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Discussion Paper No. 915

**PRODUCT DIFFERENTIATION
AND ENTRY TIMING
IN A CONTINUOUS TIME SPATIAL
COMPETITION MODEL**

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October 2014

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Product differentiation and entry timing in a continuous time spatial competition model*

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Abstract

We extend the well-known spatial competition model (d'Aspremont et al., 1979) to a continuous time model in which two firms compete in each instance. Our focus is on the entry timing decisions of firms and their optimal locations. We demonstrate that the leader has an incentive to locate closer to the centre to delay the follower's entry, leading to a non-maximum differentiation outcome. We also investigate how exogenous parameters affect the leader's location and firms' values and, in particular, numerically show that the profit of the leader changes non-monotonically with an increase in the transport cost parameter.

Keywords: Location; Hotelling model; Continuous time; Entry timing

JEL Code: L13, R32, C72

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1 Introduction

Researchers in economics and marketing have emphasised the importance of (horizontal) product differentiation in the context of firm competition (e.g. d'Aspremont et al., 1979; Brown, 1989; Lancaster, 1990). When firms launch their new products into markets, timing and product characteristics are some of the important factors for their profits (e.g. Krishnan and Ulrich, 2001). Taking into account firms' decisions regarding product differentiation, researchers theoretically and/or empirically investigate how firms determine the timing of launching their products and those characteristics (e.g. Lambertini, 1997; Thomadsen, 2007).

From the theoretical point of view, Lambertini (2002) presented pioneering work that discusses the strategic interaction between the optimal locations of the inventor (the market leader), who anticipates subsequent entry and the location choice of the follower in a Hotelling-type spatial competition model, as in d'Aspremont et al. (1979).¹ He was the first to introduce a dynamic model in the sense that time is continuous, the firm locations are fixed once entry is made and that firms earn their profits in each instance. Regarding the time structure, several papers deal with sequential locational entry in a discrete time model, which allows qualitative analyses such as how many steps the timing of investment would change given a change in other parameters (e.g. Prescott and Visscher, 1977). However, a more rigorous quantitative analysis, such as determining the percentage change in the investment time attributable to a percentage change in a parameter, requires a continuous time model.²

¹Location point is interpreted as a firm's differentiation selection because the distance between a firm's location point and a consumer's address corresponds to that between a firm's attribute and a consumer's ideal point. This interpretation is standard in spatial economics and marketing literature.

²Continuous time models are often used in models such as real option game models that investigate the timing problem of firms' entry without the locational context (e.g. Dixit and Pindyck, 1994, Chapter 9; Azevedo and Paxson, 2014). These studies introduce one or more probabilistic fluctuations into their models. Our model is deterministic and does not focus on this randomness but instead, focuses on the relation between location and entry timing. The real option game approach is useful for taking into account the endogenous timing decision.

This novel point is from Lambertini (2002) and differs significantly from those in related theoretical papers discussing sequential location choices based on Hotelling-type spatial competition models (e.g. Neven, 1987; Götz, 2005).³ Those related papers are static Hotelling models in the sense that each firm has only one profit earning chance.⁴ Lambertini (2002) considered two scenarios: (i) the follower’s timing of entry is exogenous and (ii) the follower’s timing of entry is probabilistically determined. Therefore, the follower does not endogenously determine its optimal timing of entry in either scenario. To summarise, Lambertini (2002) considered a continuous *time* model, but an endogenous entry *timing* model with continuous time *has not been considered* in locational models. Because the entry timing of followers significantly influences market leaders as well as followers (Kalyanaram et al., 1995; Vakratsas et al., 2003), we need to overcome the weakness in the model given by Lambertini (2002) and endogenise the follower’s entry-timing decision. Therefore, our paper substantially extends the model of Lambertini (2002).

We incorporate several aspects into the standard Hotelling duopoly model in d’Aspremont et al. (1979). The time horizon is infinite, as in Lambertini (2002). Each firm sets a price and earns a profit in each instance if it exists in the market, implying that a delay of entry causes a loss of profit opportunity. In anticipation of subsequent entry by the follower, the market leader initially sets its location. Because the leader’s location decision influences the profits of the follower, it also affects the timing of the entry (the length of the monopoly period), thus representing an additional value of our paper. After the location choice of the market leader, the follower determines the timing of entry and its location. When the follower enters the market, it incurs an investment cost that exponentially decreases with the standard discount rate. In contrast, consumer size increases with a growth rate lower than the discount rate. By balancing the benefit and cost of

³Many papers discussed sequential location choices in spatial competition models. Kress and Pesch (2012) and Biscaia and Mota (2013) provided comprehensive surveys on spatial competition.

⁴Lambertini (1997) and Meza and Tombak (2009) considered the endogenous timing of locations in such static Hotelling models.

staying outside, the follower determines its entry timing and location.

Compared with Lambertini (2002), our contributions in this paper are threefold. The first contribution is that we endogenise the follower's timing. The second contribution follows the first, as we introduce investment costs and a growth rate in consumer size to make the model more realistic. In addition, the growth rate ensures that the entry occurs within a finite time⁵ and, in turn, affects the leader's location. The third contribution is a strategic interaction between the leader's location and the follower's entry timing. In addition to the effects considered by Lambertini (2002), the leader's moving closer to the centre increases the follower's incentive to delay its entry, prolonging the monopoly regime. Thus, by endogenising the follower's timing, the leader has a stronger incentive to move closer to the central point. Although this strategic interaction among the leader's location, the follower's location and its entry timing is an important aspect of this problem, Lambertini (2002) does not take into account this strategic interaction because of his assumption of an exogenous entry timing by the follower.

We also show that the follower always chooses to maximise the distance between the firms whereas the leader has an incentive to locate closer to the centre to delay the follower's entry, possibly leading to a non-maximum differentiation outcome. Furthermore, the location interval between the leader and the follower is negatively correlated with the length of time for which the follower stays outside. These results are similar to those in Lambertini (2002), although the mechanism behind these results definitely differs between the two papers.

