STRATEGIES TO FIGHT LOW-COST RIVALS

by Nirmalya Kumar

Companies have only three options: attack, coexist uneasily, or become low-cost players themselves. None of them is easy, but the right framework can help you learn which strategy is most likely to work.

IT'S EASIER TO FIGHT THE ENEMY YOU KNOW than one you don't. With gale-force winds of competition lashing every industry, companies must invest a lot of money, people, and time to fight archrivals. They find it tough, challenging, and yet strangely reassuring to take on familiar opponents, whose ambitions, strategies, weaknesses, and even strengths resemble their own. CEOs can easily compare their game plans and prowess with their doppelgängers' by tracking stock prices by the minute, if they desire. Thus, Coke duels Pepsi, Sony battles Philips and Matsushita, Avis combats Hertz, Procter & Gamble takes on Unilever, Caterpillar clashes with Komatsu, Amazon spars with eBay, Tweedledum fights Tweedledee.

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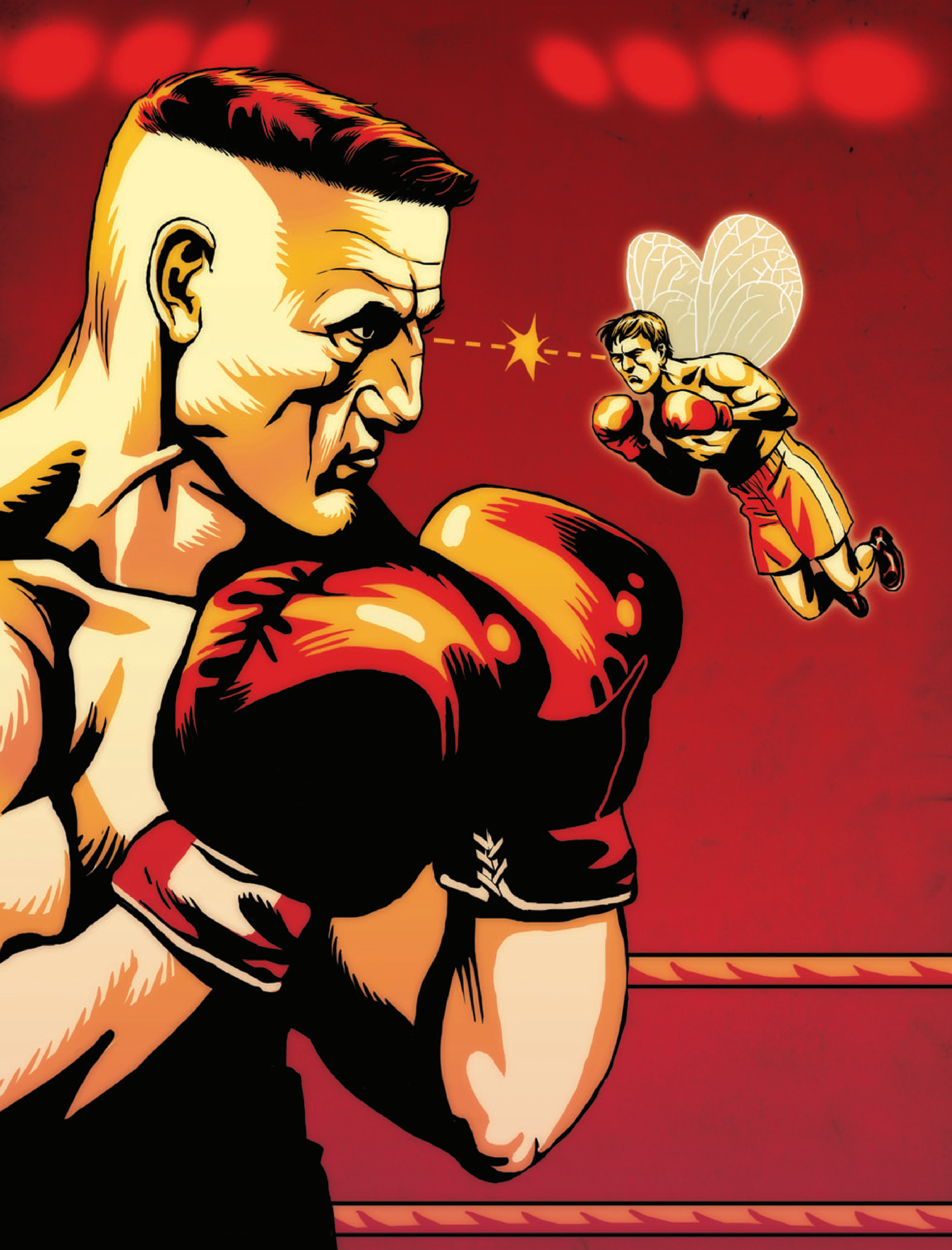

