PROF. DR. HAGEN LINDSTÄDT

QUARTERLY INSIGHTS ON STRATEGY AND MARKET DYNAMICS

NEW MARKET ENTRANTS IN OLIGOPOLIES – WHAT INCUMBENTS CAN DO

SPOTLIGHT ON THE BASIC MATERIALS, CHEMICALS, AND HEALTH CARE INDUSTRIES

OCTOBER 2010

HAGEN LINDSTÄDT, KERSTIN FEHRE

New market entries are a fact of life. Multinationals invest huge sums to expand to new markets, small firms grow and turn into serious competitors; start-ups attack established incumbents. The resulting changes in competitive dynamics often have lasting effects on the entire industry. And every single market follows different rules: lots of good reasons why incumbents should think carefully about what the most promising response to new entries will be. Three case examples illustrate this point.

THE CHALLENGE

THE NEW PLAYERS SEEM WILLING TO DO ALMOST ANYTHING FOR MARKET SHARE

For several years, young, globally oriented businesses from emerging economies – mostly China and India – have been attacking well-established suppliers using innovative technologies and business models. In their hunger for growth, the new entrants often disregard the rules that have governed the industry until that point. Some even appear to defy the ultimate goal that European, North-American and Japanese companies pursue, the goal that makes their actions somewhat more predictable: value creation. The new players seem willing to do almost anything for market share; or perhaps they simply work on longer planning horizons starting with a phase of aggressive growth.

No matter who the new entrants are, their attacks upset established structures and force incumbents to look for new answers – especially in markets that have so far been served by just a few suppliers. Unfortunately, established players are often caught off guard; the responses we hear from top management teams tend to be emotional and based on personal beliefs. Typically, they sound like these:

- *„Being the market leader, we should stop them from getting in. We should fight back on all fronts – using sales power, expanding capacity, cutting prices. We have the economies of scale and we have the customer contacts.“*
- *„Our product is better quality, we have the superior technology, we are more innovative and we invest a lot – so we are not really at risk.“*
- *„We've got to show them that we're not going to take this. What we should do is fight back, but with limited risk, just to test their reaction. Otherwise, all our competitors will think we just sit by and watch.“*
- *„With our share of the market, there's nothing that would hurt us as badly as price cuts. So it's 'grin and bear it' for us.“*

IT WILL BECOME INCREASINGLY DIFFICULT TO AGREE ON A COURSE OF ACTION

Emotions and rules of thumb are bad advisors. What's more, they tend to go different ways for different individuals. As a result, there will be lots of controversial discussions in top management and it will become increasingly difficult to agree on a course of action. The team will get stuck, while it really should get active.

THE RESPONSE

CORPORATE MANAGERS NEED TO PUT THEMSELVES IN THE SHOES OF EACH COMPETITOR

Companies "under attack" need a sober, acute analysis of their specific situation – based on intimate market knowledge, comprehensive data on cost structures and customer behavior, and a thorough evaluation of their own position and strategic options. A particularly critical issue is the responses that conceivable actions are likely to provoke from other market players. Corporate managers need to put themselves in the shoes of each competitor whose reactions could be relevant for their own strategy.

A key approach is strategic gaming, using a highly effective simulation technique that goes much further than the usual scenario technique does: Rather than just running through a handful of business case scenarios, a range of conceivable actions and counter-actions are evaluated and (as far as possible) quantified, always taking proper account of the usual uncertainty factors regarding future developments.

THE PROFITABILITY OF THE WHOLE INDUSTRY IS REALIGNED IN A MATTER OF JUST A FEW YEARS OR EVEN MONTHS

An effort like this can hardly be shouldered alongside the day-to-day business, which is probably why corporate leaders so often rely on gut decisions. What they fail to see is that new market entries are typically situations where thorough analysis is essential: often, the profitability of the business, even the whole industry, is realigned in a matter of just a few years or even months.

