RI HUB

A research collaboration between the University of Melbourne and the Ruthven Institute

KEY FINDINGS

1. Research over 40 years has shown that market share has a small positive impact on a firm's profitability.
2. Most have therefore sought market dominance, but niche firms can be as profitable as larger firms.
3. Context alters the significance of market share. The levels of concentration and competition in an industry are important, as are capital intensity and whether the firms are in the manufacturing or service industries. This suggests that (dis)economies of scale, product quality, and customer service/focus are also critical.
4. Market share or positioning needs to be determined in conjunction with other strategic drivers/choices.
5. While RI's nuancing of the five potential market positions and the identification of *unsafe* market positions has not been replicated by academic research, it is consistent with studies that have considered the performance of large and small firms.
6. Credit rating agencies use market share, together with industry growth prospects, as part of their business and credit risk evaluation.

AUTHORS

Ruth Dunkin, Sabutay Fatullayev & André Sammartino

POSTERA CRESCAM LAUDE

THE UNIVERSITY OF MELBOURNE

PRACTICE NOTE #5

MARCH 2021

BE THE MASTER OF YOUR OWN DESTINY

The Issue: *RI strategy rule 5 urges firms to secure a winnable position in their industry, as a major player, a niche player, an ultra-niche player, a boutique operator, or an exotic operator. What does this mean for practice?*

Our academic literature search found the following.

- Market share has a small positive impact on a firm's profitability, but this effect is contextual. It varies across countries, industries, and with the extent of competition.
- Although the original research showed that the higher the market share and the larger the firms, the more profitable they were likely to be:
  - large firms can reap both economies of scale, but also diseconomies of scale
  - a moderate number of players in a market will encourage efficiency
  - excessive market power can attract regulation
- Because innovation is not just invention, assessing innovativeness therefore requires more sophisticated measures than the number of patents or amount of R & D expenditure.
- High market share improves profitability more strongly in manufacturing industries than in service industries and to a greater extent for B2C firms than B2B firms. The impact of market share on profitability is also weaker in firms that are significantly affected by digitisation. This reflects the different bases upon which each group of firms seek to compete – cost/price; product quality and customer responsiveness, and differences in barriers to entry.
- New technologies blur industry boundaries by allowing for ready substitutes from other industries, further muddying market share effects.
- The relationship between market share and profitability is more pronounced in emerging economies than it is in developed ones.
- The RI rule is not explicitly supported by academic research. However, its broad parameters are, and many of its conclusions are consistent with findings and theorising about firm performance.

- The RI rule is based on an analysis from the large IbisWorld database over 40 years,. The IbisWorld analysis has allowed more nuanced guidance about market positioning for smaller firms and is consistent with academic research on firm survival rates.
- Studies on the profitability and survival rates of niche firms found that smaller specialised firms could cater for specific customer segments, thereby avoiding direct competition with large generalist firms who tend to target the centre of the market. By focusing on different segments, firms are then differentiated by different organisational capabilities and face different competitive landscapes. The greater the competitive pressure, the less likely is the firm to survive. And the less intense the competition, the more capacity a firm has to develop strategic partnerships with other firms and suppliers, thereby strengthening their organisational capabilities.
- ·Although the academic research shows that market share matters and together with linked strategic elements explains 40% of a firm's profitability, other researchers focused on *strategy as enacted* as opposed to *designed*. These researchers were more focused on the competencies and capabilities of firms in executing, or enacting, a particular strategy. In other words, the design of a successful strategy was not in their eyes sufficient to guarantee success for the firm. Rather it was their capacity to execute a chosen strategy (in full) that would determine their success.
    - Both the existing academic studies and the RI analysis agree that establishing a market share goal as part of a firm's strategy needs to be meshed with other strategic drivers; it is insufficient on its own to drive profitability. However, selecting a particular market position can moderate the level of competitive pressure the firm experiences and allow it to develop its distinctive organisational competencies.
    - It is not just what a firm decides to do, but how it goes about it that will determine its ultimate level of success and sustainability.

The Implications for Practice.