Finally, we show that the entry timing becomes earlier as the growth rate of consumer size or the parameter of consumer transport cost increases, and becomes later as the discount rate increases. We numerically investigate how those exogenous parameters influence their profits. A notable result is that the profit of the market leader non-

⁵This phenomenon implies that just introducing a timing endogeneity into Lambertini (2002) without a growth rate yields no entry and a perpetual monopoly by the leader.

monotonically changes with an increase in the consumer transport cost parameter.⁶

2 The Model

Two firms, $i \in \{1, 2\}$, produce homogeneous goods. Consumers are uniformly distributed over the unit segment $[0, 1]$ as proposed by Hotelling (1929).⁷ Each consumer at point $x \in [0, 1]$ purchases at most one unit of the good and decides from which firm to purchase if he does make a purchase. The consumer at point $x \in [0, 1]$ incurs a quadratic transportation cost $c(x_i - x)^2$ and pays price p_{it} at time $t \in [0, \infty)$ when buying a good from firm i located at $x_i \in [0, 1]$. To summarise, the utility of the consumer at point $x \in [0, 1]$ at time $t \in [0, \infty)$ is given by

$$u_t(x; x_1, x_2, p_{1t}, p_{2t}) = \begin{cases} \bar{u} - p_{1t} - c(x_1 - x)^2 & \text{if purchased from firm 1,} \\ \bar{u} - p_{2t} - c(x_2 - x)^2 & \text{if purchased from firm 2,} \\ 0 & \text{otherwise,} \end{cases} \quad (1)$$

where \bar{u} denotes the gross surplus that a consumer at point x enjoys from purchasing the good, and c is a parameter describing the level of transportation cost or product differentiation. Let us assume that \bar{u} is so large that each consumer prefers to purchase one good over not buying when at least one firm is present in the market.⁸

Assumption 1 $\bar{u} > 3c$.

The game proceeds as follows: Each firm i chooses the time of entry $T_i \in [0, \infty)$ and location $x_i \in [0, 1]$ at the same time, and then chooses price $p_{it} : \mathfrak{R}_+ \rightarrow \mathfrak{R}_+$ at each time t , which is a function from time $t \in [0, \infty)$ to a real number $[0, \infty)$ and is displayed as p_{it} for simplicity. In addition, we assume that firm 1 is the leader who just entered at $T_1 = 0$,

⁶The transport cost parameter can be interpreted as a parameter that describes the level of product differentiation because the cost parameter corresponds to a consumer's disutility between the consumer's ideal point and the degree of a product's attribute. This interpretation is standard in the literature on spatial economics and marketing.

⁷This setting and the following assumptions are standard in the literature on spatial economics.

⁸In other words, firm 1, located at $x_1 = 0$, has an incentive to supply a positive amount at location 1, after maximizing its profit.

whereas firm 2 is the follower who enters at time T_2 , to be subsequently and endogenously determined. In this way, firm 1 decides x_1 at time $T_1 = 0$ once and subsequently chooses price p_{1t} at each time t . After observing firm 1's actions before firm 2's entry, firm 2 chooses to enter at time T_2 and location x_2 and thereafter chooses p_{2t} at each time t . Firm i can choose its location only when it makes its entry in the project, at which time it incurs an entry cost $F_i(T_i)$. We also assume (without loss of generality) that $x_1 \leq 1/2$ holds in equilibrium.

Now, let us describe the present value of the firms at time 0 given that firm 2 would enter at point x_2 at time $t = T_2$. Note that firm 1 enters at point x_1 at time $t = T_1 = 0$. The timing is exogenous⁹ but x_1 is to be determined endogenously in the following analysis. The total profit of firm 1, the leader, is given by

$$V_1(T_2, x_1, x_2, p_{1t}, p_{2t}) = \int_0^{T_2} \int_0^1 p_{1t}(x; x_1) e^{-(r-\alpha)t} dx dt + \int_{T_2}^{\infty} \int_0^{\bar{x}} p_{1t}(x; x_1, x_2, p_{2t}) e^{-(r-\alpha)t} dx dt - F_1(0), \quad (2)$$

where r denotes the interest rate, α denotes the growth rate parameter of the market and \bar{x} denotes a point at which the consumer is indifferent between purchasing from firm 1 or 2. From (1), $\bar{x} = [p_{2t} - p_{1t} + c(x_2^2 - x_1^2)] / [2c(x_2 - x_1)]$. We assume that $r > \alpha$ to ensure that the follower enters in a finite time. Firm 1 earns monopoly profit flow at $t \in [\tau, \tau + d\tau)$ until firm 2 enters the market, and firm 1 earns duopoly profit flow after firm 2's entry.

The total profit of firm 2, the follower, is given by

$$V_2(T_2, x_1, x_2, p_{1t}, p_{2t}) = \int_{T_2}^{\infty} \int_{\bar{x}}^1 p_{2t}(x; x_1, x_2, p_{1t}) e^{-(r-\alpha)t} dx dt - F_2(T_2). \quad (3)$$

After entry, firm 2 earns duopoly profit flow at $t \in [\tau, \tau + d\tau)$ to which it supplies.

Let us now make the following assumptions for the entry cost function F_i .

⁹A similar interpretation is made in Chronopoulos et al. (2014) as a non-preemptive duopoly. In their paper, the roles of the leader and the follower are defined exogenously. Consequently, the future cash flows of the leader are discounted to time $t = 0$.

Assumption 2 (i) $F_i(T_i) = F_i e^{-rT_i}$,

(ii) $F_1(0) = F_1 < \int_0^\infty \int_0^{\bar{x}} p_{1t}(x; x_1, x_2, p_{2t}) e^{-(r-\alpha)t} dx dt$ for all $x_2 \in [x_1, 1]$,

(iii) $F_2(0) = F_2 > \int_0^\infty \int_{\bar{x}}^1 p_{2t}(x; x_1, x_2, p_{1t}) e^{-rt} dx dt$ for all $x_1 \in [0, x_2]$.

Assumption 2 (ii) suggests that F_1 is small enough that the leader can earn non-negative total profit at time 0 whenever the follower enters and wherever the follower locates. Similarly, Assumption 2 (iii) suggests that F_2 is sufficiently large enough to enable the follower to enter sequentially at $T_2 > 0$ in an equilibrium, because we would like to avoid simultaneous entry at time 0 and focus on sequential entry.¹⁰ This assumption also implies that the leader, but not the follower, has already learned how to enter the market efficiently.

3 Equilibrium

In this section, we derive the price, location and timing outcomes in the subgame perfect equilibrium. First, given locations x_1 and x_2 , we consider the problem of prices at each time t before and after the entry of firm 2. Then, we derive the local profits of the leader and the follower at each time t .