However, this obsession with traditional rivals has blinded companies to the threat from disruptive, low-cost competitors. All over the world, especially in Europe and North America, organizations that have business models and technologies different from those of market leaders are mushrooming. Such companies offer products and services at prices dramatically lower than the prices established businesses charge, often by harnessing the forces of deregulation, globalization, and technological innovation. By the early 1990s, the first price warriors, such as Costco Wholesale, Dell, Southwest Airlines, and Wal-Mart, had gobbled up the lunches of several incumbents. Now, on both sides of the Atlantic, a second wave is rolling in: Germany's Aldi supermarkets, India's Aravind Eye Hospitals, Britain's Direct Line Insurance, the online stock brokerage E*Trade, China's Huawei in telecommunications equipment, Sweden's IKEA furniture, Ireland's Ryanair, Israel's Teva Pharmaceuticals, and the United States' Vanguard Group in asset management. These and other low-cost combatants are changing the nature of competition as executives knew it in the twentieth century.

What should leaders do? I'm not the first academic (nor, I daresay, will I be the last) to pose that question. Several strategy experts, led by Harvard Business School's Michael Porter in his work on competitive strategy and Clayton Christensen in his research on disruptive innovations, and Tuck School's Richard D'Aveni in his writings on hypercompetition, have described the strategies companies can use to fight low-cost rivals. But that body of work doesn't make the phenomenon less interesting – or render the threat any less formidable. For, despite the buckets of ink that academics have spilled on the topic, most companies behave as though low-cost competitors are no different from traditional rivals or as though they don't matter.

Over the past five years, I've studied around 50 incumbents and 25 low-cost businesses. My research shows that ignoring cut-price rivals is a mistake because it eventually forces companies to vacate entire market segments. When market leaders do respond, they often set off price wars, hurting themselves more than the challengers. Companies that wake up to that fact usually change course in one of two ways. Some become more defensive and try to differentiate their products – a strategy that works only if they can meet a stringent set of conditions, which I describe later. Others take the offensive by launching low-cost businesses of their own. This so-called dual strategy succeeds only if companies can generate synergies between the existing businesses and the new ventures. If they cannot, companies are better off trying to transform themselves into solution providers or, difficult though it is, into low-cost players. Before I analyze the various strategy options, however, I must dispel some myths about low-cost businesses.

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The Sustainability of Low-Cost Businesses

Be it in the classroom or the boardroom, executives invariably ask me the same question: Are low-cost businesses a permanent, enduring threat? Most managers believe they aren't; they're convinced that a business that sells at prices dramatically lower than those incumbents charge must go bankrupt. They cite the experience of U.S. airlines, which, after the industry's deregulation in the 1980s, succeeded in beating off cut-price providers such as People Express. What they forget is that low-cost airlines soon reemerged. By slashing fares and cutting frills, entrants like Southwest Airlines and JetBlue have grabbed a chunk of America's domestic air travel market. Unlike their predecessors, they're making money hand over fist, too.

