Introduction

The Rule of Three: What It Is and How It Works

The skies are open for business, and the U.S. airline industry is in the midst of a major reshuffling. The UAL Corporation, parent of United Airlines, is preparing to acquire most of the assets of U.S. Airways for $4.3 billion. Meanwhile, Trans World Airlines, having filed for bankruptcy, has announced its plans to be acquired by AMR, the parent company of American Airlines. The nation's third largest carrier, Delta Airlines, is rumored to be in acquisition talks with Continental, the fifth largest U.S. airline.

From all indications, the industry appears to be moving in the direction of a consolidated structure that supports three major airlines—United, American, and Delta/Continental—while it leaves room, at least for the moment, to smaller, more localized airlines. Carriers such as Southwest, American West, and Alaskan Airlines can survive in their niches and even do well. What lies in store for Northwest, currently the #4 U.S. carrier, as it seeks to compete with the industry's Big 3 is less clear, but its size and the breadth of its services are not enough to protect it from the powerful forces of competition.

Big companies are not protected either from competitive market forces or from acquiring hands. On the contrary, they are just as vulnerable—in many cases, even more so—than the small firms, and frequently they must scale back. General Motors, the world's largest producer of cars and trucks, has had such traumatic operational difficulties that recently GM executives announced the long-standing Oldsmobile line would be discontinued after 2001. Although they wield enormous power, these giants of industry cannot rely on their size, their alliances, or their command of the market to protect them from aggressive competitors and changes in their industries. “The bigger they come, the harder they fall” runs the old adage. That rule applies to dinosaurs in any era, both in nature and in the business world. For over 150 years we’ve known that natural selection processes favor those species and individuals who are the most efficient, healthy, and fit. According to what we call the Rule of Three, “natural” competitive market structures evolve by an analogous selection process that favors the strongest, most efficient companies.

Natural Market Structures

Simply put, the Rule of Three states that naturally occurring competitive forces—if allowed to operate without excessive government intervention—will create a consistent structure across nearly all mature markets. In one group three major players compete against each other in multiple ways: they offer a wide range of related products and services, and they serve most major market segments. The Big 3 are familiar enough in the automobile industry: General Motors, Ford, and DaimlerChrysler. But there are plenty of other examples: NBC, ABC, and CBS among the television networks; ExxonMobil, Texaco, and Chevron among petroleum producers; Philips, SCS-Thomson, and Siemens in the European semiconductor market; TRW, Equifax, and TransUnion among credit bureaus; Gerber, Beech-Nut, and Heinz in the production of baby foods; Merck, Johnson & Johnson, and Bristol-Myers Squibb among the pharmaceuticals. These are the “full-line generalists” that form the core, the inner circle, of the market in which they participate. Why competitive markets favor three major players—not two or four or more—is an important question we take up in chapter 1.

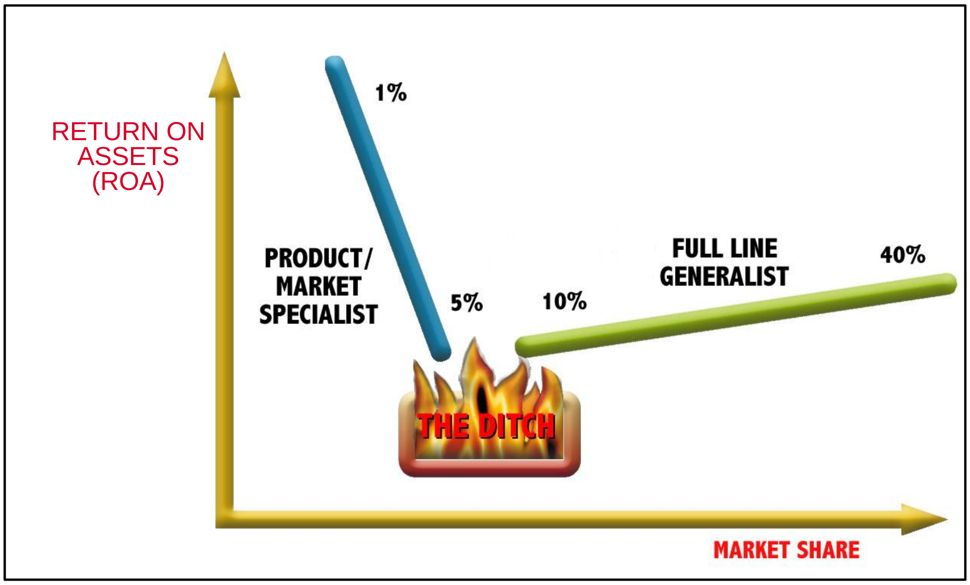
As a market matures, the Big 3 become better defined and better able to solidify their positions. Anyone who wants to participate in that market has to play by the rules the big boys set. Because it is extremely difficult to go toe-to-toe against a full-line generalist, smaller players begin to carve out those areas in which they can effectively specialize. Usually they choose one of two paths: either they become *product specialists* such as Cambridge Soundworks and Carver Corporation in high-end stereo tuners, amplifiers, and audio equipment, Leather World in a trendy clothing, or Comedy Central and CNN in the vast television network industry now ruled by NBC, ABC, and CBS (with the Fox Network close behind); or they define themselves as *market specialists* targeting a specific demographic group or geographical region. The Limited, for example, serves the apparel and fashion needs of young, educated, moderately affluent professional women; the WB network focuses on teens and their voracious need for entertainment.