The following are the equilibrium prices. Notably, the maximisation of the instantaneous profit flows is equivalent to the maximisation of the total profits. In other words, firm 1 maximises the following equation with respect to p_{1t} before firm 2 enters $t \in [0, T_2)$ when T_2 is exogenously given:

$$\max_{p_{1t}} \int_0^1 p_{1t}(x; x_1) dx. \quad (4)$$

After firm 2 enters $t \in [T_2, \infty)$ when T_2 is exogenously given, firm 1 maximises the following with respect to p_{1t} :

$$\max_{p_{1t}} \int_0^{\bar{x}} p_{1t}(x; x_1, x_2, p_{2t}) dx; \quad (5)$$

¹⁰If simultaneous entry occurs, this model reverts to the standard location–price model of d’Aspremont et al. (1979).

and firm 2 maximises the following with respect to p_{2t} :

$$\max_{p_{2t}} \int_{\bar{x}}^1 p_{2t}(x; x_1, x_2, p_{1t}) dx. \quad (6)$$

Solving these maximisation problems results in the following lemma.

Lemma 1 *The prices set by the leader and the follower are*

$$\tilde{p}_{1t} = \begin{cases} p_1^M = \bar{u} - c(1 - x_1)^2 & t \in [0, T_2) \\ p_1^D = \frac{c}{3}(x_2 - x_1)(2 + x_1 + x_2) & t \in [T_2, \infty), \end{cases} \quad (7)$$

$$\tilde{p}_{2t} = p_2^D = \frac{c}{3}(x_2 - x_1)(4 - x_1 - x_2) \quad t \in [T_2, \infty). \quad (8)$$

Proof. See Appendix ■

For $t \in [0, T_2)$, the monopoly leader maximises its price under the constraint that all consumers purchase its good. Assuming that $x_1 \leq 1/2$ without loss of generality, the furthest consumer is located at 1. The consumer turns out to be indifferent between purchasing the good at price p_1^M and not purchasing the good. p_i^D ($i = 1, 2$) is derived using the standard calculation in the context of spatial competition (e.g. d'Aspremont et al., 1979).

The instantaneous profit flows of the two firms are

$$\pi_{1t}(x_1, x_2) = \begin{cases} \pi_1^M(x_1) = \int_0^1 p_1^M dx = \bar{u} - c(1 - x_1)^2 & t \in [0, T_2) \\ \pi_1^D(x_1, x_2) = \int_0^{\bar{x}} p_1^D dx = p_1^D \bar{x} = \frac{c}{18}(x_2 - x_1)(2 + x_1 + x_2)^2 & t \in [T_2, \infty), \end{cases} \quad (9)$$

$$\pi_{2t}(x_1, x_2) = \begin{cases} 0 & t \in [0, T_2) \\ \pi_2^D(x_1, x_2) = \int_{\bar{x}}^1 p_2^D dx = p_2^D(1 - \bar{x}) = \frac{c}{18}(x_2 - x_1)(4 - x_1 - x_2)^2 & t \in [T_2, \infty). \end{cases} \quad (10)$$

Note that $\bar{x} = (2 + x_1 + x_2)/6$. Substituting the outcomes of equations (7) to (10) into equations (2) and (3), the total profits of the leader and the follower are derived as

$$V_1(T_2, x_1, x_2, p_{1t}, p_{2t}) = \int_0^{T_2} \pi_1^M(x_1) e^{-(r-\alpha)t} dt + \int_{T_2}^{\infty} \pi_1^D(x_1, x_2) e^{-(r-\alpha)t} dt - F_1, \quad (11)$$

$$V_2(T_2, x_1, x_2, p_{1t}, p_{2t}) = \int_{T_2}^{\infty} \pi_2^D(x_1, x_2) e^{-(r-\alpha)t} dt - F_2(T_2). \quad (12)$$

3.1 Follower

We consider the problem of the follower regarding when it enters and where it locates in the market. With regards to the location, we have the following:

Lemma 2 *The follower always locates at $x_2 = 1$.*

Proof. From equation (12), x_2 only depends on π_2^D . From equation (10), we have

$$\frac{\partial \pi_2^D(x_1, x_2)}{\partial x_2} = \frac{c}{18}(4 + x_1 - 3x_2)(4 - x_1 - x_2), \quad (13)$$

which is positive for x_1 and $x_2 \in [0, 1]$. Thus, the optimal location for firm 2 is at 1, regardless of the other parameters. ■

From Lemma 2, we show that the follower always locates as far away from the location of the leader as possible when entering the market. This result replicates that of Lambertini (2002) and seems to be robust to the endogeneity of the follower's entry timing. Substituting the equilibrium profits and the location of the follower into the total profit functions V_1 and V_2 , we have

$$V_1(T_2, x_1, 1, \tilde{p}_{1t}, \tilde{p}_{2t}) = \frac{1 - e^{-(r-\alpha)T_2}}{r - \alpha} [\bar{u} - c(1 - x_1)^2] + \frac{e^{-(r-\alpha)T_2}}{r - \alpha} \frac{c}{18} (1 - x_1)(3 + x_1)^2 - F_1, \quad (14)$$

$$V_2(T_2, x_1, 1, \tilde{p}_{1t}, \tilde{p}_{2t}) = \frac{e^{-(r-\alpha)T_2}}{r - \alpha} \frac{c}{18} (1 - x_1)(3 - x_1)^2 - F_2 e^{-rT_2}. \quad (15)$$

We note that if $F_1 \leq F_2$, the leader's value is always greater than the follower's value in our setting. That is, since $\pi_1^D \geq \pi_2^D$, we have

$$V_1 - V_2 \geq \frac{\pi_1^M}{r - \alpha} (1 - e^{-(r-\alpha)T_2}) - F_1(1 - e^{-rT_2}) > \left(\frac{\pi_1^M}{r - \alpha} - F_1 \right) (1 - e^{-(r-\alpha)T_2}) > 0. \quad (16)$$

We use Assumption 2 (ii) from the end of the last section to ensure $F_1 < \pi_1^M/(r - \alpha)$, the present value of profits when the leader sustains monopoly profit forever.

Thus, the rest of the follower's decision problem is only its endogenously determined entry timing, which is not present in Lambertini (2002). We have the following proposition.

