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Manager's Journal: Only the Big Three Will Thrive

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The stunning announcement that Daimler-Benz and Chrysler will merge to form the world's fifth-largest automaker is a harbinger of things to come -- not only in automobile manufacturing but also in numerous other globalizing industries. Industry after industry is being reorganized according to the Rule of Three: In competitive, mature markets, there is room for only three major players along with several (in some markets, many) niche players.

Together, the three "inner circle" competitors control approximately 70% of the market. The top three are volume-driven generalists who compete across a wide range of products and services, while the smaller companies are margin-driven and thrive as specialists in a small number of markets or products. Having an excessive number of "majors" in an industry tends to lead to a high degree of rivalry but also to a lot of overcapacity and low levels of profitability. With three majors, competitive intensity is strong but not excessive, and excess capacity tends to get rationalized. This market structure thus provides a good balance between efficiency and high levels of competitive rivalry. Duopolies, by contrast, tend to engage in collusive behavior.

The Rule of Three can be observed in numerous industries, including beer, rental **cars**, cereals, tires, insurance, aluminum, oil companies, chemicals, airlines, pizza chains, soft drinks and athletic shoes. Current merger activity in banking, pharmaceuticals, telecommunications and airlines is leading inexorably in the same direction.

To be viable as volume-driven players, companies must have a critical-mass market share of at least 10%. At market shares of less than 5%, financial performance turns out to be inversely correlated with market share: The smaller the market share, the higher the return on assets. In between these two numbers lies a Bermuda triangle of doomed strategies and failed ambitions.

Companies that dip below the 10% level must make the transition to specialist status to survive or merge with another company to regain a market share above 10%. Trailing badly behind Boeing and Airbus in the global commercial aviation market, McDonnell Douglas had four options: try to gain viability by finding a strong Asian partner (an option ruled out by the U.S. government); become a specialist producer of short-haul jets based on the MD-90 platform; exit the commercial aviation market; or merge with one of the big two. McDonnell Douglas chose the last option last year, merging with Boeing.

In a market with slow or negative growth, the fight for market share between No. 1 and No. 2 often sends the No. 3 company into the ditch. This happened in soft drinks (RC Cola wound up losing), beer (Schlitz) and aircraft manufacturing (Lockheed earlier, McDonnell Douglas recently). Nevertheless, a new No. 3 full-line player usually emerges, especially if the market becomes globalized. In soft drinks, the combination of Cadbury-Schweppes, Dr Pepper and 7-Up has resulted in the creation of a viable new No. 3 player, with approximately 17% market share.

These lessons apply to the auto industry. In its late 19th century infancy, more than 200 manufacturers were building **cars** in the U.S. alone, none on a national scale. It took the Model T and Henry Ford's innovations in mass production to trigger the process of industry consolidation. Almost immediately, the number of manufacturers dwindled to 70 or 80. Within a few years, the market had consolidated further into three full-line players -- General Motors, Ford and Chrysler -- and several smaller players such as American Motors (which failed in its attempts at becoming a generalist and was acquired by Renault and then by Chrysler), Checker and Studebaker. Eventually, the Rule of Three prevailed, with GM, Ford and Chrysler dominating the U.S. market.

Chrysler's crash in the mid-1970s had little to do with Japanese competition and everything to do with the fight between GM and Ford. After the 1974-75 energy crisis, GM redesigned the Chevrolet Caprice, a car that had great fuel efficiency and was rated by Consumer Reports as a "Best Buy" for several years running. As a result, GM's market share in full-size

cars jumped significantly. Ford was able to keep pace, but Chrysler couldn't. It went into the ditch, and then reemerged following its bailout as a marginal full-line player with an emphasis on minivans.

Chrysler could have remained in the ditch, giving Honda or Toyota an opportunity to become the No. 3 player in the U.S. market. However, Chrysler pulled ahead through its acquisition of AMC, while Honda failed to rapidly expand its product line to include minivans and sports utility vehicles.

When a market globalizes, many full-line generalists that were previously viable as such in their secure home markets are unable to repeat that success in a world-wide context. When this happens, there are typically three global survivors - one from the U.S., one from Europe and one from East Asia. To survive as a global full-line generalist, a company has to be strong in at least two of the three legs of this triad.

The automobile market is currently being globalized. The big, broadly defined players are Toyota, Nissan and Honda from East Asia; General Motors, Ford and Chrysler from the U.S.; and Daimler-Benz, Volkswagen, Renault, Peugeot and Fiat from Europe. The strongest contender for one of the top three global spots is Toyota, followed closely by Ford. None of the European companies have shown so far that they can become a major presence in the U.S. market (at one point, VW's U.S. market share slipped to just 4%), so they're unlikely to become global full-line players unless they ally with other firms.

What about General Motors? It's still the world's largest automaker, but it has thin margins. The broader problem for GM is that it is poorly integrated in terms of both operations and market identity. Few customers around the world even know the "GM" brand; they know the company only through its divisions, such as Chevrolet, Opel, Cadillac and Vauxhall. GM essentially operates as eight more-or-less independent car companies, none of which can rival the efficiencies of scale of Toyota's globally integrated production and marketing system. (The same Toyota assembly line can produce Terrels, Camrys and Lexus LS400s.) GM's current supremacy is based on profitless market share, which means that its lead is ultimately not sustainable.

Full-line generalists, it turns out, really need only two major brands: an upscale brand and a broad-based brand that is typically the corporate name. Thus, we have Toyota and Lexus, Ford and Jaguar... and now Chrysler and Mercedes.

Facing the challenge of keeping up with the big boys, Chrysler had three options: (1) It could remain a market specialist providing a full range of products to the North American market, with minimal ambitions overseas. (2) It could become a global product specialist, leveraging its relatively secure niches in sport utility vehicles and minivans. (3) It could try to enter the inner circle on a global scale by merging with complementary companies. Daimler-Benz, for its part, could have remained a luxury-car specialist. By merging, Daimler and Chrysler are trying to become one of the top three global, full-line companies.

The merger, as evidenced by the strong positive reaction from the stock market, presents some strong synergies. Chrysler's strengths in supplier partnering, low-cost production and product design mesh well with Daimler's global presence and emphasis on quality, both weaknesses for Chrysler. Of course, there will be challenges in meshing the two different cultures (German companies have historically not been good at mergers) and functioning effectively with a joint leadership, which usually fails.

As the auto industry evolves toward truly global competition, we see the need for DaimlerChrysler to find an Asian partner (Mitsubishi or Honda may be the best fit), while Toyota needs a strong European partner. Ford is well positioned, given its stake in Mazda and strong European presence; it is also well on its way toward integrating its operations globally.

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