

Competitive Markets and The Rule of Three

A summary of ground breaking research by Jagdish N. Sheth and Rajendra S. Sisodia.

This research explains the relationship between profitability and market share.

The research studied 200 industries, finding consistent patterns in market share and profitability, regardless of industry.

The Big Ideas

1. Almost every industry conforms to the rule of three – there is only room for three large players who dominate the industry, and smaller, niche specialists. Those in the middle constantly fight to survive.
2. Profitability (ROI) is highest for market/product specialists who have strategic control of a niche, and for the three large scale players.
3. Those companies who are not one of the big three, or do not control a niche, compete in “the ditch”—experience intense pricing pressure without the efficiency of scale or the premium reputation of being the leader in a specialty.
4. In “the ditch” it is a constant battle to find small competitive advantages. When implemented they generally prove to be temporary.

Options for companies competing in the “ditch.”

1. Aggressively pursue scale through high investment in aggressive marketing and sales, new products and services, and acquisition. Ensure clarity in which core business strategy will lead to success – low price, highest quality/innovation, or customer intimate customization.
2. Refine market and product/service focus to build greater dominance as a specialist in smaller, well-defined markets.
3. Anticipate trends in what will drive customer value in the future and attack those before larger companies, who are less agile, can.
4. Learn to use measurement. Measurement driven companies dramatically outperform those that are not.

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COMPETITIVE MARKETS AND THE RULE OF THREE

By Jagdish N. Sheth and Rajendra S. Sisodia

The “Big Three” no longer have the automobile market to themselves, but almost every market, including the one for cars, is ruled by three dominant firms. That reality does not prevent other firms from being successful. However, all firms, regardless of their market share, must still understand The Rule of Three and how it will affect their strategy and attempt to operate efficiently.

Over the past several years, the world economy, principally in the developed free market economies of Europe and North America, has been characterized by a unique economic phenomena—the combination of mergers and demergers at record levels (demergers are the spin-offs of non-core businesses). As a result, the landscape of just about every major industry has changed in a significant way, moving inexorably toward what we call the “Rule of Three.” The recent economic downturn has slowed but not halted this fundamental evolution, nor has it altered its basic direction.

We note that the Rule of Three is much more than an interesting theoretical construct; it is a powerful empirical reality that must be factored into corporate strategizing. Understanding the likely end-points of market evolution is critical to the ability of executives to develop strategies that will result in success.

WHAT IS THE RULE OF THREE?

Just as living organisms have a reasonably standard pattern of growth and development, so do competitive markets. Our research into approximately 200 industries has revealed that markets evolve in a highly predictable fashion, governed by the “Rule of Three.”

Through market forces, markets that are largely free of regulatory constraints and major entry barriers (such as restrictive patent rights or government-controlled capacity licenses) are eventually characterized by two kinds of competitors: full-line generalists and product/market specialists. Full-line generalists compete across a range of products and markets, and are volume-driven players for whom financial performance improves with gains in market share. Specialists tend to be margin-driven players, and their financial performance deteriorates as they increase their share of the broad market. Contrary to traditional economic theory, then, evolved markets tend to be simultaneously oligopolistic as well as monopolistic.

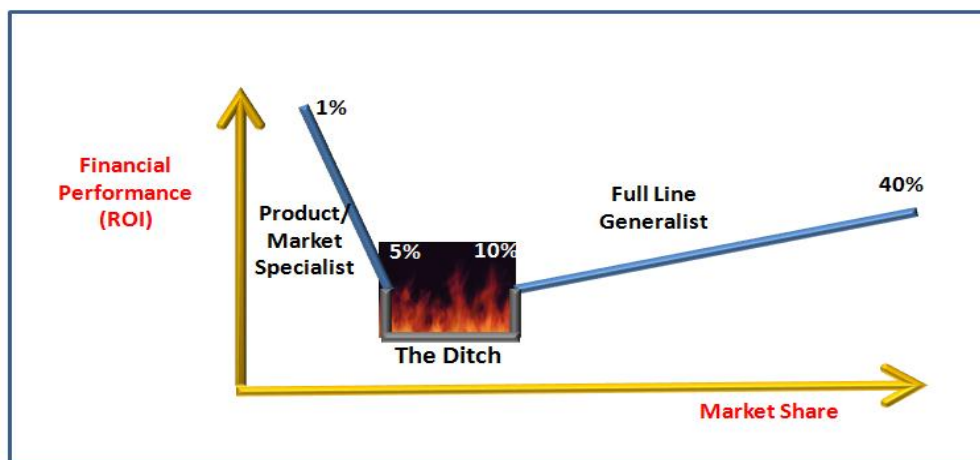


Figure 1: The Rule of Three

Figure 1 plots financial performance and market share, and illustrates the central paradigm of the Rule of Three:

In competitive, mature markets, there is only room for three full-line generalists, along with several (in some markets, numerous) product or market specialists. Together, the three “inner circle” competitors typically control, in varying proportions, between 70 per cent and 90 per cent of the market. To be viable as volume-driven players, companies must have a critical-mass market share of at least 10 per cent. As Figure 1 shows, the financial performance of full-line generalists gradually improves with greater market share, while the performance of specialists drops off rapidly as their market share increases.