Proposition 1 *The entry timing of the follower is*

$$\tilde{T}_2(x_1) = \frac{1}{\alpha} \log \left[\frac{rF_2}{\pi_2^D(x_1, 1)} \right] = \frac{1}{\alpha} \log \left[\frac{18rF_2}{c(1-x_1)(3-x_1)^2} \right]. \quad (17)$$

Proof. Differentiating $V_2(T_2, x_1, 1, \tilde{p}_{1t}, \tilde{p}_{2t})$ with respect to T_2 yields

$$\frac{\partial V_2(T_2, x_1, 1, \tilde{p}_{1t}, \tilde{p}_{2t})}{\partial T_2} = -e^{-(r-\alpha)T_2} \pi_2^D(x_1, 1) + rF_2 e^{-rT_2} = 0. \quad (18)$$

Solving this equation with respect to T_2 gives $\tilde{T}_2(x_1)$ as a solution. Note that \tilde{T}_2 is positive from Assumption 2 (iii). Examining the second-order derivative yields the following

$$\frac{\partial^2 V_2}{\partial T_2^2} = (r - \alpha) e^{-(r-\alpha)T_2} \pi_2^D(x_1, 1) - r^2 F_2 e^{-rT_2}. \quad (19)$$

Substituting $\tilde{T}_2(x_1)$ into the second-order derivative shows that $\partial^2 V_2 / \partial T_2^2 |_{T_2=\tilde{T}_2(x_1)}$ is negative. Because the first-order condition is uniquely satisfied and the second-order derivative is negative at this point, the unique, positive and interior solution exists. Thus, we have the desired result. ■

The following corollaries show the change in the follower's entry timing as the leader's location x_1 and the exogenous parameters change.

Corollary 1 *If x_1 is increased, the optimal timing for the follower to enter is delayed.*

x_1 affects the entry timing of the follower as follows. Only the denominator within the fraction inside the log in equation (17) is composed of the locations chosen by the firms. Thus, we focus on this part of the equation, namely, $\pi_2^D(x_1, 1)$. When firm 1 locates away from firm 2 (or x_1 is decreased), firm 2 can deliver the product in a broader region (\bar{x} decreases), and firm 2 can earn a higher profit (π_2^D increases). Therefore, firm 2 enters earlier (later) if firm 1 locates away from (closer to) firm 2.

Corollary 2 *If F_2 or r is increased, or as c or α is decreased, the optimal timing for the follower to enter is delayed.*

As is seen in the next subsection, x_1 depends on the previous parameters. Therefore, a change in these parameters affects the entry timing of the follower through a direct effect (Corollary 2) and an indirect effect (Corollary 1).

3.2 Leader

Finally, we consider the problem of the leader. Substituting the outcomes of the follower, Lemma 2 and Proposition 1 into the total profit function of the leader, the maximisation problem of the leader is given by

$$\begin{aligned} \max_{x_1 \in [0, 1/2]} V_1(\tilde{T}_2(x_1), x_1, 1, \tilde{p}_{1t}, \tilde{p}_{2t}) \\ = \frac{1 - e^{-(r-\alpha)\tilde{T}_2(x_1)}}{r - \alpha} [\bar{u} - c(1 - x_1)^2] + \frac{e^{-(r-\alpha)\tilde{T}_2(x_1)}}{r - \alpha} \frac{c}{18} (1 - x_1)(2 + x_1 + 1)^2 - F_1. \end{aligned} \quad (20)$$

Because the derivation of the equilibrium is complicated, we investigate the impact on the value of the leader when the location of the leader changes infinitesimally, before deriving the equilibrium outcome presented in Proposition 2. Differentiating $V_1(\tilde{T}_2(x_1), x_1, 1, \tilde{p}_{1t}, \tilde{p}_{2t})$ with respect to x_1 yields

$$\begin{aligned} \frac{\partial V_1(\tilde{T}_2(x_1), x_1, 1, \tilde{p}_{1t}, \tilde{p}_{2t})}{\partial x_1} = e^{-(r-\alpha)\tilde{T}_2(x_1)} \frac{d\tilde{T}_2(x_1)}{dx_1} (\pi_1^M(x_1) - \pi_1^D(x_1, 1)) \\ + \frac{1 - \exp(-(r - \alpha)\tilde{T}_2(x_1))}{r - \alpha} \frac{d\pi_1^M(x_1)}{dx_1} \\ + \frac{\exp(-(r - \alpha)\tilde{T}_2(x_1))}{r - \alpha} \frac{d\pi_1^D(x_1, 1)}{dx_1}. \end{aligned} \quad (21)$$

The sign of equation (21) is the key and determines the location of the leader: whether it is located at the centre (1/2), edge (0), or an interior point (strictly between 0 and 1/2). The first term of (21) represents the gain from the delay of entry by firm 2 that is caused by an increase in x_1 , allowing firm 1 to maintain its monopoly profit before the duopoly

regime begins. This term is not present in Lambertini (2002) and captures the essence behind our results. Therefore, if this term turns out to be large, our result may become significantly different from that of Lambertini (2002). The second term of (21) signifies the increase in the monopoly profit attributable to moving closer to the centre. The third term of (21) shows how the duopoly profit decreases as firm 1 moves closer to firm 2, thus intensifying competition.¹¹ The first two terms are positive and the last term is negative. Thus, if the effect of the last term is relatively small, the optimal location of firm 1 is $1/2$.

We now investigate the effect of each parameter on the equilibrium location of firm 1, which we denote as x_1^E . First, consider the effects of parameters α and r on x_1^E . As α approaches r , the weight on the periods after which firm 2 enters the market gets larger. Therefore, firm 1 needs to take into account profitability under the duopoly situation. The significance of the last term dominates that of the other two terms, which implies that the optimal location of firm 1 is $x_1 = 0$. In contrast, if α becomes smaller, the converse holds. Thus, the effect of parameter r is essentially the opposite of that of α .

Parameter \bar{u} appears only in the first term, which is increasing in \bar{u} . As the location of firm 1 becomes closer to the centre, the leader obtains the monopoly profit for a longer time because the follower's timing of entry is delayed from Corollary 1. An increase in \bar{u} yields a stronger incentive to obtain this profit. Thus, as \bar{u} increases, the leader is more likely to locate at $x_1^E = 1/2$.

Regarding F_2 and c , they affect equation (21) through \tilde{T}_2 in that an increase in F_2 or a decrease in c increases \tilde{T}_2 . Thus, the effects of these two parameters counter each other. Note that the term $d\tilde{T}_2(x_1)/dx_1$ is independent of c or F_2 . From Corollary 2, increasing F_2 delays the entry of the follower (increasing \tilde{T}_2), and F_2 does not affect equation (21) in other ways. The discounted present value of the increase in profit from a longer monopoly regime attributable to firm 1 locating closer to the centre is decreased. Thus, the first term is decreasing in F_2 . The second term is increasing in F_2 because the increase in the

¹¹Although T_2 is not endogenised, the second and third terms describe how Lambertini (2002) determined the leader's location.

monopoly profit for firm 1 from its moving closer to the centre is sustained longer due to the entry delay. Similarly, the third term is also increasing in F_2 , as the decrease in the duopoly profit for firm 1 from its moving closer to the centre is devalued from the entry delay. These three effects are complicated, and none of them are analytically dominant. We numerically examine this issue in the next section.

