence

Cooperation



Optimizing joint efforts

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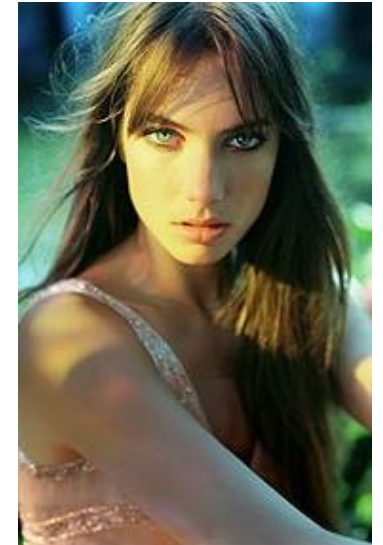
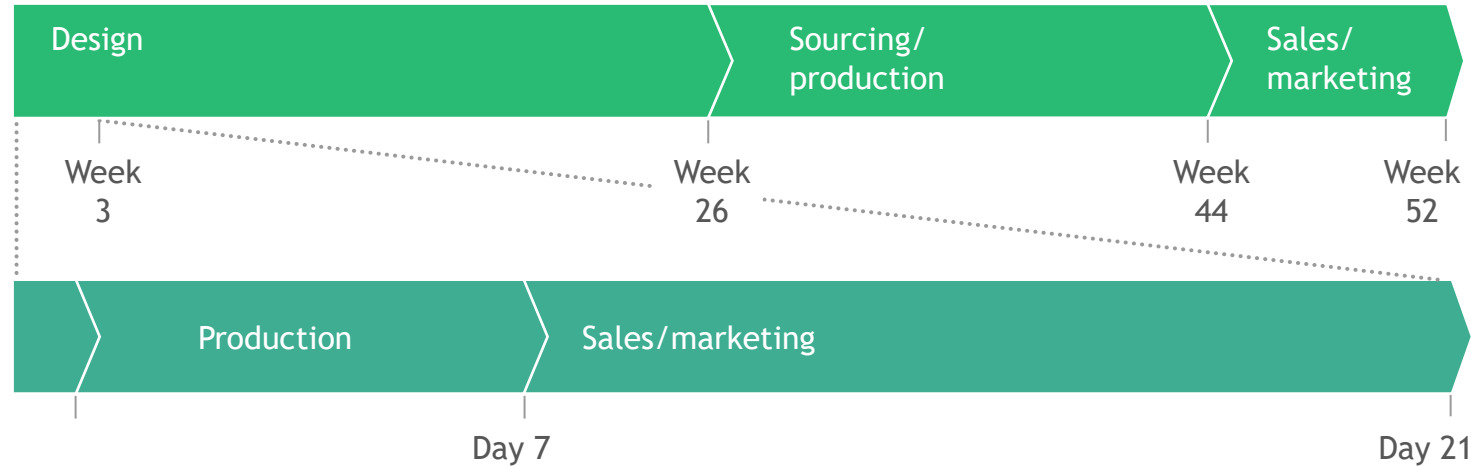


Flexibilization of the business model

Example: Zara



ZARA



Flexibilization based on ...

- 50% in-house production
- 90% of production in Europe
- Integration of IT and logistics from design through delivery



Success ...

- Design follower potential: Hardly any discounts
- Change of models at biweekly intervals: 20,000 items/year
- Outperforming the industry