Successful price warriors stay ahead of bigger rivals by using several tactics: They focus on just one or a few consumer segments; they deliver the basic product or provide one benefit better than rivals do; and they back everyday low prices with superefficient operations to keep costs down. That's how Aldi, the Essen-headquartered retailer that owns Trader Joe's in the U.S., has thrived in the brutally competitive German market. Aldi's advantages start with the size of its product range. A typical Aldi outlet is a relatively small, 15,000-square-foot store that carries only about 700 products – 95% of which are store brands – compared with the 25,000-plus products that traditional supermarkets carry. The chain sells more of each product than rivals do, which enables it to negotiate lower prices and better quality with suppliers. In fact, many of Aldi's private-label products have bested branded products in competitions and taste tests. The small number of products also keeps the company's supply chain agile. Another efficiency stems from the fact that Aldi sets up outlets on side streets in downtown areas and in suburbs, where real estate is relatively inexpensive. Since it uses small spaces, the company's start-up costs are low, which enables it to blanket markets: Aldi now owns 4,100 stores in Germany and 7,500 worldwide.

Aldi doesn't pamper customers. Its stores display products on pallets rather than shelves in order to cut restocking time and save money. Customers bring their own shopping bags or buy them in the store. Aldi was one of the first retailers to require customers to pay refundable deposits for grocery carts. Shoppers return the carts to designated areas, sparing employees the time and energy needed to round them up. At the same time, Aldi gets the basics right. There are several checkout lines, so wait times are short even during peak shopping hours. Its scanning machines are lightning fast, which allows clerks to deal quickly with each shopper. Most retailers follow local pricing, but every Aldi store in a country charges the same price, which reinforces the chain's image as a consumer champion. In 2006, Germans voted Aldi the country's third most-trusted brand, behind only Siemens and BMW. Aldi sells products far cheaper than rivals do. To suppliers' prices, the company adds about 8% to cover transportation, rent, marketing, and other overhead costs, and about 5% for staff costs. Thus, Aldi's average markup is 13% while that of most European retailers is 28% to 30%. Not surprisingly, 89% of all German households made at least one trip to an Aldi in 2005, and according to European market research firms, the chain had a 20% share of Germany's supermarket business.

As Aldi's story suggests, the financial calculations of low-cost players are different from those of established companies. They earn smaller gross margins than traditional players do, but their business models turn those into higher operating margins. Those operating margins are magnified by the businesses' higher-than-average asset turnover ratios, which result in impressive returns on assets. Because of those returns and high growth rates, the market capitalizations of many upstarts are higher than those of industry leaders, despite the larger equity bases of the latter. For instance, one of Europe's leading low-cost airlines, Ryanair, is one-seventh the size of British Airways in terms of revenues – $2.1 billion versus $15.5 billion in 2006 – but its operating margins, at 22.7%, are three times as large as BA's 7.35%. Not surprisingly, Ryanair's market capitalization of $7.6 billion (on May 28, 2006) was higher than BA's $7.3 billion.

Many price warriors don't figure in listings of the biggest companies, but they have created wealth – and pots of it. Look at *Forbes*'s list of the world's richest people in 2006, for instance, and you will discover that 12 of the top 25 billionaires made their fortunes by creating (or inheriting) low-cost businesses. They include Sam Walton's five heirs, whose combined net worth was estimated at $80 billion, Aldi's Theo and Karl Albrecht with $32 billion, IKEA's Ingvar Kamprad with $28 billion, Mittal Steel's Lakshmi Mittal with $23.5 billion, Dell's Michael Dell with $17 billion, Zara's Amancio Ortega with $14.8 billion, and Wipro's Azim Premji with $13 billion.

Interestingly, low-cost companies stay ahead of market leaders because consumer behavior works in their favor. My research suggests that if a business gets a customer to buy its products or services on the basis of price, it will lose the customer only if a rival offers a lower price. Since

A FRAMEWORK FOR RESPONDING TO LOW-COST RIVALS

When a low-cost player enters your industry:

ASK Will this company take away any of my present or future customers?

NO → Watch, but don't take on the new rival.

YES → Don't launch a price war. Increase the differentiation of your products by using a combination of tactics.

ASK Are sufficient numbers of consumers willing to pay more for the benefits I offer?

YES → Intensify differentiation by offering more benefits. Over time, restructure your company to reduce the price of the benefits you offer.

NO → Learn to live with a smaller company. If possible, merge with or take over rivals.

ASK If I set up a low-cost business, will it generate synergies with my existing business?

YES → Attack your low-cost rival by setting up a low-cost business.