The effect of parameter c counters that of F_2 with respect to how they affect \tilde{T}_2 . In addition, c enters in all the profit levels. Namely, c has two contrasting effects on the profit of firm 1. First, the monopoly profit of firm 1 is decreasing in c . When the firm supplies to all consumers, it needs to compensate consumers for transport costs by lowering its monopoly price. The compensation is higher as the consumer transport cost parameter increases. Second, the parameter c is positively related to the duopoly profit of firm 1 as in the standard Hotelling model with price competition. The effect of the first term is lower as the parameter c increases, whereas those of the second and third terms are higher. Therefore, the relative importance of the three terms influences the effect of c on the location choice of firm 1. Unlike the previous argument, this effect depends on the parameters α and r . We apply the previous argument regarding α to the effect of parameter c on the optimal location of firm 1. If α approaches r , the significance of the last term dominates that of the second term, which implies that the optimal location of firm 1 is more likely to become $x_1^E = 0$ as c increases. In contrast, if α becomes smaller, the significance of the second term dominates the last, which implies that the optimal location of firm 1 is more likely to become $x_1^E = 1/2$ as c increases. If r is sufficiently large, for example $r > 1 + \alpha$, the optimal location of firm 1 is more likely to become $x_1^E = 0$ as c increases because the first term is relatively large.

Solving (20), we have the following proposition.

Proposition 2 (a) *If (21) is positive for any $x_1 \in [0, 1/2]$, the outcome of the subgame*

perfect equilibrium is

$$T_2^* = \frac{1}{\alpha} \log \left[\frac{144rF_2}{25c} \right], \quad x_1^* = \frac{1}{2}, \quad x_2^* = 1, \quad \bar{x}^* = \frac{7}{12}, \quad (22)$$

$$p_{1t}^* = \begin{cases} \tilde{p}_1^M(x_1^*) = \bar{u} - \frac{c}{4} & t \in [0, T_2^*) \\ p_1^D(x_1^*, x_2^*) = \frac{7c}{12} & t \in [T_2^*, \infty), \end{cases} \quad p_{2t}^* = p_2^D(x_1^*, x_2^*) = \frac{5c}{12} \quad t \in [T_2^*, \infty). \quad (23)$$

(b) If (21) is negative for any $x_1 \in [0, 1/2]$, the outcome of the subgame perfect equilibrium is

$$T_2^{**} = \frac{1}{\alpha} \log \left[\frac{2rF_2}{c} \right], \quad x_1^{**} = 0, \quad x_2^{**} = 1, \quad \bar{x}^{**} = \frac{1}{2}, \quad (24)$$

$$p_{1t}^{**} = \begin{cases} p_1^M(x_1^{**}) = \bar{u} - c & t \in [0, T_2^{**}) \\ p_1^D(x_1^{**}, x_2^{**}) = c & t \in [T_2^{**}, \infty), \end{cases} \quad p_{2t}^{**} = p_2^D(x_1^{**}, x_2^{**}) = c \quad t \in [T_2^{**}, \infty). \quad (25)$$

(c) If the equilibrium location of firm 1, x_1^{***} , is strictly between 0 and 1/2, then the outcome of subgame perfect equilibrium is

$$T_2^{***} = \frac{1}{\alpha} \log \left[\frac{18rF_2}{c(1-x_1^{***})(3-x_1^{***})^2} \right], \quad x_2^{***} = 1, \quad \bar{x}^{***} = \frac{3+x_1^{***}}{6}, \quad (26)$$

$$p_{1t}^{***} = \begin{cases} p_1^M(x_1^{***}) = \bar{u} - c(1-x_1^{***})^2 & t \in [0, T_2^{***}) \\ p_1^D(x_1^{***}, x_2^{***}) = \frac{c}{3}(1-x_1^{***})(3+x_1^{***}) & t \in [T_2^{***}, \infty), \end{cases} \quad (27)$$

$$p_{2t}^{***} = p_2^D(x_1^{***}, x_2^{***}) = \frac{c}{3}(1-x_1^{***})(3-x_1^{***}) \quad t \in [T_2^{***}, \infty). \quad (28)$$

Proposition 2 shows that three types of equilibrium location for the leader can emerge. Similar to Lambertini (2002), we show that firm 1 can locate at 0, 0.5 or an interior location depending on the parameter values. However, a case exists in which the introduction of endogenous entry timing leads to different equilibrium location outcomes compared with Lambertini (2002) using the same parameter values. To grasp the intuition behind this result, we proceed with a numerical analysis in the next section.

4 Numerical Analysis

In this section, we investigate in detail the underlying properties of our model using numerical analysis. First, we investigate the effects of the key parameters, α , c and F_2 ,

on firm 1's equilibrium location, which we denote as $x_1^E \in \{x_1^*, x_1^{**}, x_1^{***}\}$. Then, we show the importance of the endogeneity of T_2 , namely the first term of equation (21). Finally, we examine the effects of the parameters on the total values of the firms in equilibrium.

4.1 The leader's location

This subsection examines the effects of parameters (α, c, F_2) on the equilibrium location of the leader.

First, let us consider the effect of α on x_1^E . Let us set the parameters as $r = 0.1, \bar{u} = 4$ and $c = 1$. We use three tables to illustrate the relationship between α and the equilibrium location for the leader. $F_2 = 20, 50$ and 100 for Tables 1 to 3, respectively. The values of α are incremented by one ten-thousandth. As explained in the previous section, we pointed out that the location x_1^E moves from $1/2$ to 0 as α approaches r . We confirm this result from all three tables.

Additionally, we investigate the effects of F_2 on x_1^E when α approaches r . $\bar{\alpha}$ denotes the lowest value for which the equilibrium x_1^E is 0 , and $\underline{\alpha}$ denotes the highest value for which the equilibrium x_1^E is $1/2$. Tables 1 to 3 imply that both $\bar{\alpha}$ and $\underline{\alpha}$ are increasing in F_2 . This implication is consistent with the intuition offered in the previous section. In addition, the range of the interior location, $\bar{\alpha} - \underline{\alpha}$, is increasing in F_2 . Therefore, as F_2 increases, the equilibrium location is likely to become interior or $1/2$ and not 0 .

