

## STRATEGIC OPTIONS OF THE LOW-COST COMPANIES

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### Abstract

The market of the low-cost companies includes those firms, national or multinational, that offer goods and services at low prices. The implementation of the price strategy, which is based on various methods of cutting costs, is favourably influenced by the existence of some factors that act not only inside but also outside a firm. Among these factors there are, on one side, the level of costs, of the profits, the returns on investments, the terms of payments, the ability of using the resources, the competitiveness of the products, their added value and, on the other side, the existence of some substitutes for products, the competitive pressure and the consumers' needs and wishes. In order to explain all these factors and to emphasize the way in which they generate competitive advantages to the low-cost firms, we made a large analysis and synthesis of the approaches existent in the specialized literature. The proposed theme also required some mathematic equations, whose interpretation justifies the essential role played by costs inside the price strategy.

**Key words:** low-cost companies, price strategy, cutting costs method, competitive advantage

**JEL Classification:** E64, P22, D24, D61

### INTRODUCTION

The purpose of the present paper is to underline the competitive advantage of the low-cost firms, resulting from the implementation of the price strategy, and to identify the factors that determine the low price, putting a particular accent on the costs of production. These objectives required not only an analysis and a synthesis of the approaches existent in the specialized literature, but also a personal interpretation of some mathematic equations, relevant for the present study. Before debating the main problems, it is necessary to give an explanation and to illustrate the concept of *low-cost company*.

The market of *the low-cost companies* includes those firms, national or multinational, that offer goods or services at low prices. In order to promote the smallest prices, these companies are using various methods of cutting costs. A special category of low-cost firms is constituted by those that sell private label goods - products made by a firm but sold under the name of another company.

A clear image about the market of the low-cost companies could be obtained by analyzing the specialized literature related to this subject. For example, Rigsby and Greco (2003) talk about the market of the low-cost companies when they present the strategy used by firms such as Wal-Mart, Ikea, Best Buy or Southwest Airlines, which could be explained with the help of the notion "low-cost provider" [...]. "As a low-cost provider, they must dominate share per market, and in order to do that, they would drive down their costs at every opportunity [...]". "They do not sacrifice quality, but emphasize best price", their philosophy being "Every Day Low Price" (1). Consequently, by offering goods and services at low costs, these firms shape the market of the low-cost companies.

Schnaars (1998) mentions "the market of the low-cost sellers", referring especially to electronics producers (Packard-Bell or Emerson) that, in order to have low prices, are using various strategies: they make standardized products, spending less "on R&D and advertising than differentiators" and they are "market followers, allowing others to innovate new product ideas, which they can imitate and produce in large volumes at very low costs" [...]. "In services, Southwest Airlines, and some of the more recent upstarts, follow a similar low-cost, low-price approach"(2).

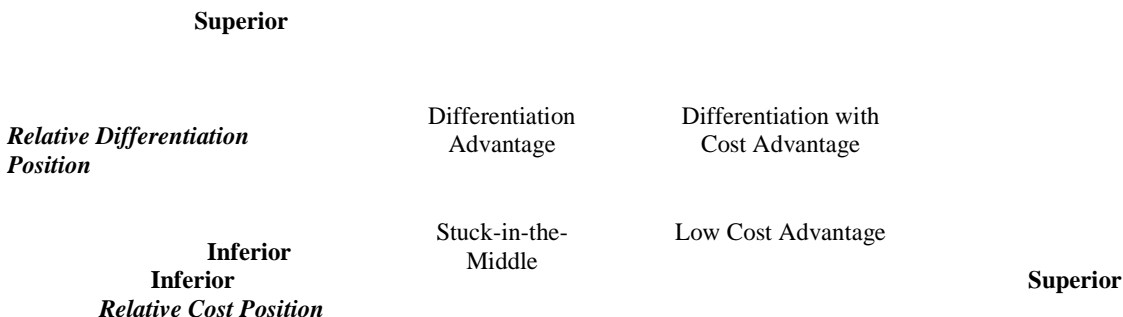
Analyzing the airlines, Calder (2003) offers a generous explanation to the market of the low-cost companies. He argues that these firms offer services at low prices not only because they are cutting costs, but also because they are forcing the passengers that want a superior comfort to make an extra payment (for example, any drink or food has a price and, moreover, in the case of some

airlines – such as Wizzair – it has to be paid an additional tax for the cabin luggage, no matter what is their weight).