NO → Switch to selling solutions or transform your company into a low-cost player.

the discounters win all their customers because of the prices they offer, they don't have to worry about traditional rivals that always charge premiums. Only new entrants with even lower cost structures can compete with the price warriors. For instance, until 2000, Southwest Airlines' costs were the lowest in the U.S. airline industry. As its employees grew older, those costs (excluding fuel costs) rose: By 2004, they were 6.2 cents per available seat-mile, which was still nearly 25% lower than the 8 cents per available seat-mile that Delta, Northwest, and United incurred. However, JetBlue, which started flying in 2000, spent only 4.7 cents per available seat-mile in 2004 – 25% lower than Southwest's costs. Clearly, JetBlue poses a stiffer challenge to Southwest than the traditional airlines do.

The Futility of Price Wars

The moment a company spots a low-cost competitor, it would do well to ask itself this question: Is our new rival targeting a segment we don't want to serve or will it eat into our sales? (The exhibit "A Framework for Responding to Low-Cost Rivals" shows companies' options in various situations.) If the new entrant has set its sights on customers no other business serves, incumbents needn't worry – for the moment. They can observe without engaging the competitor. That wait-and-watch strategy often works for companies that market products for people at the very top of the pyramid, such as wines, perfumes, and cosmetics. For instance, when Europe's supermarket chains launched private-label water, it had little impact on market leaders such as Evian, Perrier, and San Pellegrino. Bottled water is a superpremium product, and store brands serve consumers who rarely buy it.

Sometimes, entrants at low price points can provide a fillip to incumbents' business. Take the case of easyCruise, set up by the London-based serial entrepreneur Sir Stelios Haji-Ioannou, which has boosted Europeans' interest in cruises. The line's ships serve as floating hotels that dock in the afternoon and leave late at night, which allows passengers to entertain themselves at the ports of call. Since easyCruise doesn't offer lavish meals and expensive shows, it is able to charge low prices. Its customers are typically people in their twenties and thirties, many of whom cannot afford the all-inclusive packages other cruise lines offer. Although easyCruise is doing well, incumbents such as Royal Caribbean and Cunard have left this new competitor alone rather than diverting resources to attack it. They believe that when easyCruise's passengers are older and richer, they will turn to the established lines for traditional cruise vacations.

That may be an exception to the rule. Most low-cost players alter customer behavior permanently, getting people to accept fewer benefits at lower prices. EasyCruise's passengers may never switch to the higher-priced cruise lines. Moreover, low-price warriors are aided by the fact that consumers are becoming cynical about brands, better informed because of the Internet, and more open to value-for-money offers.

When market leaders finally acknowledge the threat from low-cost rivals, they usually try to match or beat their prices. All the available evidence, however, shows that price wars don't work in incumbents' favor. Not only is pricing below cost illegal in many countries, including the United States, but also low-cost business models are designed to make money at low prices – a fact that executives tend to forget. In a race to the bottom, the challengers always come out ahead of the incumbents. For instance, in the late 1980s, Aldi, Dell, E*Trade, and Southwest Airlines more than held their own when Carrefour, Compaq, Fidelity, and United, respectively, triggered price wars that were supposed to drive the challengers out of business.

Even when market leaders copy the critical elements of low-cost players' business models, they are unable to match their prices. That's because the individual elements of the model don't matter as much as the interactions among them. Consider Internet bookings for airline tickets, which don't deliver the kind of cost reductions to traditional airlines that they do to low-cost carriers. First, low-cost players generate 98% of their bookings through their Web sites, while only 20% of incumbents' customers use the Internet to make reservations. Internet bookings are more attractive to the leisure travelers who use low-cost carriers than to business travelers, who often fly to multiple destinations. Consequently, when traditional airlines set up Internet-based booking systems, the impact on their costs is limited. Second, an Internet-based reservation system is inexpensive to develop and maintain when all the aircraft in a fleet are identical, there is only one cabin class, tickets are not refundable, and passengers can't reserve seats. However, the traditional airlines' systems must provide for multiple cabin classes, handle several kinds of tickets, provide several levels of refunds, and reserve seats, making them expensive investments. Third, most incumbents participate in industry-wide reservation systems such as Sabre, which robs them of control over some seats. Finally, the traditional airlines have set up networks of travel agents, which would rebel if the carriers made a complete shift to direct bookings. For all those reasons, traditional carriers are unable to reduce their booking costs to the levels the discount airlines have achieved.