- For 40 years conventional wisdom has held that the higher the market share, the more profitable will a firm be. Therefore, it is little surprise to find that credit rating agencies review a firm's market share when assessing their business and credit risk.
    - For example, Standard and Poor's (S&P) evaluates the cashflow implications of market share when assessing a firm's competitive advantage, scale, and scope. They believe a high market share enhances a firm's ability to generate enough cash to pay its debts by allowing the firm to better adjust its strategy to changing market conditions; be more innovative; enjoy some pricing advantage; and maintain its sales and profitability.
    - But for a firm to achieve a high score in competitiveness, S&P must not only consider the firm's market share as stable or growing, but also assess the firm to be one of the top (usually two) firms AND to be operating within an industry that is growing. A leading market share in a fragmented or relatively small market with few growth prospects will not earn the firm more than an 'adequate' score in this category.

- The RI rule calls for firms to select to one of five optimal market share positions:
  - *major player* - a firm that has at least 25% of an industry's (at the four-digit level) revenue and 35%-50% share in the product groups in which it competes.[1]
  - *niche player* - generates 5% of an industry's revenue and needs to dominate a market segment (usually product-based but can be geographic-based).
  - *ultra-niche specialist* - has a 1% share of an industry's revenue and dominates a product group with at least a 75% share.
  - *boutique operator* - generates 0.1% of an industry's revenue and dominates the product sub-group.
  - *exotic operator* - has a 0.01% market share with a unique product line.
- Should a firm's market share fall within the 5%-25%, 1%-5%, and 0.1%-1% interval – suboptimal positions that do not allow a firm to be master of their own destiny - RI Rule 5 recommends firms either expand or shrink to get to an *optimal zone*.
- This can be done through organic growth, mergers and acquisitions, breaking up businesses into smaller units, selling off/discontinuing some operations, or changing industries in more extreme scenarios.

The Challenges for Implementation

- *Measurement issues.* How to define a market? How to obtain firm data?
  - It is not always straightforward to measure industry revenues and identify market share of firms within them, mainly because firms have considerable leeway in how they define and report on their operating segments. This market definition problem is exacerbated further by the blurring of boundaries between industry segments as new and/or convergent technologies allow new ways of meeting consumer needs. Sometimes, in concentrated industries, it is possible to calculate market share based on a firm's revenue as a proportion of the sum of the revenues of the largest three or four firms in that industry.
- The *increasing digitisation* of industries is weakening the previously established relationship between higher market share and higher profitability. New research is needed to understand this shifting dynamic.
- ·In the meantime, the additional nuancing of market positioning offered by RI's Rule #5 provides more detailed guidance for executives as they frame their strategies. It should be noted that the market share/positioning decision is only one element in constructing a successful strategy. It needs to be *meshed with other important decisions*, such as where in the lifecycle the firm is (see Practice Note #3).
- And having decided to either grow or reduce the size of the firm to bring it into a more optimal market position, execution of the chosen path needs to be undertaken with care.

1 As per RI Rule 5, although monopolies are technically in an optimal zone, they are not considered desirable because monopolies "tend to breed complacency and have low levels of innovation".

- Other RI rules are relevant for determining how to pursue the chosen path. For example, firms should ensure that they stay focused in one industry (Rule 1); that, in growing, they do not take on unnecessary hard assets (Rule 8); that their structures can continue to support an innovative culture and pipeline (Rules 4 & 12); and that they are simultaneously managing their finances wisely (Rule 9).
  - Divestment too requires care with timing and market approach. Too often internal reluctance or underestimation of the value of the unit can delay or deter divestment. Again, objective analysis and evaluation are needed to ensure an optimal portfolio.
  - And structural changes necessarily mean the need to engage with staff, financiers and suppliers, and customers. Each requires a detailed implementation plan that takes account of both legal and compliance requirements and the less tangible need to preserve and build goodwill.

Further Reading

For the full academic literature review, see

Fatullayev, S. and Sammartino, A. (2020) Research Note 5: RI Rule # 5 Be Master Of Your Own Destiny.

Other practioner focussed papers relevant to implementation and strategy execution:

Bloom, P. and Kotler. P. (1975) "Strategies for high market share companies", *Harvard Business Review*, November.

McKinsey (2015) How to beat the transformation odds

McKinsey (2020) What's keeping you from divesting?

McKinsey (2020) Eight lessons on how to get the growth you planned