### THE LOW-COST FIRMS AND THE COMPETITIVE ADVANTAGE OF THE LOW PRICES

The development of a business strategy depends on two interdependent aspects: on the mission and goals of the firms, on one hand, and on the ways that companies have chosen to act in order to reach their purposes, on the other hand. This choice depends on the competitive advantage of each firm. Related to this, Treacy and Wiersema (1995) mentioned three directions of competitive advantage. The first one is at the low-cost companies, defined by the authors as those firms that are focusing on the cost control, offering goods and services of a certain quality at the lowest prices. The second source of the competitive advantage is held by the innovator or production leader that, having a strong brand, may fix a price level which exceeds the limit imposed by the market. The last type of competitive advantage could be found in the case of the services leader that has this position due to its personalized services, with a superior quality. Each of these three sources of competitive advantage is pointing out a particular segment of the demand: the first one shows an elastic demand for the low prices, the other two stressing an inelastic demand for the products with a high level of innovation and, respectively, for the personalized services. The elasticity problem is also debated by Engelson (1995), which underlines the fact that a less elastic market would require a higher price.

It has also to be mentioned Porter's approach (1998) that proposed two generic models through which firms can develop long term competitive advantages ( **Figure no. 1**). The first of these strategies is based on having prices lower than the competitors due to lower costs. Gaining a cost leader position may be possible through scale economies in production, through the effects of the experience curve, through a tight cost control and also through a costs' minimization in fields such as research and development, services and advertising (3). The second strategy proposed by Porter consists in differentiating the products offered by a firm, by creating "unique" goods. In fact, this strategy coincides with the second source of the competitive advantage mentioned by Treacy and Wiersema (1995) because the differentiation is based on the customers' loyalty for a certain brand, on offering high quality services, on a last minute technology or on a unique design of a product.



**Figure no. 1 Developing competitive advantages**

**Source:** Shank, J.K., Govindarajan, V., „Strategic Cost Management and the Value Chain”, *Journal of Cost Management*, vol. 5, no. 4, 1992, p. 12

Analyzing the sources of the competitive advantage, it could be easily observed the fact that a firm's success may consists either in its reputation and differentiation of the products, which could be sold at a higher price, or in its low prices, with a good relation between price and quality.

Consequently, a producer that neither differentiates from the others, nor is cheaper, will be quickly eliminated from the market.

The low-cost firms' strategy of cutting costs and promoting the lowest possible price in order to eliminate the competitors has been largely implemented since the '70s, also due to the fact that the firms were acquainted with the "experience curve" concept. Nowadays, the low-cost companies are met in any field. For example, in the en-detail sales sector firms such as Wal-Mart, K-Mart or Toys 'R' Us are efficient operators that have prices that discourage the competitors. They promote a tough policy with suppliers, resulting gains that are translated in the low prices. In IT field, Packard-Bell or Emerson make standardized goods, available at a price much lower than the average level of the market. This is possible due to the fact that they are spending a small amount for the R&D and advertising compared to other firms that promote a differentiation strategy. Moreover, such as many other low-cost companies, they are products' imitators, allowing other firms innovate new goods that they will imitate with a very low cost, in huge quantities. The low price strategy is also used successfully by firms that act in the apparel and accessories industry. It is the case of Briggs & Stratton that already has 50% of the global market of gas engines, of Lincoln Electric's, which produces and sells welding equipments all over the world, and of other organizations such as Emerson Electric, Texas Instruments or Du Pont that also promotes prices that discourage the competitors (4). In the case of services, the airlines such as Southwest, Jet Blue, Blue Air etc., adopt a similar attitude of cutting costs that leads to low prices and to the elimination of the competitors.