Slashing prices usually lowers profits for all incumbents without driving the low-cost entrant out of business. I learned that firsthand while serving as a consultant to a European telecom-equipment provider that was competing against traditional rivals as well as a low-cost Asian competitor for a multimillion-dollar contract in Africa. All the bidders kept cutting prices in order to best the Asian rival's offer, which proved to be the lowest after every round of bidding. Eventually, the telecom giants discovered that the Asian company had offered a 40% discount on the lowest price the customer could negotiate with its rivals! Not surprisingly, the low-cost company won the contract. In addition, although the telecom giants would not have made profits on their lowest bids, the Asian contender seemed likely to do so.

When Differentiation Works

When businesses finally realize they can't win a price war with low-cost players, they try to differentiate their products in a last-ditch attempt at coexistence. This strategy, the consultant's favorite antidote, takes many forms. Companies, we're told, should adopt the following approaches:

- Design cool products, as, say, Apple and Bang & Olufsen do.
- Continually innovate in the tradition of Gillette and 3M.
- Offer a unique product mix, like that of Sharper Image and Whole Foods.
- Brand a community à la Harley-Davidson and Red Bull.
- Sell experiences, as Four Seasons, Nordstrom, and Starbucks do.

Since the tactics I've mentioned are well-known, I will not discuss them in detail. My research shows, however, that three conditions determine their efficacy. First, smart businesses don't use these tactics in isolation. For instance, Bang & Olufsen is able to compete effectively against low-cost electronics manufacturers with its design capabilities. That approach works well because the Danish company also keeps introducing new products, cultivates an upscale brand image, and invests time and money in creating cool-looking retail outlets.

Second, companies must be able to persuade consumers to pay for benefits. The ability to do so usually depends on the products they sell. For instance, Gillette, finding that it can push the "closer shave" envelope for men, has launched the Atra, Atra Plus, Sensor, Sensor Excel, Mach 3, Mach 3 Turbo, and Centro shaving systems at ever higher prices over the past 20 years. However, when the company deployed a similar strategy for Duracell batteries by emphasizing longer life, many consumers balked at paying higher prices after a certain point. That's because they found it almost impossible to notice the better performance and longer life of Duracell Ultra batteries. Energizer and Rayovac fought back by offering more batteries for the same price, which negated Duracell Ultra's long-life advantage. Eventually, Gillette had to back away from this differentiation gambit.

Many companies find it tough to persuade consumers to pay for additional benefits. A small premium for greater services or benefits is a powerful defense, as Target and Walgreens have shown. Target stocks inexpensive kitchenware and clothes developed by well-known designers such as Michael Graves and Isaac Mizrahi. It charges a bit more for products of better quality and design than those Wal-Mart sells. In like vein, Walgreens emphasizes convenience by setting up its stores close to shopping centers and providing drive-through windows for pickups, promising short checkout lines, and offering easy navigation because of smart store layouts. Both Target and Walgreens have therefore managed to hold their own against Wal-Mart. All too often, though, incumbents incur huge costs in order to deliver benefits, forcing them to ask for price premiums so large that they drive away consumers.

The third condition necessary for a successful differentiation strategy is simple: Companies must bring costs and benefits in line before implementing it. That takes time. After years of restructuring, Hewlett-Packard may finally be catching up with Dell in the personal computer business. HP has shrunk Dell's cost advantage from 20% to 10%, and since average PC prices have fallen, the absolute difference in prices is relatively small. Consumers are shopping for HP computers once again because of such benefits as instant delivery and the ability to see, feel, and touch products in stores.