Re-discovering the product: Commodity branding

Example: Starbucks



Howard Schultz

Coffee in the U.S. 1950-1990s

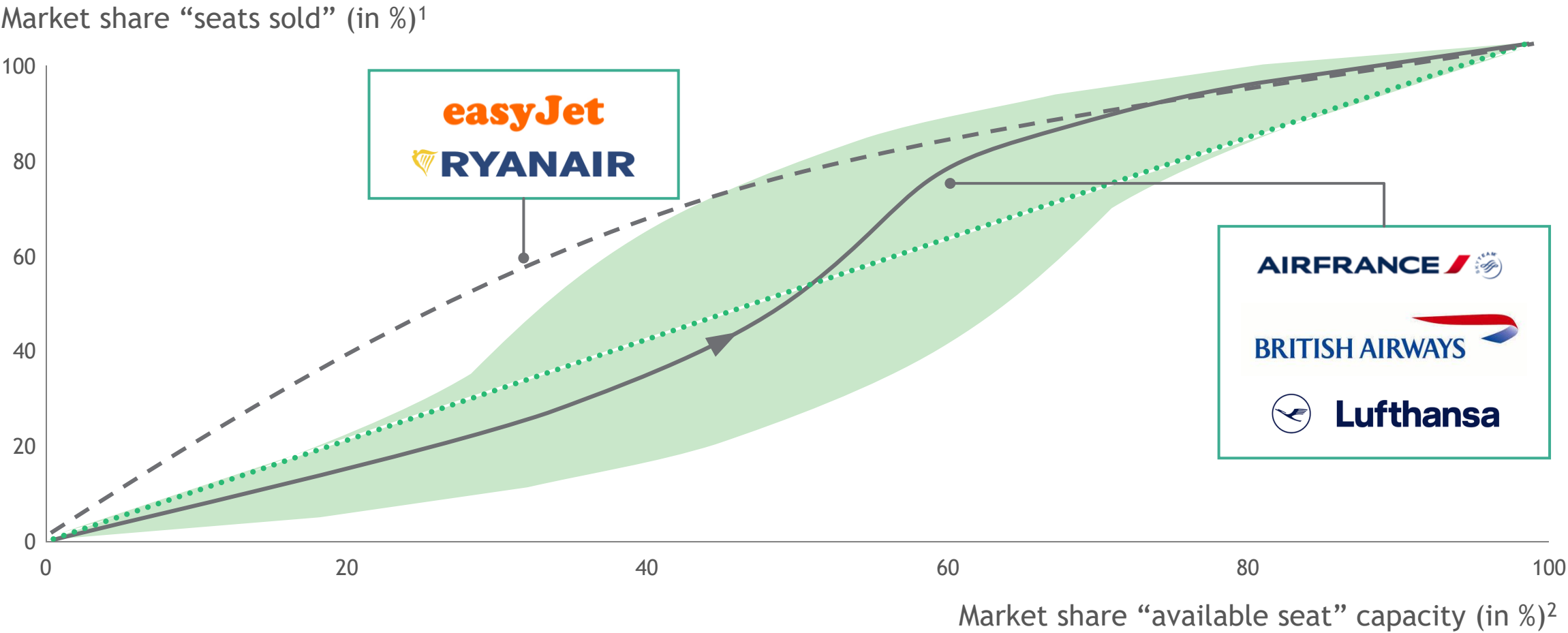


Coffee in the U.S. since 2000s

FRAPPUCCINO											
Blended Beverages											
CHOOSE YOUR MILK: Whole, 2% or Nonfat, Organic Soy milk +59¢				CALORIES: No Whip, Light (1/3 fewer calories)							
COFFEE: Decaf, Extra Coffee +49¢, Espresso Shot +79¢											
	TALL	GRANDE	VENTI		TALL	GRANDE	VENTI		TALL	GRANDE	VENTI
	16 oz.	24 oz.	32 oz.		16 oz.	24 oz.	32 oz.		16 oz.	24 oz.	32 oz.
Caramel [†]	4.29	4.99	5.49	CREME (COFFEE-FREE)	3.59	4.29	4.99				
Mocha [†]	4.29	4.99	5.49	Vanilla Bean	4.29	4.99	5.49				
Java Chip [†]	4.29	4.99	5.49	Strawberries & Crème	4.29	4.99	5.49				
Coffee [†]	3.59	4.29	4.99	Double Chocolate Chip	4.29	4.99	5.49				
White Chocolate Mocha [†]	4.29	4.99	5.49	Green Tea	4.29	4.99	5.49				
Mocha Light [†]	4.29	4.99	5.49								
SMOOTHIES											
Blended with a Whole Banana & Whey Protein (Contains Dairy)											
Chocolate, Orange Mango, or Strawberry 4.49											
ESPRESSO											
Blended with a Whole Banana & Whey Protein (Contains Dairy)											
	TALL	GRANDE	VENTI		TALL	GRANDE	VENTI		TALL	GRANDE	VENTI
	16 oz.	24 oz.	32 oz.		16 oz.	24 oz.	32 oz.		16 oz.	24 oz.	32 oz.
SIGNATURE	3.99	4.79	4.99	CLASSICS	3.69	3.99	4.39				
Caramel Macchiato [†]	3.99	4.79	4.99	Caffè Latte [†]	4.29	4.59	4.89				
White Chocolate Mocha	3.99	4.79	4.99	Iced Caffè Mocha [†]	3.99	4.79	5.29				
Cinnamon Dolce Latte [†]	3.99	4.79	4.99	Vanilla Latte [†]	4.29	4.59	4.89				
				Skinny Vanilla Latte [†]	4.29	4.59	4.89				
Espresso	2.99	3.99		Caffè Americano	2.49	2.79	3.29				
				Cappuccino [†]	3.69	3.99	4.39				
MAKE IT YOURS											
"TRY IT SKINNY": Nonfat Milk, Sugar-Free Syrup, No Whip											
FLAVOR: +49¢ Vanilla, Hazelnut, Caramel or Peppermint											
STARBUCKS REFRESHERS [™]											
Iced Beverages											
	TALL	GRANDE	VENTI		TALL	GRANDE	VENTI		TALL	GRANDE	VENTI
	16 oz.	24 oz.	32 oz.		16 oz.	24 oz.	32 oz.		16 oz.	24 oz.	32 oz.
Cool Lime	3.29	3.79	4.29								
Very Berry Hibiscus	3.29	3.79	4.29								
ICED COFFEE & ICED TAZO [®] TEA											
	TALL	GRANDE	VENTI		TALL	GRANDE	VENTI		TALL	GRANDE	VENTI
	16 oz.	24 oz.	32 oz.		16 oz.	24 oz.	32 oz.		16 oz.	24 oz.	32 oz.
Iced Coffee	2.19	2.59	2.99		Full-Leaf Tazo [®] Tea	2.29	2.49	2.79			
Iced Coffee with Milk	2.19	2.59	2.99		Hot Chocolate	2.99	3.39	3.69			
Shaken Iced Tazo [®] Tea	1.99	2.49	2.99		Kids' Hot Chocolate (12 and under)	2.89	3.19				
Iced Tazo [®] Tea Lemonade	2.99	3.49	3.99								
COFFEE, TAZO [®] TEA & MORE											
	TALL	GRANDE	VENTI		TALL	GRANDE	VENTI		TALL	GRANDE	VENTI
	16 oz.	24 oz.	32 oz.		16 oz.	24 oz.	32 oz.		16 oz.	24 oz.	32 oz.
Freshly Brewed Coffee Bag or Decaf	1.99	2.19	2.49								
Caffè Misto	1.99	2.19	2.49								
Tazo [®] Chai Tea Latte	3.49	4.29	4.49								

