3E2 MARKETING – CRIB 2018

1 (a) Discuss the functions of information gathering and risk sharing in a marketing channel.

Information gathering: a manufacturer may have more information about the supply side (e.g., costs of production) than information about the demand side (e.g., consumer tastes); vice versa for a retailer. Therefore, within a marketing channel, the manufacturer and the retailer, together with any intermediates, may pool information to optimise channel profits.

Risk sharing: when a manufacturer sells a certain amount of goods to a retailer, it obtains profits for the goods sold, and the retailer bears the demand uncertainty for the manufacturer. In return, the retailer secures a level of inventory to satisfy demand, and may also be able to obtain a bulk discount from the manufacturer.

A good answer should be able to articulate these ideas clearly.

(b) Fondant, a (fictional) video game developer, has developed the prototype of a new game. To its knowledge, no other developer has developed a similar game. Fondant now needs to commercialise the new game by developing compatible versions of it for video game consoles. There are two major video game consoles in the target market; one console has approximately 70% market share, the other has approximately 30% market share. Fondant is now considering three feasible options: (i) develop a compatible version of its new game for only the console with the larger market share; (ii) develop a compatible version for only the console with the smaller market share; (iii) develop compatible versions for both consoles. Discuss the pros and cons of these options for Fondant. Note that Fondant would have to pay licence fee(s) to the relevant console(s) in each option; the licence fee for each console would be determined upon negotiation between Fondant and the console. Also, assume that the costs of developing compatible versions are not an important factor in this decision.

It is not necessary to state the pros and cons option by option. A holistic discussion could also merit high credit. Some possible points are:

- *If Fondant develops a version that is exclusively compatible with the dominant console (i.e., the one with the larger market share), a benefit to Fondant is that it may be able to bargain a favourable licence fee deal in exchange for exclusivity. But it would be losing out on the market share of the other console; moreover, the dominant console, given its market advantage, might still be able to maintain a strong bargaining power on the licence fee.*

- *If Fondant develops a version that is exclusively compatible with the minor console (i.e., the one with the smaller market share), a benefit to Fondant is that –*

as with the previous scenario – it may be able to bargain a favourable licence fee deal in exchange for exclusivity. In this case, since the console only has a smaller market share, Fondant probably can leverage a great deal of bargaining power. Moreover, it might be able to establish long-term relationships with the minor console to strengthen the console's competitiveness, so that, in the future, Fondant can benefit from the more intense competition among the consoles when negotiating licence fees in exchange for exclusivity. But, for now, it would be losing out on the considerable market share of the dominant console.

- *If Fondant develops versions for both consoles, then it can capture the whole market, but in return loses any bargaining power that it can leverage by means of exclusivity.*

An excellent answer should be able to provide original and in-depth insights into these issues, and possibly suggest strategic marketing moves over and above the short-term consequences of the decision.

2 (a) Briefly discuss the concept of price discrimination; illustrate your answer with an example.

Price discrimination is an attempt by a firm to sell closely similar products to different customers at different prices, in order to improve profits. The rationale hinges on different customers having different valuations or willingness to pay for the same product, so that, in order to improve profits, the firm could sell at higher prices to customers with higher willingness to pay.

An example is when a museum charges students a lower entrance fee than the standard adult entrance fee. Students can be expected to have lower willingness to pay compared with the standard adult segment. Hence, charging the two segments at different prices could improve profits. Without price discrimination, if the firm charges a uniform price across both segments, then either it will be a price that is too high for students to visit the museum, or it will be a price that is so low that it will leave much money on the table for the standard adult segment. Note that in this case price discrimination is feasible because there are clear ways to identify whether a customer is a student, such as requiring that the customer presents a valid student identity card with photograph. Otherwise, some (younger) adult customers might cheat by pretending to be students, to the detriment of museum revenues.

A good answer should be able to highlight the basic notion and briefly describe a simple example in clear exposition. Additional credit can be given to discussion on the logic and feasibility of price discrimination, or on the varieties of price discrimination such as those discussed in Tellis (1986) in the major readings.

(b) Bouchon is a (fictional) high-end restaurant in a metropolitan city. Founded two decades ago, it has since gained a considerable reputation for luxurious dining. The restaurant offers the same food menu and wine menu at all times. It has recently decided to include in its wine menu not only its own wine prices, but also the prices for the same wines charged by its major competitors in the same city – a strategy that is not being practiced by any of those competitors. Discuss the pros and cons of this strategy for Bouchon.

The following are possible issues related to consumer psychology:

Pros: the strategy is possibly favourable to Bouchon if its wine prices tend to be cheaper than competitors – in which case, consumers will be more likely to consume more wine because of a perceived gain (recalling reference dependence in prospect theory); moreover, consumers will be more likely to consume more food, bearing the impression that they have 'saved' on wines.

Cons: however, the strategy also puts a constraint on Bouchon's wine prices. With this strategy, it should better not price its wine to be higher than competitors'. If indeed some of its wine prices are higher than competitors', the perceived loss could make a significant impact on consumers (recalling loss aversion in prospect theory). Lastly, the strategy could turn consumers' attention too much towards prices at the expense of quality and intangible dining experience, which may erode Bouchon's brand image as a high-end restaurant.

The long-term strategic consequences could also make an interesting discussion in a different domain of issues:

Pros: some competitors may follow suit if they also tend to price their wines competitively. This may reduce some of the positive impact of the strategy for Bouchon, or even lead to a destructive price war in the worst scenario.