Unless sizable numbers of consumers demand additional benefits, however, companies may have to yield some markets to the price warriors. Take the case of British Airways, which initially ignored low-cost rivals such as easyJet and Ryanair; then set up a low-cost carrier called Go, which it sold in 2002 to easyJet; and finally differentiated its services in several ways. BA now concentrates on long-haul flights, for which there are no low-cost carriers. In the short-haul market, the carrier has held on to some market share by emulating the best practices of low-cost rivals, such as persuading customers to use electronic tickets. On every flight, BA offers a small number of economy class seats at prices close to those that low-cost carriers charge. Because of its stranglehold on landing slots at Heathrow, a convenient and popular airport, it still attracts some short-haul customers. Even so, BA has reduced capacity on several flights to destinations in Europe, effectively conceding victory to low-cost carriers.

Strategies that help an established player coexist with low-cost rivals can work initially, but as consumers become more familiar with low-cost options, they tend to migrate to them. In the airline, PC, and retail industries, the segment choosing to pay less for fewer benefits has grown rapidly–and I'm not talking about Wal-Mart shoppers. Dell's and Southwest Airlines' shares of their industries, for instance, rose from around 3% in the early 1990s to 30% by 2006. That has left the traditional players scrapping with one another for a shrinking market, charging ever higher prices to fewer and fewer customers. These companies have to cope with smaller top lines even though they still have high overhead costs. That wreaks havoc on their bottom lines. They can stop themselves from going under by merging with or acquiring rivals, but, as executives well know, M&A isn't a panacea.

Dealing with Dual Strategies

When companies discover that the low-price customer segment is large, they often set up low-cost ventures themselves. Because of their years of industry experience as well as their abundant resources, incumbents are often seduced into believing that they can easily replicate cut-price operations. Moreover, the business models of such rivals appear to be simpler than their own. In the 1990s, for instance, all the major airlines launched no-frills second carriers–Continental Lite, Delta Express, KLM's Buzz, SAS's Snowflake, US Airways' MetroJet, United's Shuttle–to take on low-cost competition. All these second carriers have since been shut down or sold off, showing how tough it is for companies to use the dual strategy.

Although most executives don't realize it, companies should set up low-cost operations only if the traditional operation will become more competitive as a result and the new business will derive some advantages that it would not have gained as an independent entity. For example, in the financial services industry, HSBC, ING, Merrill Lynch, and Royal Bank of Scotland have set up low-cost operations in the form of First Direct, ING Direct, ML Direct, and Direct Line Insurance, respectively, because the new and old operations generate several synergies. The low-cost operations offer customers a small number of products–term deposits, savings accounts, and insurance – through cost-efficient distribution channels such as the Internet. Since they reach out to consumers the flagship banks cannot afford to serve, the no-frills businesses protect the parents. The flagship operations combine the funds the subsidiaries raise with their own, which allows them to make investments cost-effectively. That approach helps both parent and subsidiary.

A successful two-pronged approach requires the low-cost business to use a unique brand name such as HSBC's First Direct or at least a sub-brand such as ING Direct. A distinct brand helps communicate that fewer services go along with lower prices. It also allows customers' expectations to form around the low-cost business model rather than the traditional operation. First Direct customers, for example, are more satisfied with their ATM network than HSBC customers are even though both use the same machines. Whereas HSBC customers demand ATMs at every corner, First Direct customers, who don't expect so many machines, are delighted to see them.

Conventional wisdom suggests that because a low-cost operation's sources of competitive advantage aren't the same as those of the parent, the subsidiary should be housed separately. By setting up an independent unit, an established company can create a start-up operation with structures, systems, staff, and values that are different from its own. Because it is independent, the low-cost operation will be more accountable and is less likely to be smothered by the parent business's worry that the subsidiary will cannibalize its sales. However, as the case of the airlines shows, independent units are necessary but not sufficient for the success of a dual strategy. That's because common ownership often imposes constraints on low-cost operations. For instance, the trade unions didn't allow U.S. airlines to pay employees of their low-cost subsidiaries wages as low as those at Southwest Airlines and JetBlue. Unsurprisingly, those subsidiaries failed to take off.