There is a discontinuity “in the middle”; mid-sized companies almost always exhibit the worst financial performance of all. We label this middle position the “ditch,” the pothole in the market (generally between 5 per cent and 10 per cent market share) where competitive position (and, thus, financial performance) is the weakest. The rule of competitive market physics is very simple: Those closest to the ditch are the ones most likely to fall into it. Therefore, the most desirable competitive positions are those furthest away from the middle. Firms on either side of the ditch especially those close to it need to develop strategies to distance themselves. If a firm in a mature industry finds itself in the ditch, it must carefully consider its options and formulate an explicit strategy to move either to the right or the left.

The Rule of Three applies (and renews itself) at every stage of a market’s geographic evolution from local to regional, regional to national, and national to global.

A useful analogy to help understand mature competitive markets is the example a shopping mall (Figure 2). Mature markets are “anchored” by a few full-line generalists, which are akin to the full-service anchor department stores (such as Sears and JC Penney) in a mall. In addition, a number of other players are positioned as either product specialists or market specialists. In a mall, a store such as Footlocker is clearly a product specialist, while The Limited is more of a market specialist. While Footlocker sells only athletic shoes, The Limited has a precisely-defined target market young, affluent, educated, professional women and caters to a wide range of their fashion needs. Store image, customer image and employee image all blend into one homogenous mix. The same company likewise operates stores such as Victoria’s Secret, Lane Bryant and Limited Express, each a market specialist targeting a different customer group. This structure illustrates a maxim that we will discuss later that the best way for a specialist to grow profitably is to spawn new specialists.

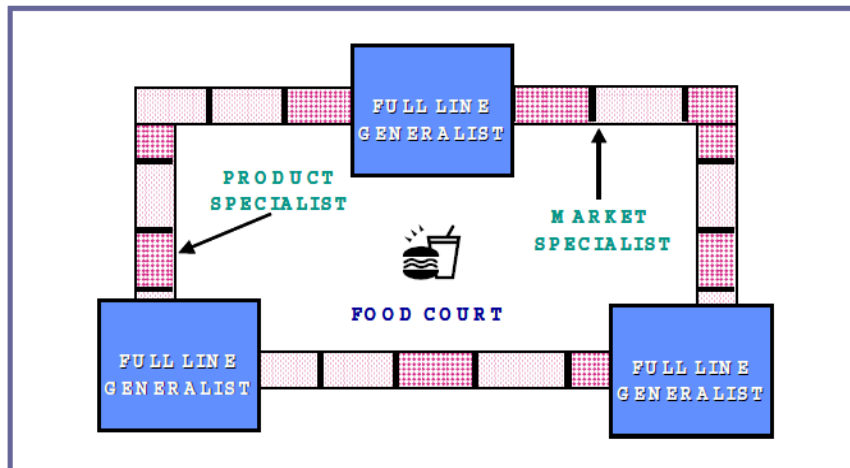


Figure 2: The Shopping Mall Analogy

COMMON ELEMENTS IN MARKET EVOLUTION

By analyzing the evolution of about 200 competitive markets, we have made the following generalizations:

1. A typical competitive market starts out in an unorganized way, with only small players serving it. As markets expand, they get organized through consolidation and standardization. This process eventually results in the emergence of a handful of “full-line generalists” surrounded by a number of “product specialists” and “market specialists.” Contrary to the prevailing wisdom that they only occur when an industry matures or shrinks, such shakeouts often take place during market expansion (witness the cellular telephony industry in recent years).

2. With uncanny regularity, the number of full-line generalists that survive this transition is three. Typically, the market shares of the three eventually hover around 40, 20 and 10 per cent, respectively.

Together, they generally serve between 70 per cent and 90 per cent of the market, with the balance going to product/market specialists. We have found that the extent of market share concentration among the big three depends on the extent to which fixed costs dominate the cost structure.

3. The Rule of Three applies (and renews itself) at every stage of a market’s geographic evolution from local to regional, regional to national, and national to global.

4. The financial performance of the three large players improves with increased market share-up to a point, typically 40 per cent. Beyond that point, diseconomies of scale set in, along with the potential for regulatory problems related to heightened anti-monopoly scrutiny.

5. The big three companies are typically valued at a substantial premium (measured by the price-earnings ratio) over those in the ditch.

6. If the top player commands 70 per cent or more of the market (usually because of a proprietary technology or strong patent rights), there is often no room for even a second full-line generalist. When IBM dominated the mainframe business many years ago, all of its competitors had to become niche players to survive. When the market leader has a share of between 50 and 70 per cent, there is often only

room for two full-line generalists. Similarly, if the market leader enjoys considerably less than a 40 per cent share, there may (temporarily) be room for a fourth generalist player.

7. A market share of 10 per cent is the minimum level necessary for a player to be viable as a full-line generalist. Companies that dip below this level must become a specialist to survive; alternatively, they must consider a merger with another company to regain a market share above 10 per cent. In the U.S. airline industry, US Airways, Northwest and America West are all in the ditch; each will eventually have to shrink into specialty status or merge with one of the Big Three (American, United and Delta) to survive. Previous ditch players, such as Eastern, Braniff, PanAm and TWA, have already perished.