The low price strategy may even revolutionize a whole industry in which the base of the competition had been established in another manner and from this reason the competitors are not economically and psychically prepared to make the necessary steps in order to minimize the costs. It was the case of Harnischfeger that tried to revolutionize the industrial equipments sector in 1979. Having at the beginning a market share of only 15%, Harnischfeger reconceived its industrial equipment so that they could be easily produced, by using a smaller number of modularized parts. Moreover, the firm demanded larger quantities from the parts of the industrial equipment in order to cut its costs. The result consisted in offering products with an acceptable quality and a price 15% lower than the initial one, fact that allowed an increase of the company's market share at 35%.

It is noticeable that gaining a low-cost position often requires a high market share and also some advantages such as having favorable access to the raw materials, drawing up products that could be easily made, maintaining a large range of correlated products in order to divide the costs and serving the main types of clients for having a higher level of sales. The implementation of a low-cost strategy also requires substantial capital investments in equipments, an aggressive price policy and the acceptance of some initial losses due to the need of having the largest market share. On its turn, the high market share will generate economies when doing the acquisitions, fact that will lead to a greater cost reduction. Consequently, the position of low-cost company will ensure high profits that have to be reinvested in new equipments and facilities so that the firm can maintain its cost supremacy.

Schnaars (1998) identifies two types of low-cost firms: those that usually gain lower profits than the companies that offer differentiated products, but have a larger market share which allows cutting costs and prices – they are called market leaders – and firms that are looking for the highest profits. These last ones have a smaller market share, although their products are often differentiated, but their profit rates are greater. It is the case of the private labels that practice lower prices than the traditional producers. Yet, as Porter (1998) remarked, in both case of the low-cost companies the profits are above the average level of the market because the cost position gives firms a defensive attitude towards the competitors. The position of the low-cost firms ensures them protection against powerful buyers because they can exercise their strength only to reduce the prices of the next competitor. The low-cost firms are also protected against powerful suppliers by having a larger flexibility in surpassing the inputs' costs increase. The factors that generate a low-cost position usually give the possibility to the firms of setting some barriers against other companies, in terms of scale economies or cost advantage. Consequently, the low-cost position protects firms against all

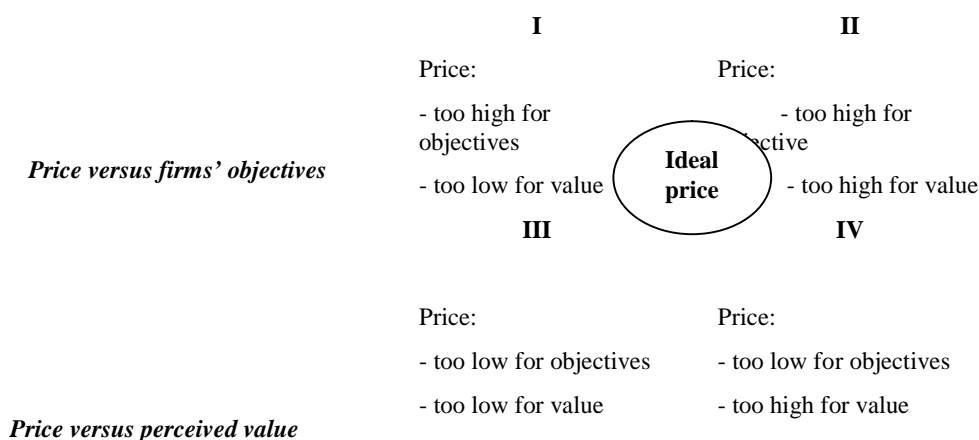
the three competitive forces of the market because the development of their business will continue to erode the profits not only of the most efficient competitors but also of the less efficient ones, because they are the first affected by the competitive pressure.

