When stores like Walmart, Sam’s Club and Costco began their rapid expansion in the 1990s, supermarkets were thrown for a loop. The limited service, thinner assortments and “every day low pricing” of items in these “supercenters”—including food items—created enormous cost savings and increased credibility with consumers. What was a Safeway or a Stop & Shop to do in the face of such competition?

A new paper from the Stanford Graduate School of Business looks at the strategic pricing decisions made by grocery firms during that period (1994-2000) in response to the shock to their local market positions by the entry of Walmart. The paper answers the question: Is “every day low pricing” (EDLP) better than promotional pricing that attempts to attract consumers through periodic sales on specific items? Researches find that, while EDLP has lower fixed costs, promo results in higher revenues—which is why it is the preferred marketing strategy of many stores.

The research also is the first to provide econometric evidence that repositioning firms’ marketing approaches can be costly. Switching from promo to EDLP is six times more expensive than migrating the other way around—which explains why supermarkets did not shift en masse to an “every day low pricing” format as predicted when Walmart entered the game, according to the paper.

“You need a major event to cause a pricing strategy switch that can be observed, and the entry of Walmart into the grocery market provided that natural experiment,” says Harikesh Nair, associate professor of marketing at the business school and a co-author of the study with Paul Ellickson, assistant professor of marketing and economics, and Sanjog Misra, associate professor of marketing and applied statistics, both at the University of Rochester.

Running calculations on the data, Nair and his colleagues found that, for the median store, promo pricing yielded $6.2 million more per year in revenues than an EDLP strategy. Moreover, changing from an EDLP to a promo strategy required only $2.6 million in costs over four years, while switching from a promo to an EDLP approach required outlays six times as large.

The debate over which strategy is better stems from the fact that EDLP seems to have its advantages. It enables retailers to reduce inventory costs, better coordinate supply chains and reduce the risk of stock shortages by smoothing the demand variability induced by frequent sales.

“Now we have empirical evidence to show why most stores chose promo pricing and stuck with it during a competitive shock—it earns more revenues and is too expensive to change,” says Nair.

Analysis also revealed that the entry of Walmart resulted in a $1.7 million loss in annual revenues for the median incumbent EDLP supermarket, while it resulted in a loss of only $690,000 a year for the median promo store. “The entry of Walmart thus hurt EDLP stores by twice as much,” says Nair. “A
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