8. In a market suffering through a downturn, the fight for market share between Nos. 1 and 2 often sends the No. 3 company into the ditch. For example, this happened in soft drinks (RC Cola wound up in the ditch), beer (Schlitz), aircraft manufacturing (Lockheed first, then McDonnell Douglas), and automobiles (previous battles between GM and Ford drove Chrysler perilously close to extinction).

9. Nevertheless, in the long run, a new No. 3 full-line player always emerges. In the global soft drink market of today, the combination of Cadbury-Schweppes, Dr. Pepper and 7-Up has resulted in the creation of a viable new No. 3 player behind Coke and Pepsi, with approximately 17 per cent share.

10. The No. 1 company is usually the least innovative, though it may have the largest R&D budget. Such companies tend to adopt a “fast follower” strategic posture when it comes to innovation.

11. The No. 3 company is usually the most innovative. However, its innovations are usually “stolen” by the No. 1 company unless it can protect them. Such protection becomes more difficult to secure. The extent to which the third-ranked player is comfortable or precarious depends on how far away that player is from the “ditch.”

12. The performance of specialist companies deteriorates as they grow market share within the overall market, but improves as they grow their share of a specialty niche.

13. Reckless growth can rapidly lead specialists into the ditch. The airline, People’s Express, is a classic example. After a few years of heady growth, the Newark, N.J.-based carrier flamed out as it added flights to Europe and across the continent.

14. Specialists can make the transition to successful full-line generalists only if there are two or fewer incumbent generalists in the market.

15. Alternatively, specialists serving a niche that has gone mainstream can sell out to full-line generalists, as Mennen, Maybelline and Gatorade have done.

16. Successful product or market specialists typically face only one direct competitor in their chosen specialty.

17. If they face excessive competition in their niche, specialists can move up to become superniches.

For example, some cruise lines have made this transition, as have many boutique practices.

18. Successful superniche players (that specialize by product and market) are, in essence, monopolists in their niches, commanding 80-90 per cent market share.

19. Successful market growth (finding new markets for existing products) requires product strength, and successful product growth (developing new products for existing markets) requires market strength.

20. Companies in the ditch exhibit the worst financial performance and have a very difficult time surviving.

21. Ditch dwellers can emerge as big players by merging with one another, but only if there is no viable third-ranked player to block them. General Motors achieved this in the early years of the automobile industry.

22. A better strategy for ditch companies may be to seek a merger with a successful full-line generalist. The ditch can be a very attractive source of bargains for full-line generalists looking to rapidly boost market share.

23. Ditch dwellers can emerge as specialists only if they are able to identify a defensible niche in which they have a sustainable competitive advantage through unique resource endowments. For example, Service Merchandize has re-emerged as a jewellery specialist.

The evidence to support these generalizations is strong and consistent. There is a powerful logic driving market evolution in this direction. The Rule of Three draws on fundamental truths about consumer psychology (e.g., the “evoked set” of brands typically considered by most consumers consists of three alternatives), competitive dynamics and the balance of power.

WHEN THE RULE OF THREE DOES NOT APPLY

The Rule of Three applies wherever competitive market forces are allowed to determine market structure with only minor regulatory and technological impediments. It would, therefore, not apply in markets where the following factors are significant:

1. Regulation. If regulatory policies hinder market consolidation (as they have in Japan) or allow for the existence of “natural” monopolies (as was the case with the local telecommunications market), the Rule of Three does not apply. With deregulation, it comes into play, as with the U.S. airline, trucking and telecommunications industries.
2. Exclusive rights. If patents and trademarks are major factors in a market, it must be viewed as a collection of sub-monopolies, and it is thus not subject to market forces.
3. Major barriers to trade and foreign ownership of assets. In this case, we are likely to see the Rule of Three operate at the national level but not at the global level. The Rule of Three may still be seen in the formation of global groups or alliances, as is occurring in the global telecommunications and airline markets.
4. Markets with combined ownership and management. If ownership and management are combined, as in the case of professional services, the market process is not allowed to work. Ownership creates an emotional attachment, and inhibits rational economic decision-making.

When these barriers begin to fall, markets start moving towards the Rule of Three.

CONCLUSIONS

Ultimately, the Rule of Three is about the search for the highest level of operating efficiency in a competitive market. Industries with four or more major players, as well as those with two or fewer, tend to be less efficient than those with three major players. The role of the government is to ensure that free market conditions do indeed prevail, to allow industry rationalization and consolidation to occur naturally, and to step in when an industry seeks to consolidate too far, i.e., to a level where fewer than three players control the lion's share.

As more markets become global or are transformed through technology in coming years, managers everywhere will have to reassess their corporate positioning and strategic goals. For some, this will spell a once-in-a-lifetime opportunity to seize the initiative and firmly establish their companies on a larger stage. For many others, it will require hard thinking about strategic choices, and the courage to make painful but necessary decisions about markets not served and products not offered.

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