Changing paradigms

Example: Low-cost carriers



1. Revenue share of Pax kilometers (RPK) 2. Share of available seat kilometers (ASK)
Source: BCG project experience



It's difficult for incumbents to change the rules of the game

ZARA

Zara created a locally integrated business model, violating the industry's success patterns

- Production in Europe—not in Asia
- Hardly any discounts—no frequent “sale”
- Rapid imitation instead of innovation



Branding and trading-up of a commodity category
Strategy difficult to pursue by incumbents

- Change of image would lack credibility
- Willingness to “destroy” own customer base

easyJet

 **RYANAIR**

Low-cost carriers have changed the industry's paradigms
Incumbents' response restricted by “legacy assets”

- Structure of airline's fleet
- Hub-and-spokes model



But: Incumbents can also innovate business models

Example: Progressive Car Insurance

PROGRESSIVE

Starting point

Top-10 US insurance company

- 4th largest player in fragmented auto market (8% share)

Increasing commoditization of auto insurance marketplace

- Competing on prices with undifferentiated risk measurements

Strategic actions

Introduced in 2011

Snapshot
Discount

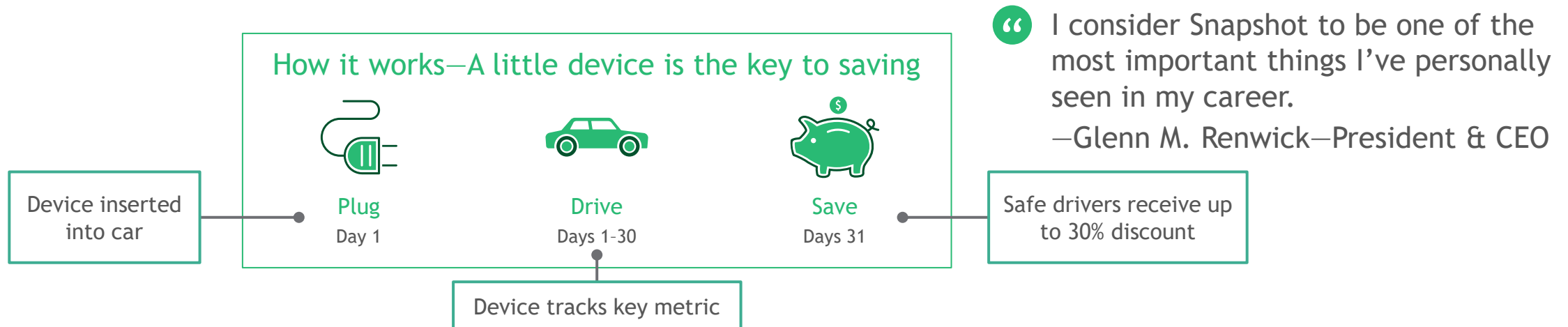
- Capability to optimize pricing via real-time driving data

Enabled more accurate customer segmentation in order to tailor discounts

Results

Improvement on all major metrics

- Increased sales volumes
- Improved retention
- Improved loss ratio of customer base



Three patterns of strategic behavior

Evasion



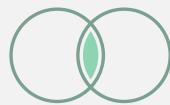
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Hardball



