Conventional wisdom dictates that when a company introduces a new product, rival companies will experience reduced profits. However, new research by Professor Raphael Thomadsen indicates that firms may need to reevaluate how they view product expansion.

Typically, when we consider the effect of a company’s introduction of a new product on a rival company, we assume decreased profits for the rival due to lost sales from customers who switch to the new product. In addition, we expect to see decreased market prices as rivals scramble to retain customers. But although it may seem counterintuitive, rival companies may actually benefit.

A rival company is likely to benefit from a competitor adding a new product under the following conditions:

**CONDITION 1**
The new product is a relatively close substitute for the introducing company’s existing products and is a more distant substitute for the rival’s products, which is common among product line extensions.

**CONDITION 2**
The new product attracts a moderate number of customers who were unserved before the new-product introduction.

Thomadsen’s research shows that when a company expands its product line as described in condition 1, it has an incentive to price its existing products less aggressively, thereby extracting the maximum consumer surplus from its newest offering. By softening price competition, rival firms benefit as well.

This phenomenon occurs quite often because a significant portion of new-product introductions are very similar to products the company already produces. If the new product serves customers who were not previously served by any product, it creates a relatively high willingness to pay on the part of these customers. The firm is incentivized to raise prices considerably to extract the highest price premium, and its rivals can follow suit and raise prices (condition 2).

For example, after Yoplait introduced its light yogurt, it raised its prices significantly, allowing Dannon to raise prices as well. Dannon increased prices more than 10 percent, and despite a drop in units sold, revenues increased five percent.

“What happens to number one brands when number two brands add products and vice versa? I find what’s happening often is that revenues are going up instead of down. I suspect that profits will go up a smaller percentage, but given that revenues are going up 40-50-60 percent of the time, we would expect that profits go up a significant fraction of those times, maybe 25 to 30 percent of the time profits are going up as well.”

—Raphael Thomadsen

**KEY TAKEAWAYS for Managers**

- Understanding how product line expansion affects the profits of both the expanding firm and rival firms is essential to understanding the nature of competition.
- Managers should not necessarily worry that a competitor’s new offering will be harmful. Profits may even increase if price competition softens.
- Consider how your rival is likely to respond to your new-product introduction. If each of the rival’s products becomes more profitable after the new-product introduction, it’s unlikely that the rival’s response will be to trim its product line.
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“Seeking an Expanding Competitor: How Product Line Expansion Can Increase All Firms’ Profits”

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Publication: *Journal of Marketing Research*, Volume 49, Number 3, June 2012, pages 349–360

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