In some cases a company becomes a *super-nicher,* specializing in both a product category and a market segment. Foot Locker is a product specialist focused on athletic shoes, but it serves several demographic markets, including children (Kids Foot Locker) and women (Lady Foot Locker). Southwest Airlines began as a company offering “no-frills” air service to a particular geographical area, although as it has extended that service to other regions, it has been forced to become more and more like its competitors.

As markets grow and mature, there is yet a third group of participants. Neither fish nor fowl, they are often too large and diverse to be considered specialists, yet not large enough to compete successfully against the Big 3. That is, they cannot match the #1, #2, and #3 players in achieving economies of scale and scope. Accordingly they try to reduce costs by cutting prices, product quality, and service, but their return on assets (ROA) remains quite low. Even worse, they are caught in a “ditch” between the Big 3 on the right side of the ditch and the product or market specialists on the left side (see diagram). The Big 3 can control up to 90 percent of the market, whereas each product or market specialist, by appealing to a small group at the high end or low end, controls between 1 and 5 percent of that market. Those companies caught in the ditch usually capture only between 5 and 10 percent of a given market, and find themselves unable to compete effectively against either the Big 3 or the specialists.

[Insert diagram “The Rule of Three and the ‘Ditch’” near here.]

US Airways, for example, grew out of the mergers that Allegheny Airlines struck with several regional specialists including Mohawk (New York and New England), Lake Central (Indiana and Ohio), Pacific Southwest (California), and Piedmont (Mid-Atlantic and South), each of which served the needs of a well-defined geographical area. When US Air tried to become a full-line generalist, the company ran up against American, United, and Delta, and it lost money, falling into the ditch between the far-flying generalists and the regional specialists. Unable to mount a real challenge to the Big 3, US Airways corporate executives have recently accepted an acquisition offer from United, and the company will soon become just another topic in books on aviation history. The story of US Airways as well as those of other ditch-dwellers is the topic of chapter 2.



The Rule of Three and the "Ditch"

In nearly all markets the various players comprising the Big 3, the specialists, and the ditch-dwellers share a number of important characteristics. Our analysis of literally hundreds of markets, both local and global, provides evidence from which we can both observe the maturation of these industries and draw inferences about the nature of competition and the fundamental "laws" that govern competitive markets. Bloated, inefficient companies may rule for a while, but they don't last long. The pattern in competitive markets indicates that only the most efficient rise to the top. Chapter 3 presents a theoretical model of market evolution in which four forces come together to promote efficiency: industry consolidation, government intervention, the establishment of de facto standards (either for products or processes), and shared infrastructure.

Even mature markets, however, can suffer radical disruption when technology or regulation changes or when the entry of a new player succeeds in altering the rules of competition. In 1987, the Big 3 in coffee—General Foods, Procter & Gamble, and Nestlé—controlled about 90 percent of the U.S. market. But Starbucks appeared on the scene, creating a market for upscale coffee preferences that dramatically challenged the Big 3 and the commodity-like nature of their offerings. All three had produced canned, ground coffees (some of it even freeze-dried) that were made from the inexpensive beans of the robusta coffee plant of West Africa. Competition between the leaders was based strictly on price, since the tastes of their products were virtually indistinguishable. In chapter 4 we examine this industry disruption in greater detail and chronicle the toppling of incumbent leaders as competitive markets are stretched or condensed.

In observing both the forest and the trees, we have studied the elements that characterize companies holding similar positions within their respective industries. For instance, most #1 companies should and do behave differently than #2 companies. Most #3 companies exhibit significant differences in strategy and outlook that distinguish them from their two major competitors. Ditch-dwellers also share certain characteristics, and only a limited number of alternatives, some decidedly unpleasant, are available to them as they try to extricate themselves: they can go bankrupt; they can attempt to get out on their own by becoming product or market specialists; they can merge with another ditch-dweller in hopes that their combined resources will enable them to challenge one of the Big 3; or they can choose to be acquired by one of the major players.

