How to fight in a free-for-all

June 1, 2009

From media to pay TV channels like HBO, ad-sponsored entrants pose unique challenges to high-quality incumbents.

When a new competitor offers customers products and services free of charge, how should a fee-charging incumbent react? If the incumbent is of higher quality than the new entrant, will the incumbent triumph? And is there an optimal strategy for incumbents to follow when faced with an ad-sponsored competitor?

In "Strategies to Fight Ad-Sponsored Rivals," professors Ramon Casadesus-Masanell and Feng Zhu propose four possible business models that incumbents can adopt to compete with ad-sponsored entrants, while remaining true to their own mission and brand.

Ad-sponsored competitors provide customers with products or services free of charge, generating their revenues through ads. They exist in a wide range of media-related industries, including newspapers, music, the Internet and TV. These competitors pose a challenge to incumbents, who provide their products and services to customers via subscriptions or fees.

To compete, incumbents may turn to price adjustments — but larger-scale strategies are often required, including the selection of a new business model. In this context, a business model "is a set of committed choices that lays the ground for the competitive interaction that will occur between the incumbent and the ad-sponsored entrant down the line."

Four possible business models

1. In a pure subscription-based model, the incumbent provides one ad-free product at

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a positive price.
2. In a pure ad-sponsored model, the incumbent provides a product free of charge, with ads that may affect the product's quality.
3. In a mixed single-product model, the incumbent?s product has both ads and a positive price.
4. In a mixed product-line-extension model, the incumbent provides both a product with ads and a positive price, as well as a free, low-quality, ad-sponsored product.

Clearly, incumbents should not select a business model haphazardly, and their choice may be influenced by the presence of an entrant, current advertising rates and the fixed costs that go along with utilizing a mixed business model.

In general, when an ad-sponsored competitor exists, incumbents are more likely to choose a pure model rather than a mixed model, in order to avoid the possibility of cannibalizing sales of a high-quality product with a low-quality, ad-sponsored product, and to eliminate the danger of profit-eroding price reductions.

What model should an incumbent choose if it wants to force the entrant out of the market entirely? The only choices are a pure ad-sponsored model and a mixed product-line-extension model — but success depends on having high advertising rates.

The entry of a rival

Selecting the optimal business model requires a consideration of many factors, the most primary of which is the existence of an ad-sponsored rival. Without a rival, the incumbent is in a monopoly situation, and its only concern is selecting a business model that will maximize its profits. Once it chooses the model, it can make tactical decisions concerning price and/or advertising intensity.

In a duopoly, where a rival exists, an incumbent's concerns change, and its decisions must be made with the entrant in mind. When both competitors offer ad-sponsored products, consumers will choose the one that is higher quality. Balancing the number of ads with product quality is key to selecting a model that will attract consumers while maintaining brand integrity. Bear in mind that some consumers might find advertising an irritation, which affects how they view the product or service.

Killing off the entrant is not always imperative; indeed, in some situations, the incumbent and entrant can coexist, and both achieve profits.

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Don't be all things to all people

What can managers take away from this study? First, it does not always make sense for an incumbent to try to be all things to all people, which is one reason incumbents may choose to select a mixed product-line-extension model. In a duopoly situation, a pure business model usually makes more sense — increased strategic focus and narrower scope will help an incumbent to better compete.

Second, when facing an ad-sponsored entrant, a reconfigured business model may very well be the best defense. Managers can look to examples such as The Boston Globe, Spain's Metro and iTunes for real-world cases of incumbents facing and reacting to ad-sponsored entrants.

Selecting an effective business model often involves factors beyond just one ad-sponsored rival. Other factors may include higher quality ad-sponsored rivals, multiple entrants, consumers' potential fondness for advertising, vertical vs. horizontal differentiation, reputation effects and multi-homing. In each case, the incumbent's consideration of the optimal business model will be influenced differently.

One benefit from this study is that it clearly separates the notions of "strategy" and "business model" — that is, "a strategy is a plan of action as to what business model is to be chosen for the different situations that might arise."

Managers of incumbent companies would do well to consider this study's strategies for competing against upstart entrants seeking to gain market share and consumer loyalty with their ad-sponsored offerings. Just because a product or service is "free" doesn't mean it's better — and it's up to incumbents to consider innovative business models to protect and grow their brand effectively.

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