

Manager's Journal: The Myth of Market Share

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By Richard Minter

Correction: Monday's Manager's Journal, "The Myth of Market Share," misidentified Jack High. Mr. High is a professor of economics at George Mason University and a former acting dean of the university's School of Management. (WSJ June 18, 1998)

Jubilant General Motors executives recently announced their May sales figures, showing that GM's share had surged to more than 32% of the U.S. car market. A few months earlier, they were deciding how to deal with a crisis: Domestic market share had fallen to 28.6% in February. Though GM's market share had been sinking since 1992, the executives had assured Wall Street that it wouldn't fall below 30%. It had, and it continued to fall in March.

The GM executives, who promised for years that they wouldn't trade profits for market share, now recanted. They began offering 1.9% financing, fat rebates and thinly profitable lease rates. GM sold thousands of cars at near cost to rental chains -- all in the name of market share.

Under pressure from unions and dealers, which want to keep factories humming and cars rolling off the lots, GM is repeating a strategy that cost it tens of millions of dollars in the 1980s and failed to stop the fall of its market share (then 40%). As a result, GM's earnings per share are significantly below those of other auto makers. Last year Ford, with a market share of about 25%, earned \$978 more in profit than GM on each car sold.

Nearly every public corporation is mesmerized by market share. Keeping it, growing it, justifying it -- try to talk to a senior executive without the subject coming up. This obsession, based on flawed theories, drives down profits and pushes businesses into costly moves like GM's. Except in very rare cases, managers should ignore market share. This is heresy to high-powered consultants and business school professors who champion the cult of market share. They make three arguments, all of which are wrong.

The first is "leadership." The theory is that the dominant firm can add features to its product or reduce its marginal profit to control the price. This forgets that consumers, not producers, decide what features are important and how much they are worth. Trying to use market power to tell customers what they need or how much they should pay ultimately topples "market leaders." IBM learned this lesson the hard way in the late 1980s, when it lost ground to Compaq and never regained its pre-eminent position in the personal computer market.

True, market leaders can set prices by reducing marginal profits, thereby increasing sales. But why should they? If the percentage reduction in price per unit is larger than the percentage increase in market share, the firm loses money. This is usually what happens. Seven-Up proved this point with its massive growth in the late 1970s, largely due to discounting. It soon learned that profits didn't follow from leadership and was eventually acquired by Cadbury Schweppes.

Cutting margins to boost sales also invites competitors to match the new low price. If the competition's cost structure is the same or lower, then a pointless price war follows. This spiral periodically engulfs the airline industry, as it is doing to GM and other auto makers now. "It's a game of chicken," one GM executive told this newspaper.

The second argument is simple and widely believed: As market share increases, so do profits. This view overlooks comparative advantage and price. There are always markets that are cheaper for a niche player to serve than a mass producer. Why go after the next 10% of market share when the necessary price reductions will bring demands for discounts from the 30% you already serve? And among that 30%, there are almost always customers who cost more than they are worth. In both cases, attempts to maximize market share mean lower profits.

This is a lesson AT&T has yet to learn. The long-distance giant literally buys market share by mailing millions of checks that can be cashed only when the recipient agrees to switch. Of course, MCI and Sprint do the same thing. Savvy customers now switch only long enough to cash the check, or they play the companies off each other, often bidding up the bribe to \$100. There are no reliable estimates of how much this costs the phone giants, but market share is the misguided motivation.

The third argument for market share is based on economies of scale: The more widgets you make, the cheaper they are per unit. But economies of scale don't come automatically from bigger market share or greater volume. Doughnuts are cheaper by the dozen only when bakers use the knowledge gained from increased production to shrink costs. Most firms squander executive energy on market-share growth instead of exploiting the economies of scale that are supposed to come with it. "They think of market share as an end in itself. It's not," says Jack High, acting dean of the George Mason University Business School in Fairfax, Virginia.

To be sure, there are a few situations in which a market-share strategy makes sense. The most persuasive case for such a strategy involves what economists call a "network externality" -- when the benefits or price of a product are less important to users than its compatibility with other people and other products. Word-processing software is a case in point. WordPerfect was the leader in market share in the early 1980s, but Microsoft Word was gradually beating smaller rivals like Wordstar and XyWrite. Then Microsoft made Word compatible with its spreadsheet, database and other programs, giving the word processor an advantage and building market share. As Word's share grew, even dedicated WordPerfect users switched so that they could be compatible with the greatest number of users and programs.

In the vast majority of businesses, however, the idea of network externalities doesn't apply. Price, features and other factors matter a lot more than compatibility.

The appeal of market share is partly psychological. It's a lot easier for an executive to win internal support for trimming margins than for making more radical changes to improve a product. Given internal resistance to change, it is often easier to buy market share than to enhance profits. According to economist Tom Rostici of George Mason, executives "feel embarrassed pounding their chest and saying that their company is the most profitable. It's nicer to say that they have the most market share -- especially if they aren't that profitable."

Statistical evidence that pursuing market share is folly comes from Donald V. Potter, president of Windermere Associates, a Moraga, Calif.-based consulting firm. Mr. Potter's firm has conducted a groundbreaking study of more than 3,000 public companies. It found that more than 70% of the time, the firm with the biggest share of the market doesn't have the highest rate of return.

The Windermere study examined some 240 industries that have at least five competitors with annual gross sales of more than \$50 million apiece. Among the top four firms in each of 240 industries, the market-share leader led the industry in pretax returns on assets only 29% of the time -- only 4% better than random chance. In highly concentrated industries, market leaders did slightly better (they had the best industry returns 38% of the time) and in high-growth industries they did slightly worse (only 27% had the best industry returns). Though the study tracked profits in terms of return on assets, the results would be virtually identical if profits were measured in terms of return on equity.

Mr. Potter points to an array of industry leaders bested by their smaller rivals. Steelcase, the nation's largest office-furniture maker, earns about half the rate of return of Hon Industries, which is only one-third its size. Wal-Mart earns lower rates of return than the Family Dollar and Dollar General chains. Merck may be the market leader in pharmaceuticals, but Pfizer is the profit leader.

Profit leaders, even ones with the largest market share, do two things that other big firms don't: They continually trim costs, and they aggressively weed out customers who generate low returns. They ignore market share because they know that size doesn't matter -- profits do.

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