Another factor that affects incumbents' low-cost businesses is the allocation of resources. When disruptors are new ventures, they face market tests of their capital

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needs. Subsidiaries face internal resource-allocation processes that optimize different criteria – both for legitimate reasons, such as higher margins and lower risk, as well as illegitimate ones, such as power and politics. Consequently, the parent may end up starving the new unit. Remember how Bausch & Lomb didn't provide a budding business with enough resources to launch the disposable contact lenses it had developed? The new lenses were cheaper than the permanent lenses B&L then marketed. They also didn't need to be stored in solutions, which contributed to the parent's profits. Therefore, B&L left the field open for Johnson & Johnson to launch a profitable new business.

A two-pronged strategy delivers results only when the low-cost operation is launched offensively to make money – not as a purely defensive ploy to hurt low-cost rivals. Companies should let their old and new businesses compete with one another and incorporate cannibalization estimates into business models and financial projections. Dow Corning's creation of Xiameter is an excellent illustration of how companies should use the two-pronged approach. Despite enjoying a 40% share of the global silicones market in 2000, Dow Corning found low-cost competitors entering the industry. Rather than slashing prices, it decided to set up a low-cost business. Two years later, after segmenting the market and identifying potential customers, Dow Corning created Xiameter. Compared with Dow Corning, which sells 7,000 products, the subsidiary sells only 350, all of which face intense competition from low-cost players as well as from the parent. Xiameter's limited range prevents it from eating up its parent's sales.

Xiameter found that it had to offer products at prices 20% lower than Dow Corning's in order to take on other low-cost players. It uses every tactic in the book to do so. Instead of quick deliveries, Xiameter promises a shipping date seven to 20 days from the order date so that it can schedule the manufacture of its products when Dow Corning's factories are idle. It doesn't offer any technical services, so it hasn't invested in a service facility. To keep its supply chain efficient, Xiameter sells only full truck, tank, or pallet loads of products. Customers either enter orders on a Web site or pay an extra $250 to order by e-mail or phone. Once set, a shipping date cannot be changed unless the customer pays a 5% fee; a rush order incurs a 10% premium; and an order cancellation fee is 5%. Such rules make production planning easier. Xiameter offers only 30-day supplier's credit, which helps reduce working capital needs, and it prices products in just six currencies to limit currency risk. In 2001, Dow Corning posted sales of $2.4 billion; in 2005, the combined sales of Dow Corning and Xiameter were $3.9 billion. That increase helped the parent company turn a loss of $28 million in 2001 into profits of $500 million in 2005. The strategy has also helped customers better appreciate the additional benefits that Dow Corning provides, enabling it to charge premium prices.

Switching to Conquer

If there are no synergies between traditional and low-cost businesses, companies should consider two other options: They can switch from selling products to selling solutions or, radical though it may sound, convert themselves into low-cost players.

Switch to solutions. Since low-cost players turn incumbents' basic products or services into commodities, existing companies may be able to succeed by selling solutions. By offering products and services as an integrated package, companies can expand the segment of the market that is willing to pay more for additional benefits. Solutions offer several advantages: They include a large service component, so it's hard to evaluate the quality of the solutions various companies provide. Over time, the seller develops a deep understanding of the customer's business processes, so the customer finds it difficult and costly to change suppliers. Furthermore, since low-cost players have limited product ranges and service capabilities, they cannot offer solutions.

Despite the popularity of this strategy, making the changeover is difficult. Many companies, such as Boots, Compaq, Xerox, and Unisys, didn't succeed because they assumed that selling solutions required modifying their existing business models rather than transforming them. Most companies see selling solutions as a way to hawk more products at higher prices. They develop combinations of products and services that work more or less seamlessly, and call them solutions. Then they look for customers with problems to fit the solutions. That never works. A good solution provider starts by working with customers to understand their problems before designing solutions.

Selling solutions requires a company to manage customers' processes and increase their revenues or lower their costs and risks. Take the case of Australian giant Orica's mining services division (the erstwhile ICI Australia's explosives business), which sells explosives to stone quarries. To set up a blast, experts drill holes in rock faces over the course of several days. The holes are filled with packaged explosives on the day of the blast, a task that can take up to five hours. Loading the explosives is often a race against the clock since blasting times are restricted. Drilling and blasting costs are a significant component of a quarry's operating costs. Because of strict controls on the storage and handling of explosives, companies used to order just enough explosives for one blast, which Orica would deliver on the appointed day.