Specialists, in contrast, are well advised to stay in that position unless they can detect inherent weaknesses in one of the Big 3 and choose a compatible partner from the ditch with which to merge. In the final three chapters of the book, we present strategies appropriate to each of these market positions and examine the implications of industries such as pharmaceuticals and airlines that are becoming global in scope.

Basic Principles

As in any argument, we take certain basic principles and definitions for granted. We offer examples of these principles in the book, but assume that for purposes of exposition these axioms are self-evident. For instance, we believe that:

- The first criterion for determining market position is revenue from sales, not size of the company, number of employees, market capitalization, brand quality, and the like (although all are important).
- New markets come into existence as a result of new technology, new standards, and new tastes or needs that can develop on their own or at the hands of able marketers. For example, microprocessors and operating systems offered new technologies that helped make the personal computer industry a reality. VHS won out over Betamax in the standards war waged by the makers of

videocassette recorders. Chrysler developed the minivan, capturing a huge market by recognizing and responding to new tastes and trends.

- Most consumers are attracted to the offerings of full-line generalists because of attractive price points, convenience, accessibility, and so forth, while specialists and super-nichers better serve the extremes of a market's high end and low end.
- Without outside intervention and government controls, competitive markets evolve in ways that ultimately reward the most efficient companies. Efficiency is the first rule of the game.
- Markets evolve in such a way that either they are nearly free of competition, as in the case of a monopoly, or they become so intensely competitive that no one makes any money. There is a sense in which a market can suffer from too much competition: customers are confused by the sheer volume of choice, so much so that they don't buy anything; and competing companies duel it out by lowering prices or cutting back on quality such that their returns are severely compromised.

These last two principles simultaneously exert pressure on every player in a competitive situation, whether it is an athletic contest, a struggle for existence, or a global market. These two forces are (1) the *demand for efficiency* and (2) the *need for relief from excessive competitiveness.* The fastest dinosaurs were no match for the supple and agile species that could find alternative food sources in times of feverish competition. Similarly in the business world a market that is too intensely competitive strangles everyone. Profits go to keeping a step ahead of the competition. Monopolies are concerned with increasing the demand for products and services. So long as that demand is high, they can probably coast along without challenges from industry upstarts. As competitors raise the efficiency bar, however, each player has to move that much faster just to keep pace. That makes breaking out of the pack just that much harder.

The effects of this relentless drive for efficiency filter down to each of the company's stakeholders. Squeezed for greater productivity but often inadequately rewarded for their contributions, employees become increasingly disgruntled. Customers, the supposed beneficiaries of cutthroat competition, also feel the negative impact of hyper-intense competition. While prices may fall, service usually takes a tumble as well: how often do you find unhappy employees offering customers great personal service? Nostalgic for the way it *used* to be, before competition reached this fever pitch, customers come to feel as if they have been forgotten in the process. As the company spends more of its profits on operations, new initiatives, and the latest technology, shareholders grow increasingly dissatisfied with quarterly announcements of lowered expectations and falling market capitalization.

When the drive for efficiency runs headlong into the wastefulness of hyper-competition, most markets respond with a logical solution. The initial players, whose numbers are large in an infant market, experience a shakeout. Three dominant players emerge, with any number of specialists and niche players off to the side. As we will see in later chapters, this structure offers the best possible balance between efficiency and competitive intensity since the specialists enjoy their high margins and loyal customers while the Big 3 rely on volume to drive up their returns on assets.

Specialists and full-line generalists exist side by side in any market. Think of their relationship as analogous to that of the stores in a large shopping mall. Anchoring the structure are the major department stores, which offer a full line of products and services and get most of the mall traffic. Along the corridors or spokes of the mall are the specialty shops, which cater to a well-defined audience (market specialists such as The Gap, Banana Republic, Victoria's Secret) or which sell only specific items (product specialists such as Hallmark, Swatch, Kay Jewelers). In the Rule of Three, this hypothetical market (the mall) is anchored by three full-line generalists with a number of product and market specialists occupying largely non-competitive positions.

Prognostications and Promises

Economists have long assumed that markets are either oligopolistic, in which a handful of large firms divide up the spoils, or monopolisitic with many smaller firms coexisting in specialized niches. The reality in most markets is clearly different. While they may start out approximating monopolistic competition, they end up in a pattern that includes *both* types of players. With startling regularity, we have found the number of dominant players in each industry is confined to three. Any other number, greater or smaller, is usually a temporary aberration.

The Rule of Three is most common in the United States. The banking industry in this country, for instance, is undergoing a process of consolidation, perhaps to the chagrin of those consumers who prefer the personal service of the small-town lender. Size and wealth are two important, but by no means exclusive characteristics of the winners, who in this industry have yet to emerge. Citicorp's merger with the Travelers Group and NationsBank's acquisition of Bank of America make those two entities early favorites. A third survivor may be the recent combination of Wells Fargo & Company and Norwest Corporation, although Bank One and First Union are certainly still in the running. At the moment, it is too competitive and volatile an industry to identify the Big 3. There is a long way to go before the banking industry completes this process.

