BEYOND THE LOSS-LEADER STRATEGY

BUSINESS MODELS BASED ON CROSS-SUBSIDIZING NO LONGER WORK

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23%

The percentage increase since 2010 of shoppers who visit multiple stores and websites to find the best prices for groceries

Many companies selling goods and services to consumers follow a decades-old formula: They offer blockbuster deals on frequently bought products to grab the attention of price-sensitive consumers, and make up for the resulting losses by charging higher prices on other products or services that are purchased less often or are harder to compare. Grocery stores recoup the cost of low prices on milk, bread, and bananas by selling higher-margin items like health and beauty products. Banks offer free current accounts as a way to make more money from loans and insurance. Electronics retailers sell cheap televisions to boost profits from cable, mount, and installation service sales.

This loss-leader strategy has been the bedrock for many successful businesses. However, the business model has developed a fatal flaw: It assumes that consumers primarily purchase from one provider at a time when the Internet has made it much easier for consumers to find individual products at the right price by visiting multiple websites or online aggregators. As a result, more consumers now tease apart their purchases, wrecking the foundation of loss-leader tactics.

There are many well-known instances of businesses in various industries being blindsided by this online threat. Low-cost airlines and online booking aggregators have wreaked havoc with package holiday providers by helping consumers disaggregate their travel purchases. Online retailers are devastating electronics players by forcing them to lower prices not only on headline items but also on high-margin add-on items.

Now, more businesses in other industries have come under attack. In the past four years, more people have started to shop at multiple grocery stores and websites to get the best prices. Amazon and specialists like Wag.com steal away customers by selling high-volume consumer products such as pet food for about a third less than in many grocery stores. Discounters such as Aldi and Lidl push lower-priced foodstuffs. Peer-to-peer lenders undercut retail banks by offering loan and savings products at more attractive rates, leaving banks to sell more of the lower profit, transactional products, such as checking and savings accounts.

In this environment, companies relying on cross-subsidizing inevitably suffer slow but irreversible profitability declines. They must stop such disruptors from cherry-picking their highest-margin products and customers. The traditional loss-leader formula is failing. It must either be forsaken or refined.

A REALISTIC ROUTE TO PROFITABILITY

In order to reduce interdependence between transactions and to stop rivals from taking away high-margin business lines and customers, companies must strengthen their defenses on highly profitable products and customers while cutting the resources they devote to less profitable product segments. They must examine if high prices charged in some areas subsidize other parts of their business, and reduce those subsidies. At the same time, companies need to raise prices for low-value

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customers to reduce cross-subsidies, even if it means reducing overall market share.

That's a tall order. For starters, most companies' top-level numbers – such as sales volumes and profit margins – do not provide the granularity needed for them to understand if their most profitable products are at risk. Warning signs can be very subtle: A small decline in a highly profitable category could indicate a benign change in consumer behavior – or it can portend a big shift of profitable customers to a competitor.

But it can be done. Some companies are already improving their ability to identify if high-margin products and customers are at risk. For example, one grocery store quickly discovered a competitor stealing away some of its high-margin razor and blade sales by broadening the scope of its sales analyses to include lower-margin related items. Even though razor sales were sliding, it found that shaving foams and gel sales remained constant – the tell-tale sign of a disruption in progress.