When new competitors entered the market, starting a price war that showed no sign of abating, Orica transformed itself into a solution provider. It started out by supplying emulsion explosives in bulk. After the customer placed an order, a mobile manufacturing unit containing intermediate chemicals arrived at the quarry, mixed chemicals on-site, and delivered the explosive down predrilled blasting holes. Orica drew profiles of rock faces with lasers to identify the best places for drilling, converting blasting from an uncertain art to a precise science. The greater consistency of emulsion explosives and better-placed holes required quarries to drill fewer blast holes, which reduced costs. Because of better blasts, rock yields also improved, reducing downstream processing costs. Over time, Orica offered to provide broken rock to customers instead of explosives. It now bills customers according to the quantities of broken rock it delivers.

Becoming a solution provider has yielded significant benefits for the company. Since Orica sells explosives as part of a service, the product's price is less transparent. Furthermore, blasting solutions require the company to integrate several products and services, so its average sales are bigger than when it sold only explosives. Since Orica manages blasts at several customer sites, it has enhanced its competence and knowledge. Customers in the meantime have become more dependent on the company's blasting solutions because they have stopped investing in the process.

Switch to low-cost models. In theory, a company can consider switching from a high-cost to a low-cost business model. In practice, such a transformation is unlikely because the incumbent will have a profitable albeit shrinking business to maintain. Moreover, switching to a low-cost business model means acquiring capabilities that are different from the company's existing competencies. It's hard to imagine many market leaders having the stomach for that.

Never doubt the power of example, though. One company has successfully achieved such a transformation, and your organization could be the second. In 1991, Michael O'Leary was tapped to turn around Ryanair, an unprofitable, high-cost, traditional airline. The airline had been pursuing a strategy of advertising prices somewhat lower than those of Ireland's flagship carrier, Aer Lingus. O'Leary realized that success depended not on being 10% cheaper but on being 80% to 90% cheaper, and he believed that was possible only if Ryanair transformed itself. O'Leary made several tough decisions to convert Ryanair into one of Europe's leading low-cost airlines. He replaced the entire fleet, which comprised 14 types of planes, with a fleet of Boeing 737s. Rather than operating out of secondary airports, Ryanair started operating from secondary cities, such as Torp, 65 miles from Oslo; Charleroi, 37 miles from Brussels; and Beauvais, 35 miles from Paris. In addition to charging lower fees, some of these airports also paid Ryanair to fly into them. At O'Leary's prompting, Ryanair stopped accepting bookings through travel agents and moved to direct bookings, at first through call centers and later over the Internet.

The airline took several other steps to remake itself. It eliminated business class to concentrate on economy class and leisure customers. It stopped serving free meals and beverages on flights, instead making them available for purchase – a move that allowed the airline to reduce the number of attendants on each flight from five to two. Ryanair eliminated seat assignments to speed up boarding and stopped carrying cargo, which reduced aircraft turnaround times from 45 minutes to 25 minutes. It also simplified ground services, developed extensive guidelines for maintenance services, and outsourced both. At present, Ryanair operates 103 aircraft and flies more than 300 routes from 15 European bases. In 2005, the airline had, at 90%, the highest on-time rate of all European airlines, lost the fewest bags, and had the fewest cancellations. In the 12 months that ended March 31, 2006, Ryanair flew 35 million passengers – up 26% over the previous year. Its revenues, at $2.1 billion, were 28% higher than the previous year's and generated an after-tax profit of $387 million. Importantly, Ryanair cut costs (excluding fuel costs) by 6% in 2005–2006, showing that O'Leary is still working his low-cost magic.

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Low-cost players will continue to mushroom, and some will succeed. However, there will always be two kinds of consumers: those who buy on the basis of price and those who are partial to value. Therefore, there will always be room for both low-cost players and value-added businesses. How much room each will have depends not only on the industry and customers' preferences, but also on the strategies traditional businesses deploy. If incumbents don't take on low-cost rivals quickly and effectively, they can blame no one for their failure but themselves.

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