Evidence is mounting that the phenomenon of the Rule of Three is occurring in European and Asian markets with greater frequency, especially in the wake of globalization. In the Japanese elevator and escalator industry, for example, Toshiba, Hitachi, and Mitsubishi control almost 90 percent of the Japanese market. Those three major players provide 30-minute service response anywhere in Japan on any day under any circumstances. As that industry globalizes, however, we predict that Otis will present a serious challenge to their domination.

In the United Kingdom, Thomson, Airtours, and Owners Abroad account for 55 percent of the market for pre-packaged vacations. Among British grocery retailers, the Big 3 are Sainsbury, Tesco, and Argyll, which also happens to be the owner of the U.S. chain Safeway. In book manufacturing, the lion's share of the market goes to Coral, Ladbrokes, and William Hill. In the cement industry, the Big 3 are Blue Circle, Rugby Portland, and Castle, each one scrambling for a higher share of a dwindling market.

In our research we also noted that industries do *not* comprise numerous large and small players lined up according to their performance records. In virtually every industry with three big players, the pattern is distinctly non-linear. The Big 3 usually do well; that is, they may have low margins but excellent returns on assets. The ditch, however, remains a major trap for the mid-sized companies, those that are smaller than the Big 3 but bigger than the niche players, whose financial performances are usually the worst of all. Once you move beyond the ditch and go further down the scale of market share, financial performance starts to improve as niche players reap the profits of high margins.

The financial performance of the Big 3 improves with market share—but only up to a point. Beyond approximately a 40 percent share of the market, the Big 3 begin to experience diseconomies of scale and come under the watchful eye of regulators and anti-trust litigation. If, on the one hand, the market leader holds a market share between 50 and 70 percent, a third full-line generalist has little room and will either fall into the ditch or be forced to become a specialist. Boeing and Airbus, for example, pushed McDonnnell Douglas into its specialty status and eventually led to Boeing's acquisition of the company in 1997. If, on the other, the market leader—say, IBM in the heyday of mainframes—commands 70 percent or more of the market, there is practically no room for either a second or a third full-line generalist. Such dominance, however, rarely lasts, and newcomers will gradually gain a foothold to challenge even the most powerful company. Such precedents are surely not lost on Microsoft, although the signs are increasing that the software maker is no longer as monopolistic as it once was, not with Linux and TK controlling greater shares of the market for operating systems.

Inferences about the Rule of Three receive substantial support from researchers who have found distinct evidence of "natural market structures" characterized by a progression of market shares among industry leaders, as well as a "stuck-in-the-middle" competitive position in which companies are too small to succeed as generalists but too big to succeed as specialists.[1] Nowhere in this literature, however, did we find an overarching theory of market evolution that accurately describes the patterns we had seen. This book seeks to fill that gap.

We also believe that this book will greatly benefit anyone involved in business, including CEOs and managers who are concerned with their company's market performance and strategies for competing. Managers need to understand and appreciate business context. In particular, they must understand how their industry is structured, what stage of evolution it has entered, and how that evolution is likely to continue. With this perspective they can better cultivate their innate strengths, formulate reasonable strategies to leverage their position within the industry, and maximize their chances of success.

We believe that the degrees of managerial freedom are limited, that managers are not completely free to choose which markets they want to compete in and which competitors to target. Although some may view themselves as "masters of their universe," there are forces beyond their control that are constantly changing the structure of their industries. Thus, they need to rely on the best managerial judgment and tools for strategic analysis they can muster. For this reason the Rule of Three will prove extremely valuable, not only in helping them to see both the forest and the trees, but to sharpen their foresight and prepare to deal with future turns in their competitive markets. The framework presented in this book, we believe, will be invaluable in helping them understand and meet both immediate and long-term challenges.

Based on a company's relative position within its industry, and the stage of that industry's evolution, there are smart choices and foolhardy ones. Ignoring the market structure presented by the Rule of Three can cause business managers and entrepreneurs to engage in "unnatural" acts of marketplace behavior, which are doomed to failure. Observing the laws of competitive markets, however, will help them set objectives that their company can reasonably hope to meet while they set strategies that will help them get out and stay out of the ditch. In chapter 1, we lay out the laws that are fundamental to competition and the relative stability of industries and markets.

[1] See, for example, Robert D. Buzzell, "Are There Natural Market Structures?" *Journal of Marketing*, 1981; and Michael E. Porter, *Competitive Strategy: Techniques for Analyzing Industries and Competitors* (New York: Free Press, 1980).