Discipline through deterrence

Cooperation



Optimizing joint efforts



Deterrence by commitment to fighting

The conquest of Mexico by Spain in 1519

Cortés (Spanish conqueror)



Starting situation

- Landing with 500 soldiers and some hundreds of Indians
- Horses and cannons

Cortés ordered that all ships be burnt (except one), which made retreat impossible and served as a signal to Moctezuma that resistance would lead to fighting, not retreat

Moctezuma II (Aztec sovereign ruler)



Starting situation

- Over 200,000 soldiers
- Very good knowledge of the area

Moctezuma decided not to fight, but to provide Cortés and the Spanish Crown with huge amounts of gold every year



Deterrence by credible commitment

Boeing versus Airbus in the race for the super-jumbo

Illustrative profit and loss matrix



Market entry¹

No market entry
despite
marketing effort

<div data-bbox="1108 449 1426 771"> <p>\$5 bn</p> <p>\$0 bn</p> </div>	<div data-bbox="1439 449 1758 771"> <p>-\$2 bn</p> <p>-\$1 bn</p> </div>
<div data-bbox="1108 778 1426 1099"> <p>-\$3 bn</p> <p>\$0 bn</p> </div>	<div data-bbox="1439 778 1758 1099"> <p>-\$3 bn</p> <p>\$10 bn</p> </div>