α	...	0.0961	0.0962	...	0.0969	...	0.0976	0.0977	...
x_1^E	0.5	0.5	0.432	...	0.171	...	0.014	0	0

Table 1: Location of firm 1, x_1 , when $r = 0.1, \bar{u} = 4, F_2 = 20$, and $c = 1$. We have $\underline{\alpha} = 0.0961, \bar{\alpha} = 0.0977$.

Second, we investigate the effect of c on the equilibrium location of the leader. Figure 1 illustrates the equilibrium location of firm 1 for different values of c when $F_2 = 20$ and $F_2 = 13$. Consider the case in which an interior solution can exist. An interior solution exists when α approaches r . We consider the same values as in the previous numerical

α	...	0.0964	0.0965	...	0.0973	...	0.0981	0.0982	...
x_1^E	0.5	0.5	0.453	...	0.192	...	0.011	0	0

Table 2: Location of firm 1, x_1 , when $r = 0.1, \bar{u} = 4, F_2 = 50$, and $c = 1$. We have $\underline{\alpha} = 0.0964, \bar{\alpha} = 0.0982$.

α	...	0.0966	0.0967	...	0.975	...	0.0983	0.0984	...
x_1^E	0.5	0.5	0.46	...	0.212	...	0.024	0	0

Table 3: Location of firm 1, x_1^E , when $r = 0.1, \bar{u} = 4, F_2 = 100$, and $c = 1$. We have $\underline{\alpha} = 0.0966, \bar{\alpha} = 0.0984$.

analysis; $r = 0.1, \alpha = 0.096$ and $\bar{u} = 4$. As $\bar{u} > 3c, c \in (0, 4/3)$. When $F_2 = 20$, the value of x_1^E declines from $1/2$ to approximately $1/10$ as c increases. In this case, firm 1 never locates at point 0. When $F_2 = 13, x_1^E$ moves from $1/2$ to 0 as c increases. Figure 1 demonstrates the following concept. If the interior solution exists in the equilibrium, x_1^E is decreasing in c . As F_2 increases, x_1^E is more likely to take a higher value for a given c .

Third, we show the effects of both c and F_2 on the equilibrium location of the leader. Tables 4 and 5 illustrate the equilibrium location of firm 1 for different values of c and F_2 when $r = 0.1, \bar{u} = 4$ and $\alpha = 0.098$ for Table 4 and $\alpha = 0.097$ for Table 5. For these values of r and \bar{u} , these values of α allow interior solutions of x_1 . Thus, for α very close to r , at approximately 0.099, we primarily have $x_1 = 0$; however, for most values of α , we tend to have the other corner solution at $x_1 = 1/2$.

By examining the interior solutions, we can better understand the effects of c and F_2 . Values of c increase by 0.1 up to 1.3, as $\bar{u} > 3c, c \in (0, 4/3)$. F_2 is increased from 10 to 200 in increments of 10. Both tables show two trends. As c increases, if an interior solution exists in the equilibrium, x_1^E decreases. As F_2 increases, x_1^E increases if the interior solution exists in the equilibrium. As noted in the previous section, the effects of these two parameters tend to counter each other.

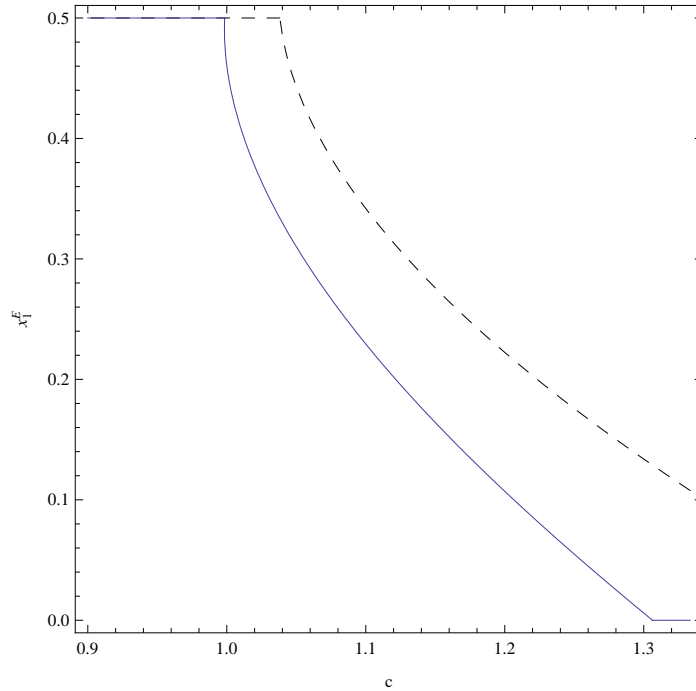


Figure 1: Plotted values of optimal location for firm 1 with respect to $c \in (9/10, 4/3)$ when $F_2 = 20$ (dotted) and $F_2 = 13$ (solid).

4.2 On the importance of endogenous timing by the follower

One of the main points of this paper in contrast to previous papers, including Lambertini (2002), is that the follower's entry timing is endogenised and the leader determines its location considering this move. To determine its importance, we examine the relative sizes of the three terms in equation (21). Equation (21) is the first-order derivative of V_1 with respect to x_1 . The first term represents how the marginal change in the leader's location delays the follower's entry, allowing the leader to prolong its monopoly regime.

Using the parameters and the leader's location x_1 in Table 2, we derive concrete values of equation (21) in four cases. The common parameter values are $r = 0.1$, $\bar{u} = 4$, $c = 1$ and $F_2 = 50$. The result is summarised in Table 6.

The sum column in Table 6 indicates how firm 1 decides its location. If the value in the column is negative (positive), then firm 1 locates at 0 (0.5). If it is 0, an interior