Analyzing the competitive advantage of the low-cost companies, which results from the possibility of cutting prices, D. Bosshart (2007) talks about “an era of cheap services and products”. In the context of this era, the message send to the consumers is to increase the demand for a smaller amount of money. Bosshart notices that what nowadays consumers want are the low prices which actually constitute the powerful force of globalization.

## DETERMINANTS IN CHOOSING THE PRICE STRATEGY

“More important than setting a price is the reason you choose it” (5). Therefore, in order to analyze the methods used by the low-cost firms when implementing the cutting price strategy, it is necessary, first of all, to identify the factors with a great impact on the level of price. Among the elements that influence the price decision, Baker (2006) identifies the level of costs, of the profits, the returns on investments, the terms of payments, the ability of using the resources, the competitiveness of the products, the existence of some substitutes for products, the consumers' needs and wishes. On the contrary, Shank and Govindarajan (1993a) consider that the price is the result of the interaction among three factors: the production cost, the added value and the competitive pressure.

Indeed, the price of a good or service has to reflect a correlation between the production cost and the value perceived by consumers. This value is influenced, on its turn, by the consumers' wishes and needs from a certain moment, by the products' performances expressed through quality, speed, reliability, durability etc., by firms' performances (brand name, financial records, distribution channels etc.), by the ratio price-quality of the products promoted by competitors and also by the reputation of the rival firms (6). Engelson (1995) argues that we can talk about a "price gap" when the price of goods and services differs from the price perceived to be ideal either by the clients, or by the firm, aspect shown in the figure 2. The center of the matrix from the figure 2 points out the ideal price, any other position reflecting a price gap. While the first quarter shows the fact that the price is too high for the objectives settled by the firm and too low compared to the value perceived by consumers, the second quarter reflects a price too high not only for the objectives of the firm but also for the perceived value. In the third quarter the price is too low compared to the perceived value and to the firms' objectives and in the IV<sup>th</sup> quarter the price is too low for the ideal one, established by the firm, and for the value of the products.



**Figure no. 2 Price gap matrix**

**Source:** Engelson, M., *Pricing Strategy – An Interdisciplinary Approach*, Joint Management Strategy, USA, 1995, p.26

Nagle and Hogan (2006), analyzing the price determinants, distinguish two types of price strategies, based on costs and on the value perceived by consumers, according to the following figures:

Product    Cost    Price    Value    Customers

**Figure no. 0** *Cost-Based Pricing Strategy*

Customers    Value    Price    Cost    Product

**Figure no. 4** *Value-Based Pricing Strategy*

**Source:** Nagle, Th. T., Hogan, J., *The Strategy and Tactics of Pricing: A Guide to Growing More Profitably*, 4<sup>th</sup> edition, Prentice Hall, 2006, p. 4

The production costs seem to be closely related to the output level: on short term the average costs are decreasing while the volume increases, the other factors remaining constant. Yet, there are cases when the average costs go up when the level of production increases (this situation was met in the case of Kodak between 1950 and 1980). In order to determine exactly the factors that influence the level of costs, it is necessary to include them into a mathematic approach. So, Shank and Govindarajan (1993a) see the costs as a function that depends on a range of factors that are permanently interacting one with the other, according to the relationship:

$$\text{Cost} = \text{Factor A} \times \text{Factor B} \times \text{Factor C} \times \dots \quad (1)$$

It has to be mentioned that not all the factors have the same relevance. Their importance may be reflected in an exponential weighting of each factor in the cost equation:

$$\text{Cost} = A^a \times B^b \times C^c \times \dots, \quad (2)$$

where  $a$ ,  $b$  and  $c$  are the level of the exponent for each factor, pointing out its importance in the total cost.