No market entry

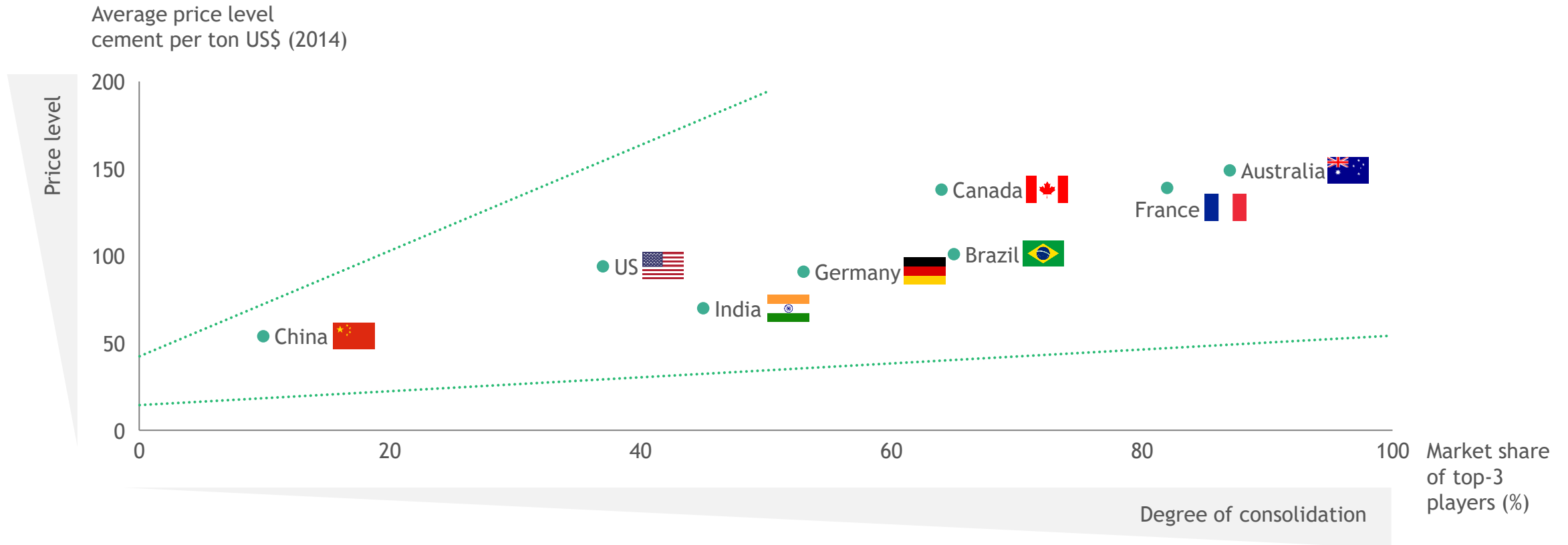
Market entry



1. Airbus' development cost is higher
Source: BCG analysis



Cement: Higher price levels in more consolidated markets



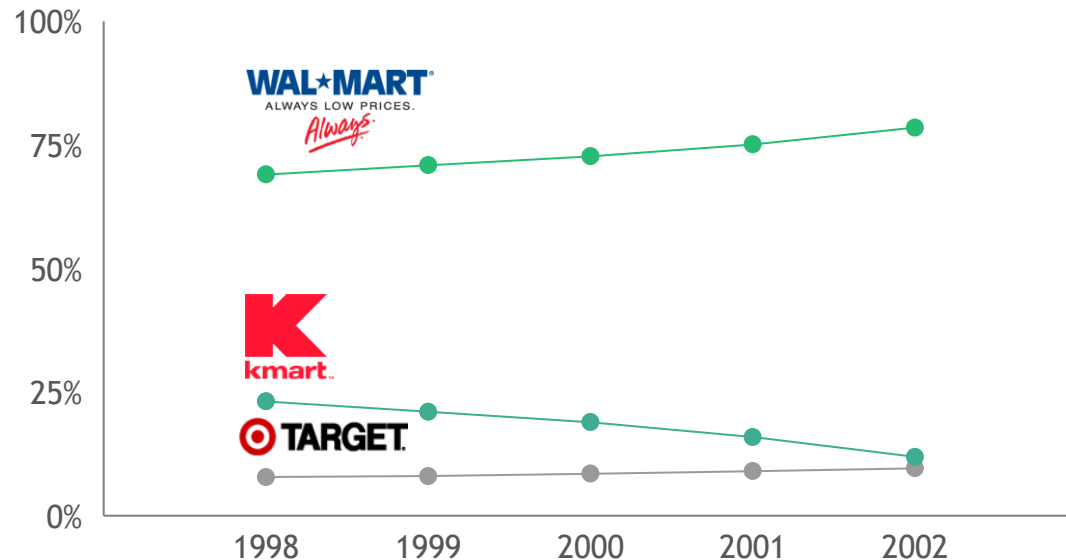
➤ Few market players will be more successful at keeping each other at bay



Wal-Mart as aggressive market leader

Wal-Mart punishes K-Mart's "last try"

Market shares Discount
Grocery USA¹



“ Lowering prices on 15,000 items to constant “BlueLight Always” prices is the same as everyday low pricing (EDLP)
DSN Retailing Today (Juli 2001)

“ Kmart Chapter 11—no blue-light special,
..., was the largest retail bankruptcy in U.S. history
BS (September 2003)

“ Gross margin benefited. ... from eliminating
K-Mart as price competitor
UBS (September)

In the 1990s, K-Mart tried to build a position on the basis of differentiation

In 2001, attempt to fight Wal-Mart with low prices

Wal-Mart fights back and in 2002 drives K-Mart into bankruptcy²

1. Other segments of the total “grocery” market include “hard discount” (e.g., ALDI) and “traditional grocery” (e.g., Safeway)

2. Under pressure from the two major shareholders (hedge funds), K-Mart has left the protection of Chapter 11 behind in May 2003

Source: Broker Reports; press; U.S. Department of Commerce; BCG analysis



Aggressive strategies can be successful, but include high risks



Credible
commitment

Clear and firm commitment due to significant financial consequences

Competitor is “forced” to adopt a specific strategy



Keeping each
other at bay

Competitors meet in the market, sometimes with different relative strengths

The major players thus have possibilities to effectively impose sanctions



Destroying
competitors

Power struggle on the basis of prices or capacities with the aim of displacing competitors

Clarity about the opponents’ staying power and/or limits

Three patterns of strategic behavior

Evasion



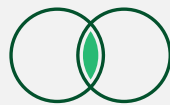
Changing the rules of the game

Hardball



Discipline through deterrence

Cooperation



Optimizing joint efforts

Cooperation: Optimization joint efforts

Titmice and nuthatches join forces in winter



Titmouse



- With sufficient nourishment available in summer
- Titmice and nuthatches form separate flocks
 - Competing for the best sources of nourishment