F_2/c	0.4	0.5	0.6	0.7	0.8	0.9	1.0	1.1	1.2	1.3
200	0.5	0.5	0.5	0.5	0.5	0.5	0.418	0.353	0.304	0.265
190	0.5	0.5	0.5	0.5	0.5	0.5	0.414	0.348	0.299	0.260
180	0.5	0.5	0.5	0.5	0.5	0.5	0.408	0.343	0.294	0.255
170	0.5	0.5	0.5	0.5	0.5	0.5	0.403	0.338	0.288	0.249
160	0.5	0.5	0.5	0.5	0.5	0.5	0.397	0.332	0.283	0.243
150	0.5	0.5	0.5	0.5	0.5	0.497	0.391	0.323	0.276	0.236
140	0.5	0.5	0.5	0.5	0.5	0.489	0.384	0.319	0.269	0.229
130	0.5	0.5	0.5	0.5	0.5	0.480	0.377	0.312	0.262	0.222
120	0.5	0.5	0.5	0.5	0.5	0.470	0.369	0.303	0.254	0.213
110	0.5	0.5	0.5	0.5	0.5	0.460	0.360	0.295	0.245	0.204
100	0.5	0.5	0.5	0.5	0.5	0.448	0.350	0.285	0.234	0.193
90	0.5	0.5	0.5	0.5	0.5	0.436	0.339	0.273	0.223	0.181
80	0.5	0.5	0.5	0.5	0.5	0.422	0.326	0.261	0.210	0.167
70	0.5	0.5	0.5	0.5	0.5	0.406	0.311	0.246	0.194	0.151
60	0.5	0.5	0.5	0.5	0.5	0.387	0.294	0.228	0.175	0.132
50	0.5	0.5	0.5	0.5	0.5	0.365	0.272	0.205	0.152	0.107
40	0.5	0.5	0.5	0.5	0.5	0.334	0.244	0.176	0.122	0.075
30	0.5	0.5	0.5	0.5	0.467	0.298	0.206	0.136	0.079	0.030
20	0.5	0.5	0.5	0.5	0.400	0.240	0.15	0.072	0.011	0
10	0.5	0.5	0.5	0.5	0.266	0.123	0.191	0	0	0

Table 4: Location of firm 1, x_1^E , depending on the values of F_2 and c , when $r = 0.1, \alpha = 0.097, \bar{u} = 4$.

location between 0 and 0.5 may arise.

The last three cases are interesting. If the first term is not present, the sum will be negative, and firm 1 has an incentive to move closer to 0. Therefore, compared with Lambertini (2002), firm 1 is more likely to locate closer to the centre, forcing firm 2 to delay its entry. This effect of delaying entry does not exist in Lambertini (2002).

4.3 On total values of the firms

Finally, from the firms' point of view, their total values are more or at least as important as their entry timing and locations. We examine how the parameters \bar{u} and c , commonly used in the Hotelling settings, affect firm values. The result for \bar{u} is straightforward, but

F_2/c	0.4	0.5	0.6	0.7	0.8	0.9	1.0	1.1	1.2	1.3
200	0.5	0.5	0.420	0.305	0.235	0.184	0.144	0.112	0.084	0.061
190	0.5	0.5	0.417	0.302	0.231	0.180	0.140	0.108	0.080	0.057
180	0.5	0.5	0.413	0.298	0.228	0.177	0.136	0.104	0.076	0.053
170	0.5	0.5	0.409	0.294	0.224	0.173	0.132	0.099	0.072	0.048
160	0.5	0.5	0.404	0.290	0.220	0.168	0.128	0.095	0.067	0.043
150	0.5	0.5	0.400	0.286	0.215	0.164	0.123	0.090	0.062	0.038
140	0.5	0.5	0.395	0.281	0.210	0.159	0.118	0.085	0.056	0.032
130	0.5	0.5	0.389	0.276	0.205	0.153	0.112	0.079	0.050	0.026
120	0.5	0.5	0.383	0.271	0.200	0.147	0.106	0.072	0.044	0.019
110	0.5	0.5	0.377	0.265	0.193	0.141	0.099	0.065	0.037	0.012
100	0.5	0.5	0.370	0.258	0.186	0.133	0.092	0.058	0.029	0.004
90	0.5	0.5	0.362	0.250	0.178	0.125	0.083	0.049	0.019	0
80	0.5	0.5	0.353	0.242	0.170	0.116	0.074	0.039	0.009	0
70	0.5	0.5	0.341	0.232	0.159	0.105	0.062	0.027	0	0
60	0.5	0.5	0.331	0.220	0.147	0.092	0.049	0.013	0	0
50	0.5	0.5	0.317	0.206	0.132	0.077	0.033	0	0	0
40	0.5	0.5	0.299	0.188	0.113	0.057	0.012	0	0	0
30	0.5	0.5	0.275	0.163	0.087	0.030	0	0	0	0
20	0.5	0.5	0.239	0.127	0.048	0	0	0	0	0
10	0.5	0.399	0.173	0.056	0	0	0	0	0	0

Table 5: Location of firm 1, x_1^E , depending on the values of F_2 and c when $r = 0.1, \alpha = 0.098, \bar{u} = 4$.

	x_1^E	First term	Second term	Third term	Sum
$\alpha = 0.0985$	0	40.844	45.943	-107.283	-20.496
$\alpha = 0.0973$	0.192	53.826	42.398	-96.224	0
$\alpha = 0.0965$	0.453	80.420	34.584	-115.004	0
$\alpha = 0.092$	0.5	77.479	31.673	-45.367	63.785

Table 6: Values of the three terms in equation (21) when $r = 0.1, \bar{u} = 4, F_2 = 50$, and $c = 1$.

that for c is more complicated.

An increase in \bar{u} improves the leader's value and possibly worsens the follower's value. \bar{u} only appears in the monopoly profit phase of the leader. As it increases, firm 1 has

more incentive to move closer to the centre, giving firm 2 an incentive to delay its entry if the leader has not already located at the centre. Because there is only one effect to be considered, the result is simple.

Examining the impact of the change in c on the values of the leader and follower requires greater care. We set the parameters as $r = 0.1$ and $\bar{u} = 4$. Figure 2 demonstrates that the value of the follower is monotonically increasing in c whereas that of the leader does not move monotonically. In a Hotelling setting, transport cost c can be interpreted as the degree of product differentiation. A larger c indicates a greater degree of product differentiation.

In our model, if c increases, the follower always enjoys a positive effect on its total profit, which is not always true for the leader because the effects of an increase in c are classified into three categories: (i) a decrease in T_2 , (ii) a decrease in π_1^M and (iii) an increase in π_1^D . In other words, as product space becomes more differentiated, (i) the follower enters earlier, (ii) the monopoly profit decreases and (iii) the duopoly profits after entry increase. The follower only faces (i) and (iii), which are both positive effects for the follower, yielding that V_2 is increasing in c . However, effects (i) and (ii) are negative for the leader, whereas effect (iii) is positive. As c increases, (ii) and (iii), presented by π_1^M and π_1^D respectively, are linearly changed whereas (i), presented by \tilde{T}_2 , decreases proportionally to $-\log c$. Thus, when c is close to zero, the effect (i) dominates (iii), and V_1 is decreasing in c . When c is relatively large, effect (i) is small, effect (iii) dominates (i) and (ii) and V_1 is increasing in c .