Assuming that there are only two factors,  $A$  and  $B$ , then the equation (2) may take the form of a standard multiple regression equation:

$$\log \text{Cost} = a \log A + b \log B. \quad (3)$$

This form allows the cost equation to be estimated from a series of observations of each of the four explanatory factors and of actual cost over some time period.

Considering these three equations, Shank and Govindarajan (1993b) try to determine the change in the global unitary cost if one of the two factors doubles. So, if the global cost is  $CT$ , it can be represented as:

$$CT = A^a \times B^b. \quad (4)$$

If  $A$  doubles, then the equation (4) becomes:

$$CT' = (2A)^a \times B^b, \quad (5) \quad \text{meaning:}$$

$$CT' = 2^a \times A^a \times B^b, \quad \text{resulting that:}$$

$$CT' = 2^a \times CT. \quad (6)$$

Consequently,

$$CT_{\text{final}} / CT_{\text{initial}} = 2^a. \quad (7)$$

According to the equation (7), the percent change in total cost when  $A$  doubles is given by raising the number 2 to the  $a$  exponent,  $a$  being the exponent of the  $A$  factor from the regression equation. The change in the total cost is given by the value  $(1 - 2^a)$ , expressed as a percentage.

In the case of some factors such as the scale or the experience, for which a greater quantity leads to a lower cost, the value of the  $2^a$  will lie between 0,5 and 0,99. The interpretation given by Shank and Govindarajan (1993a) to this result consists in the fact that when doubling any factor that reduces the total cost, the average cost will go down, but will not go below of the half of the initial value. Consequently, the unitary cost will diminish up to the moment when it has, at most, half of the initial value.

Riley (1987), analyzing the determinants of the cost, classifies them in two large categories: "structural determinants and execution determinants" (7). The category of the execution determinants includes those factors that are correlated to the ability of a firm to do successfully any activity. Consequently, these determinants play an important role in measuring the performance of a company.

From the structural determinants' perspective, a firm has the possibility to choose at least five strategic solutions, according to its economic structure that influences the cost position for each product category (8):

- Scale economies: according to which it is established the level of investments in R&D, in production and in marketing resources;
- Scope economies: that are closely correlated to the degree of vertical integration;
- Experience: resulted from the previous activities;
- Complexity: that reflects the amplitude of a range of products or services;
- Technology: according to which it is established the type of the technological process for each of the stage from the firm's value chain.

In each firm, the analysis of the value chain is a method used to divide the chain in relevant activities in order to better understand the costs behavior. Once identified the value chain and diagnosed the determinants of the cost for each activity, the firm can obtain a competitive advantage by the help of one of the two methods proposed by Shank and Govindarajan (1992):

- A deeper control of the cost determinants than the control made by the competitors;
- Reconfiguration of the value chain.

Considering all these remarks, it can be concluded that the first requirement when adopting a price strategy is to reduce the costs. From this reason, the analysis of the methods used by the low-cost firms will be mainly focused on the cutting costs strategies.

## CONCLUSIONS

Considering all the aspects analyzed in this study, we agree to the fact that the competitive advantage of the low-cost companies lies in the possibility of promoting low prices for good or services that have a similar quality to those of the competitors. From all the factors that influence the price strategy - level of the profits, the returns on investments, the terms of payments, the ability of using the resources, the competitiveness of the products, their perceived value, the competitive pressure, the existence of some substitutes for products, the consumers' needs and wishes – the production costs play an essential role. On their turn, the costs are influenced by two types of factors: structural determinants, among which we notice scale and scope economies, experience, complexity and technology, and execution determinants, meaning those factors that are correlated to the ability of a firm to do successfully any activity.

Nowadays, the low-cost companies are largely spread not only geographically but also by sectors, being present in any activity field. Therefore, they can be met in the food industry, in the clothing sector, in IT, in auto industry, in the equipment and apparel industry and even in the service sector, a good example for this being the low-cost airlines.

## NOTES

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