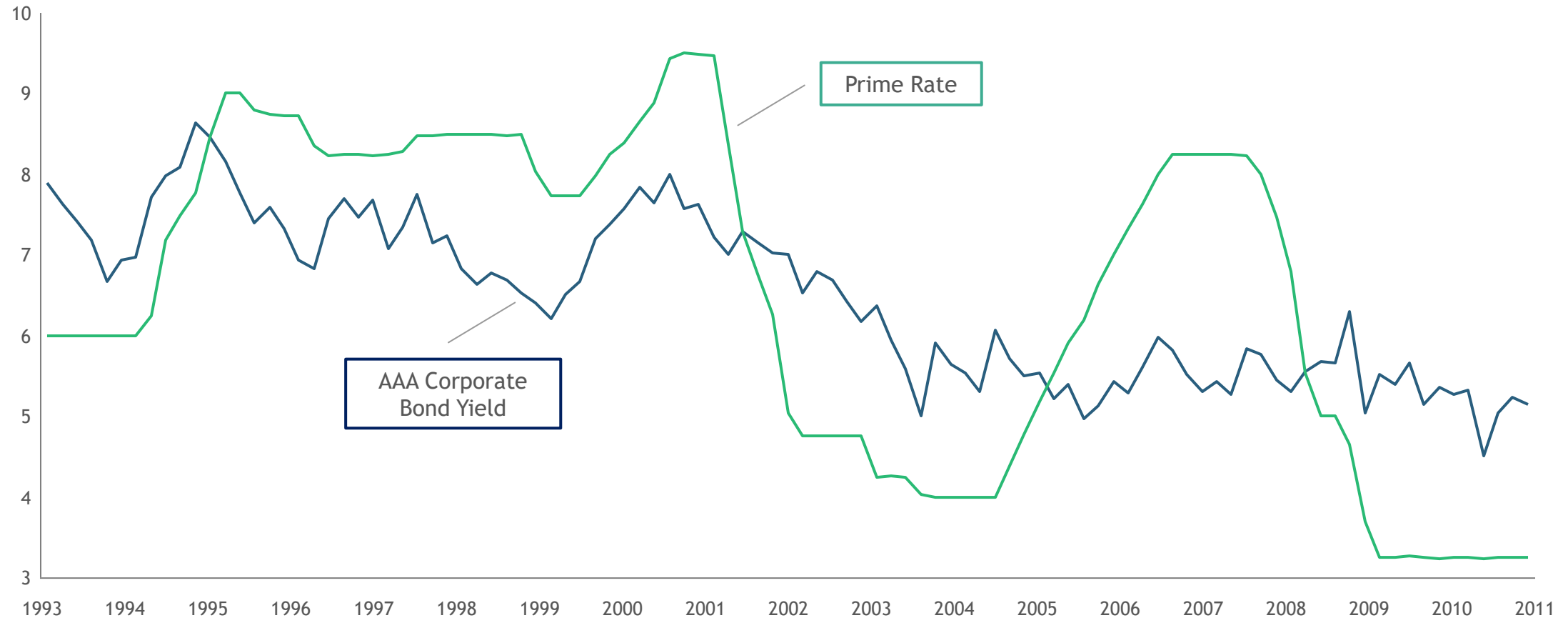
- When nourishment gets scarce in winter
- Titmice and nuthatches flock together in search of nourishment and to keep off predators



Nuthatch

Under difficult environment conditions, cooperation may prove to be better than aggressive competition

Intense competition in the U.S. commercial lending market?



Price changes are related to substantial changes in the money market

All banks adjust their prime rates within a few days

Major commercial banks assume the role of price leader one after the other

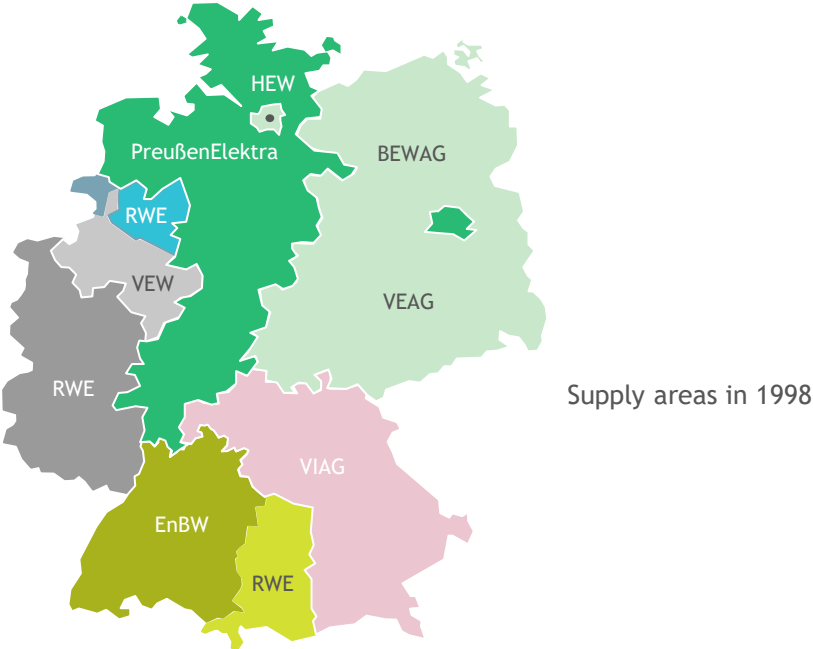
Price war in the German electricity market upon deregulation