In the usual static Hotelling game, only effect (iii) exists, yielding that greater differentiation on a product space always enlarges the values of duopoly firms. This result is well known in the related literature. However, in our dynamic Hotelling game, greater differentiation in a product space may not benefit both firms, thus indicating the importance of introducing timing into the consideration.

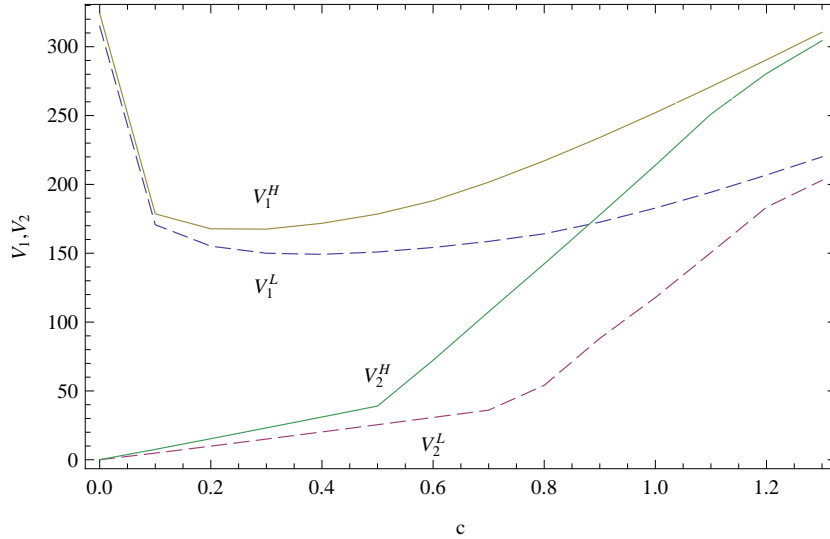


Figure 2: Plotted values of the values of the leader and the follower with respect to $c \in \{0.001, 0.1, 0.2, 0.3, \dots, 1.3\}$, when $r = 0.1$, $\bar{u} = 4$. V_1^H and V_2^H are the values of V_1 and V_2 when $\alpha = 0.098$ and $F_1 = F_2 = 60$. V_1^L and V_2^L are the values of V_1 and V_2 when $\alpha = 0.097$ and $F_1 = F_2 = 20$.

5 Concluding Remarks

In this paper, we develop a duopoly model that determines the follower's entry timing, firms' locations and their prices. Examining the timing of investments is important when considering firms' entry strategies. Hence, we extend Lambertini (2002), which in turn extends the location-price competition model (d'Aspremont et al., 1979) by using a continuous time model in which firms earn profits in each instance and the follower's entry timing is given exogenously. Our model endogenises the follower's entry timing. In doing so, we introduce parameters such as investment costs and a market growth rate to make the model and the outcome more realistic.

We find that these changes create a strategic interaction between the leader's location and the follower's entry timing. As a result, the leader has greater incentive to locate closer to the centre to delay the follower's entry. We also find that the follower always locates as far away as possible from the leader, which is a robust result also seen in Lam-

bertini (2002). Numerical analyses are also presented that investigate how the exogenous parameters affect the leader's location and the firms' values. In particular, the profit of the leader changes *non-monotonically* with an increase in the transport cost parameter.

A potential future study should address the last result, for which the relationship between the firm values and the transport cost parameter c is nontrivial. c can be interpreted as a parameter that describes the degree of product differentiation. Therefore, c is important for firms and their marketing strategies, necessitating its careful estimation. Another issue that needs to be addressed is making the entry timing fully endogenous. In this paper, we allow the follower to enter endogenously; however, the game starts when the leader enters at $T = 0$, thus exogenously. This setting is intentional in order to compare our result to Lambertini (2002). However, we may allow the leader to endogenously enter and, more interestingly, allow a preemption by the firms to enable full analysis of the endogenous entry timing model, as indicated by Fudenberg and Tirole (1985).

Appendix

Proof of Lemma 1:

The duopoly result is a straightforward maximisation of profit by the two firms, as previously stated. See, for example, d'Aspremont et al., (1979).

As for a monopoly, firm 1 is located at or to the left of $1/2$, which we denote as x_1 . Firm 1 sets up its price so that the consumer at 1 or at a point to the left of 1 is indifferent between purchasing and not purchasing. That is, the consumer at 1 has no surplus, as otherwise firm 1 has an incentive to increase its price without losing any of its consumers. Let this indifferent consumer be denoted \hat{x} .

Firm 1's profit is given by

$$\begin{aligned} \pi_1 &= p_1 \hat{x}, \\ \text{s.t. } \quad \bar{u} - p_1 - c(\hat{x} - x_1)^2 &= 0. \end{aligned}$$

Substituting p_1 of the constraint into the profit and maximising with respect to \hat{x} gives

$$\frac{\partial \pi_1|_{p_1}}{\partial \hat{x}} = \bar{u} - c(3\hat{x} - x_1)(\hat{x} - x_1) > 0,$$

from Assumption 1. Thus, the firm sets \hat{x} to be at 1 and we have the monopoly result.

Finally, we must show that the monopoly and duopoly results are sensitive to time only with respect to the entry timing. We show in three steps that this point holds.

First, after the follower enters the market (at a given T_2), the corresponding profits are independent of time t . That is, firm 1 maximises the following with respect to p_{1t} :

$$\max_{p_{1t}} \int_0^{\bar{x}} p_{1t}(x; x_1, x_2, p_{2t}) dx$$

and firm 2 maximises the following with respect to p_{2t} :

$$\max_{p_{2t}} \int_{\bar{x}}^1 p_{2t}(x; x_1, x_2, p_{1t}) dx.$$

The result is the aforementioned simple duopoly.

Second, given this result, firm 2 determines T_2 . Firm 2 maximises equation (3) with respect to T_2 , and notably, this process does not depend on how firm 1 sets its prices before firm 2 enters the market.

Third, because firm 1's price before firm 2's entry, p_{1t} , $t \in [0, T_2)$, does not affect post-entry competition (the first step) or entry timing (the second step), firm 1 maximises the following with respect to p_{1t} :

$$\max_{p_{1t}} \int_0^1 p_{1t}(x; x_1) dx.$$

Therefore, the profit maximisation problem corresponds to the maximisation of the integrand. Therefore, firm 1 achieves the monopoly instantaneous profit flow as previously given.

Hence, we show that the maximisation of the instantaneous profit flows is equivalent to the maximisation of total profits.

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