Analysis of the competitive environment

3) Degree of product differentiation

Product differentiation taxonomies
A. Vertical vs. horizontal

1) **vertical**: two products differ in overall quality. It is possible to say in this case that one good is "better" than another. Vertical product differentiation examples include products with ranked ingredients or dychotomous materials (ex. fake vs original).

2) **Horizontal**: the products have the same overall quality, but different combinations of characteristics. They are different according to features that can't be ordered in an objective way (ex. colour, styles – modern / antique –, shapes, flavours, tastes…).



Product differentiation taxonomies
B: Natural vs. strategic

B1) Natural: differences between products derive from natural attributes or feature and NOT from deliberate strategies

- <u>Geographic variation</u>: in the minds of consumers the location of a seller automatically differentiates a product/service

- <u>New technology</u>

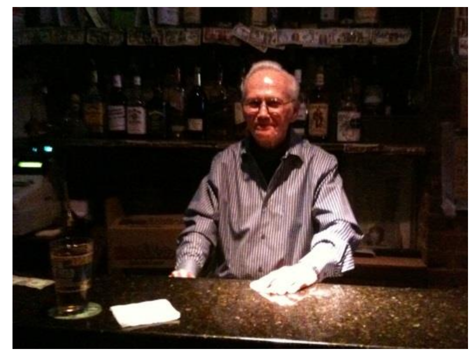
- <u>Community or national differences</u>

- <u>Consumer tastes and preferences</u>

Product differentiation taxonomies
B: Natural vs. strategic (cont.)

B2) Strategic: different features are consciously created by suppliers

- Additional services: ex. Cheaper credit, faster delivery times, extended warranty, more comprehensive after-sales service
- Rate of change of product differentiation: consumers might feel the need to purchase new styles or models with superficial changes in characteristics (ex. clothing / video games)
- Factor variations



- Consumer ignorance

- Brands and trademarks

The boundary between natural and strategic differentiation is often blurred.

Differentiation and advertising

Advertising and market structure

1. **Perfect competition**

Here advertising has no role because producers are price takers and because of the perfect competition hypothesis

2. **Monopoly**

Advertising has limited scope (no need to divert consumers from competitors). It can have a role only if it increases the total industry demand

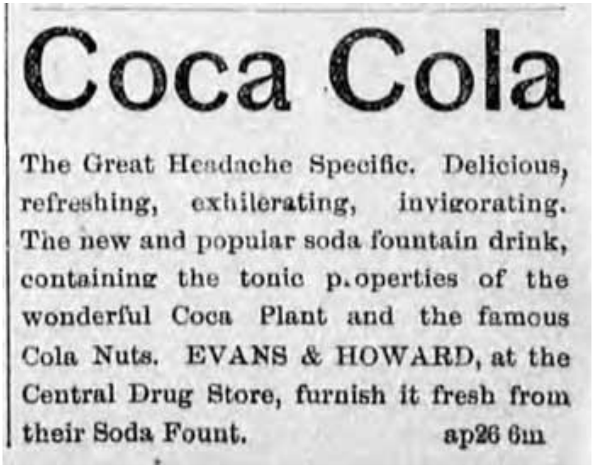
3. **Oligopoly**

There is a strong incentive in advertising.

Advertising types

1. **INFORMATIVE**

It provides consumers with information on the existence of a product or on its features



Coca Cola

The Great Headache Specific. Delicious, refreshing, exhilerating, invigorating. The new and popular soda fountain drink, containing the tonic p.operties of the wonderful Coca Plant and the famous Cola Nuts. EVANS & HOWARD, at the Central Drug Store, furnish it fresh from their Soda Fount. ap26 6m

2. **PERSUASIVE**

It makes claims that may not be objectively verifiable in order to change consumers' perceptions and stimulate sales

No clear boundaries between the two categories

Why do firms advertise?

1. To launch a new product (more informative than persuasive)
2. To provide information on price and quality
3. To increase or protect the market share. With a stagnating demand advertising increases
4. To establish a brand’s image or to strengthen consumers’ brand loyalty (it can be considered an investment in raising entry barriers)

Advertising as barriers to entry

- It increases start-up costs in order for entrants to establish name recognition
- It builds up reputation effects that could be difficult for entrants to overcome, even with high advertising expenditures;
- Economies of scale: differently from entrants, the incumbent who has advertised in the past does not have thresholds to overcome: any advertising expenditure in the current period is supposed to cause an increase in sales. Entrants, instead, have to advertise a large number of times in order for the message to enter consumers’ minds.

Advertising intensity

Industry expenditure on advertising as a proportion of sales (**advertising intensity**) can be a signal of strong/weak non-price competition (oligopoly)

Product group	Advertising-to-sales ratio
Airlines	3.85
Babycare products	39.70
Bath and shower additives	1.55
Beer	0.05
Blu-ray disc	5.28
Carbonated soft drinks	8.48
Cars	0.03
Cereals	7.11
Cheese	14.95
Chocolate bars	2.43
Cinema	0.30
Coffee	3.11
Deodorants	8.64
DVD players	0.68
Hair colourants	16.48
Internet service providers	21.84
Magazines	6.66
Mobile phones	9.18
Motor insurance	8.79
Rail travel	0.97
Shampoos	2.59
Sportswear	0.26
Tea	2.49
Televisions	0.58
Vitamins	9.62

Source: Adapted from Advertising Association (2009) *Advertising Statistics Yearbook 2009*, Table 18.1, pp. 206–12, researched and compiled by WARC (http://www.warc.com).

Advertising intensity (cont.)

Advertising intensity also depends on the characteristics of products:

1) **Search goods**: their features can be easily determined by consumers prior to purchase. Informative advertising to ensure consumers are aware of product's price or existence. No role for persuasive advertising because consumers can easily verify by themselves the product's characteristics.
2) **Experience goods**: their features can be verified only with consumption, after purchase. Both informative and persuasive advertising can be used (even if consumers can verify the truth of what stated after purchase, with effects on re-purchase).
3) **Credence goods**: their quality cannot be assessed by consumers also after their purchase and consumption, because the judgement requires specialized knowledge. Both informative and persuasive ads.

Advertising intensity (cont.)

Another distinction is between:

1) **Convenience goods**: relatively cheap and frequently purchased.
2) **Shopping goods**: expensive and rarely purchased (ex. Furniture, cars, houses).

In this case where is more reasonable to expect the highest advertising intensity?

Summary

Analysis of the competitive environment

1. Seller concentration
2. Barriers to entry and exit
3. Product differentiation degree
   - taxonomies
     - Vertical/horizontal
     - Natural/strategic
   - Advertising
     - Market structure
     - Informative/persuasive
     - Reasons for advertising
     - intensity

Reading list

- Chapters 15 (**only** 15.1, 15.2), 16 (**exl**. 16.4, 16.6, 16.7, 16.8), Lipczynski et al., 2013