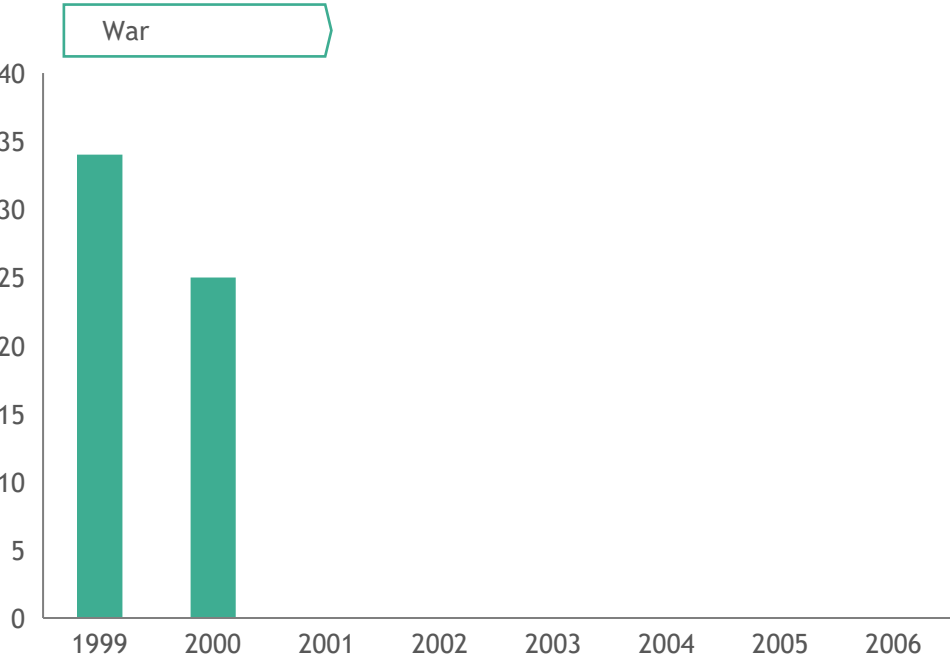
Falling prices in all segments—incumbents losing market share
Established players' responses include marketing, reorganization, and M&A

Market consolidation after deregulation (I)

Utilities “rule” via grid coverage

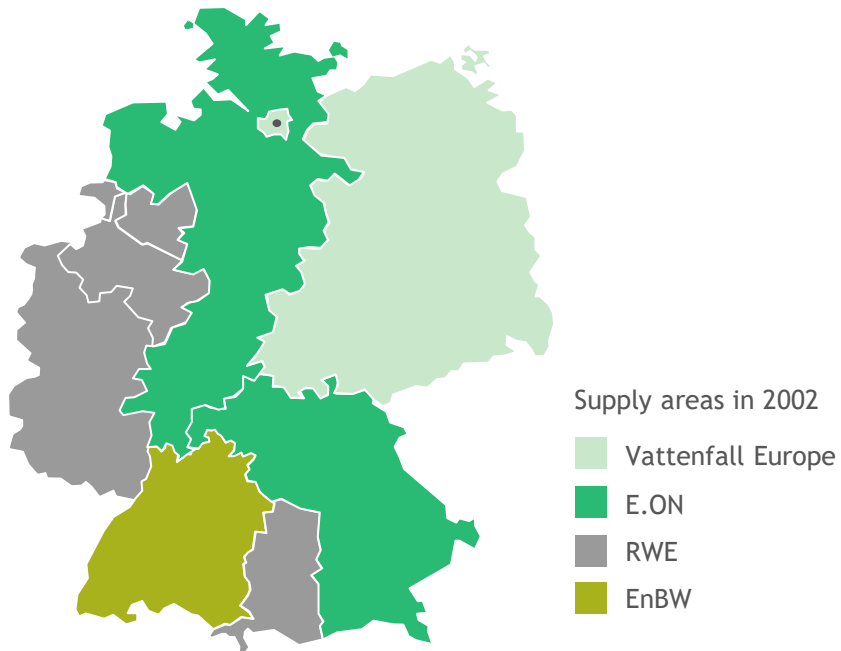


Development of power prices
(€ per month and household at 3,600 kWh/a)