Cons: this is also like a price-matching strategy that helps the competitors monitor each other's prices, and may actually help to keep prices at a collusive high level, at the expense of consumers.

An excellent answer should demonstrate original, in-depth insights into consumer psychology as well as strategic competitive issues surrounding the strategy.

(c) Presently Bouchon is often fully booked with a long waiting list on weekends, but there are often many empty tables on weekdays, especially at weekday lunchtimes. In view of this, Bouchon has decided to implement the following pricing strategy from next month onwards: there will be a 20% discount on food at weekday lunchtimes, and a 10% discount on food in weekday evenings. On weekends customers will be paying the full prices listed on the same food menu. Discuss the pros and cons of this strategy for Bouchon.

Pros: the strategy should be able to divert customers with high price sensitivity to patronise on weekdays rather than weekends; there will be less pressure on availability over weekends, services may improve, and there will be less loss of customers who would only patronise on weekends but hate to be put on a waiting list. Moreover, the strategy might be able to attract customers with lower willingness to pay who might otherwise not patronise Bouchon.

Cons: restaurant customers are perhaps not used to seeing that the <u>*same*</u> *menu carries different prices at different times. Weekend customers may perceive this to be an unfair practice; the restaurant might even lose some loyal customers as a result. In addition, the practice might render the restaurant a 'profiteering' image, which could lead to long-term damage of brand reputation.*

Credit will be especially given to answers that touch on both standard economic as well behavioural ramifications of the strategy.

3 (a) Describe the dollar auction, and discuss its relevance to competitive innovation.

The dollar auction is an open-bid auction with a cash prize. Bidding is sequential, the highest bidder gets the prize and pays his/her bid, while the second-highest bidder (who does not get the prize) also has to pay his/her bid. The auction can easily lead to a war of attrition: the second-highest bidder at any stage would find it preferable to outbid the highest bidder and win the prize, as long as the highest bid is not higher than the second-highest one by more than the prize itself (which is to be expected if the highest bidder is always profit-seeking). The two highest bidders will engage in continuously outbidding each other, possibly until one or both of them exhaust their bidding resources.

The dollar auction is a simple way to illustrate an innovation 'arms race': if the market has a 'winner takes all' characteristic for the best innovation, while innovation quality is positively correlated with investment, the competing innovators would attempt to out-invest each other to the detriment (or even destruction) of both of them. At the end, even the competitor who win would face a Pyrrhic victory with which winning comes with a significant damage to its resources.

An answer that articulates these concepts fluently will be awarded a high credit.

(b) Cotta, a (fictional) software company, has already made a small initial investment to develop a new software product; presently development is at a stage of conceptualisation without any prototype. It is already known in the industry that Cotta is developing this software, although Cotta has kept its stage of development a secret. At this point, the management at Cotta learn that a rival developer with similar resources and standing in the industry has been developing a similar software; the competitor has also kept its stage of development a secret. Discuss what Cotta could do at this point regarding the development of the new software product.

There are several possible options. First, Cotta should make an estimation of how fast the development of its product could be; it should also estimate the quality of the final product given its own previous record in developing products in this and/or related software categories. At the same time, it should try to examine the competitor's track record in products in the same and/or related categories, and make a comparison of its and the competitor's brand reputation too. All the information could help Cotta to estimate the likelihood that Cotta could win the market, if it pursues further development of the product. If the likelihood is dim, Cotta might well withdraw at this point.

Such research might be complemented by a stock taking of Cotta's other current projects. Cotta might then find it preferable to divert resources for the new software to some of those current projects, given the risk. Alternatively, Cotta might decide to divert resources from other projects to this one in order to increase its chance of ultimate success with this product. But it should try to keep this increased effort as secretive as possible, so as to avoid the competitor ramping up its resources too as in a war of attrition.

At the same time, Cotta might decide on a vapourware strategy, whereby it lets it be known to the outside world that the development of the new software is close to completion. This bluff might help fend off the competitor and drive the competitor to withdraw, although it might backfire if Cotta does not deliver the product soon enough, so that its bluff is exposed.

That said, it might also be suggested that Cotta should do the opposite, that is, Cotta should hold back any plans to launch the new software. Instead, Cotta should wait for the competitor to launch their product, observe the reactions of the market to the competitor's product, study where the competitor's product needs improvement as it is being tried out by customers, and launch an improved version later on. This is the kind of second-mover advantage that was discussed in class, and could be a strategy under consideration.

The above are just some possibilities. An excellent answer should demonstrate original, in-depth insights into the strategic competitive issues.

(c) Before Cotta has acted upon the information in (b), the competitor reaches out to Cotta with the following proposal: the two companies will invest resources equally to develop the product together; after the completion of the development, each of the two companies will be free to market the product independently under its own brand name. Discuss the pros and cons for Cotta in accepting this proposal.

This is a co-opetition proposal. The pros and cons are in some sense two sides of the same coin.

Pros: in accepting the proposal, Cotta would get to learn about the competitor's stage of development of their software. Co-opetition could also align the incentives of the two companies for now, pool the risk, improve the product, and reduce uncertainties due to each side's lack of information about the other.

Cons: in accepting the proposal, Cotta would also be leaking information to the competitor. Cotta might also be less able to capture a dominant market share with the final product, since there will also be another product with a similar quality. Unless, that is, Cotta has such a strong brand or manages so well with its marketing or sales/after-sales services that it can still win over much of the market.

Note that the question does not call for the student to argue for a stance for or against the proposal. As with part (b), an excellent answer should demonstrate original, in-depth insights into the strategic competitive issues.