THINK LIKE A DISRUPTOR

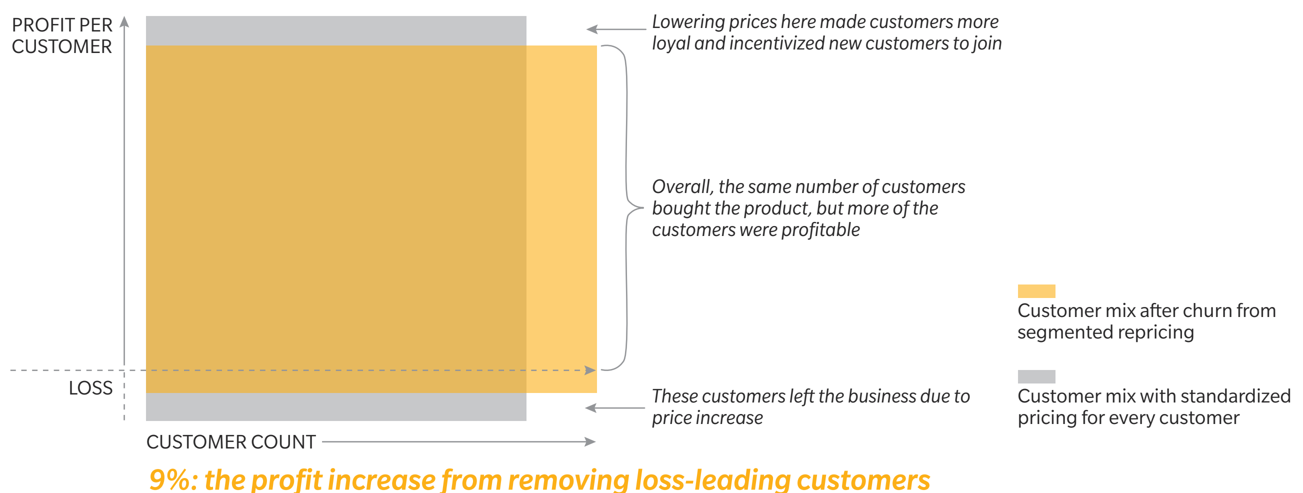
After identifying the problem, companies must assess which products they would target if they were a disruptor with detailed inside knowledge of their core business – and then act quickly to do something about it.

For some businesses, this mindset is already second nature. For example, innovative technology companies will constantly disrupt their own product lifecycles by introducing new products even when their current product line remains profitable. They know that they must disrupt their own sales; otherwise, competitors will do it for them.

Now, other companies are following suit. For example, banks are trying to fend off peer-to-peer lenders by building their own platforms or striking up partnerships – such as Metro Bank's recent tie-up with the peer-to-peer lender Zopa. Grocery store Tesco offers its own AmazonPrime-style subscription service

EXHIBIT 1: REDUCING LOSS-LEADERS IN A $1 BILLION SERVICE PROVIDER

HOW A SERVICE PROVIDER REDUCED THE PROPORTION OF UNPROFITABLE CUSTOMERS AND INCREASED AVERAGE PROFITABILITY



Source: Oliver Wyman analysis

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called Tescosubsciptions.com, which undercuts prices in its stores on certain high-margin, easy-to-ship items.

At the same time, businesses are de-incentivizing and driving away unprofitable customers. One service company struggling to maintain the margins of its repair and warranty business asked certain customers to pay higher prices after analyses showed that they were likely to cost more than other customers to serve over multiple years. While it made profits from the sales to most of its warranty customers, a few were dragging down margins by requesting more than six repairs per year. The company restored its business profits by tailoring its pricing to reflect each individual's long-term value. Customers with high so-called lifetime values could buy products at lower prices, while those with low customer lifetime values were charged more. The result: The proportion of unprofitable customers was halved and the business' margins improved by over 9 percent. (See Exhibit 1.)

MAKE TOP CUSTOMERS YOUR PRIORITY

Strategies based on cross-subsidizing are unsustainable in a digital, price-sensitive world in which customers pick and choose what they buy and where. New entrants will likely steal away high-margin products and customers, undermining incumbents' business models. To fend off these threats, companies must hone their own best product offers and treat top customers as a high priority.

Cutting prices and offering better services for profitable products and customers can be painful and difficult to justify, especially if a company identifies an online threat in an early, nascent stage. But waiting can be fatal. Reducing profits today can often be the only way to protect a business for tomorrow. In the long run, experience has shown that the value of retaining the best customers can more than offset short-term pain.

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