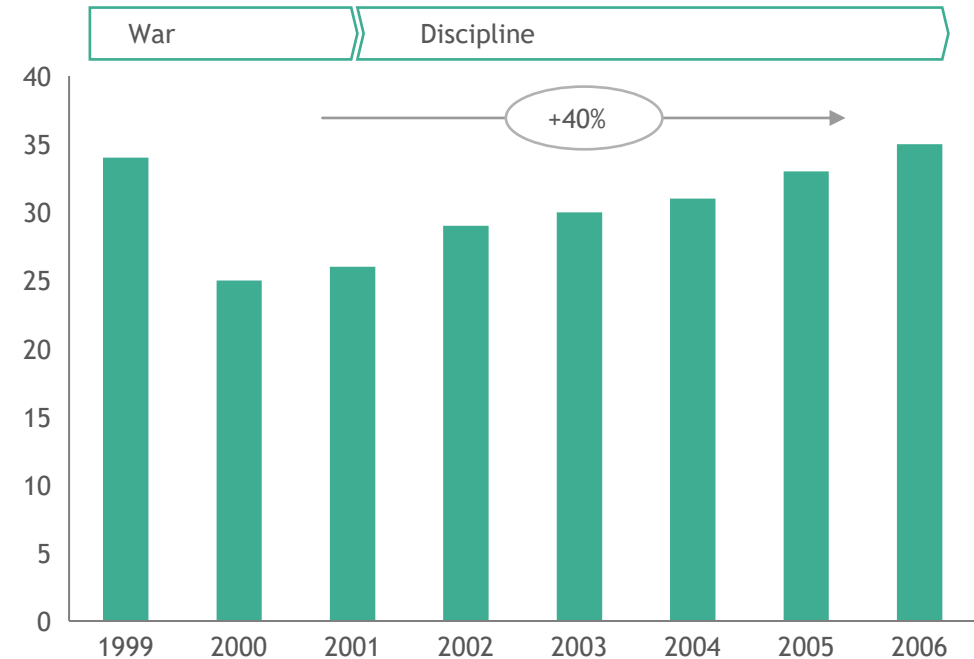


Market consolidation after deregulation (II)

Utilities “rule” via grid coverage



Development of power prices
(€ per month and household at 3,600 kWh/a)



Significant increase in prices since 2000 as a result of the disciplined approach of incumbents

New players with low market shares or quickly exiting the market

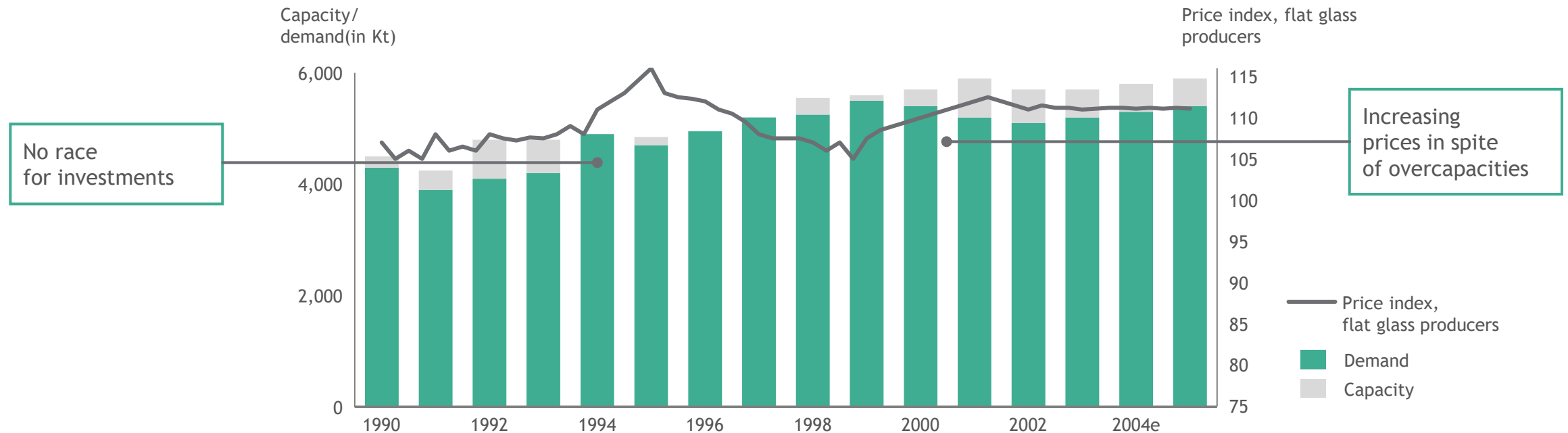
Transmission fees to “support discipline”

Source: VDEW Jan. 2003, BCG analysis

A case of nerves in the glass industry?

Sustainable capacity policy will stabilize prices

Development of capacity, demand, and prices of flat glass, Nafta 1990-2005e



High growth in the 1990s was not supported by high investments

No overreaction to decreasing demand since 1999, but capacity reductions¹

Some new capacity is realized within the framework of joint-venture models²

1. Pilkington closed down two lines, Ford one captive line 2. Joint venture of AFG/Asahi (No. 2) and Vitro (No. 5) in Mexico

Note: High minimum investments (€100-150M for a running time of 10-15 years). Break-even utilization at 60%-70%

Source: Pilkington; JPMorgan Europe Equity Research; BCG analysis

Strategies of cooperation can be very attractive, if they work (and are legal!)



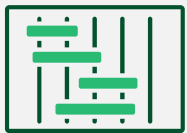
Harmonious pricing

Consistency of pricing for several periods
Activities and deviations easy to observe
Tolerating occasional pricing deviations of competitors



Acceptance of turfs

Complementary attractiveness of segments
Cooperation benefits over several periods
Credible retreat of the player giving the signal



Sustainable capacity management

Orientation of capacity planning at long-term trend
Capacity adjustment in weak phases, rather than price wars
Stability highly dependent on large players' "strong nerves"