Heatmaps visualize suppliers' strategic options and corresponding value effects

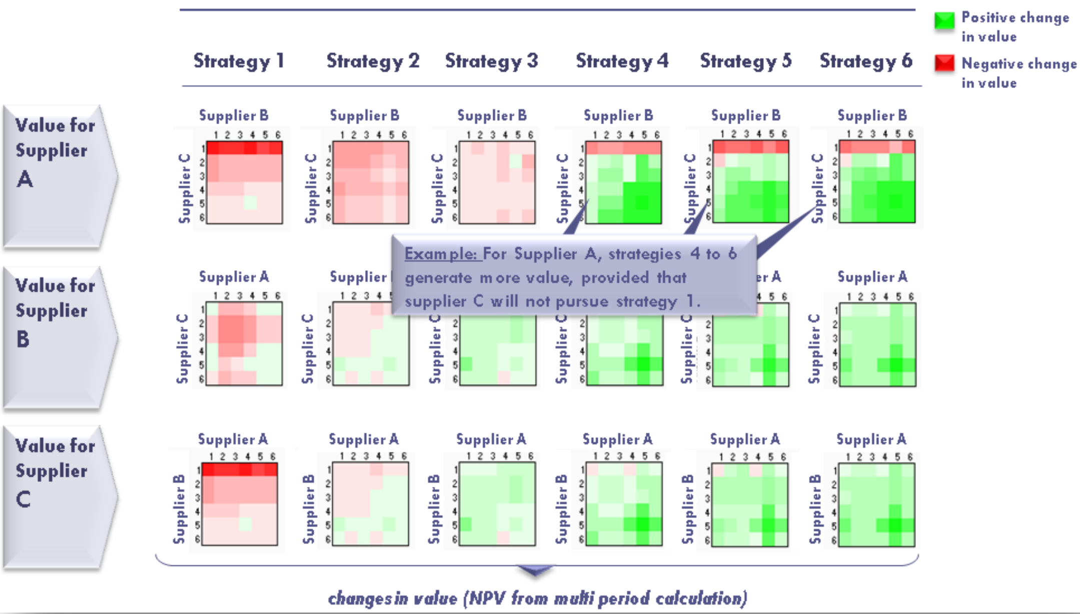


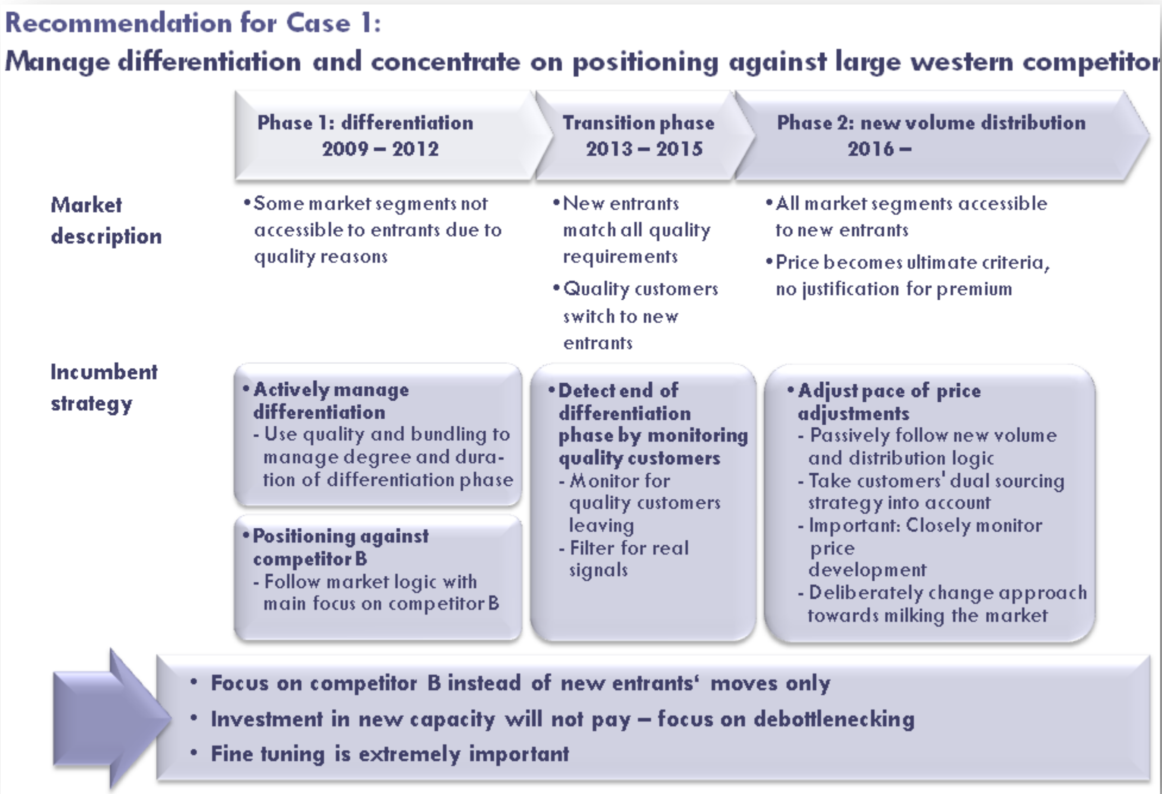
Exhibit 1 shows the result of a typical analysis: in so-called heat-maps, the changes in business value that result from competitors' probable actions are visualized for all major players.

Below are three disguised case examples from different industries. In each case, established suppliers were attacked by new entrants from threshold economies – yet for each of them, strategic gaming produced very distinct, fact-based answers to the specific situations they faced.

Case 1 – Basic Materials

A constantly growing market served by two western suppliers was entered by several Chinese competitors, one of them a serious competitive threat in terms of size and technology. The market comprised two segments, one of them well on the way towards commoditization and the other with more sophisticated applications, product features, and margins.

As often happens in situations like these, our incumbent at first only paid attention to the new entrants – their product characteristics, customers, capacities, price levels, and so on. It was all the more interesting to see the result of our quantitative analysis (exhibit 2):



IT WAS JUST AS IMPORTANT TO OBSERVE THE OTHER INCUMBENT'S ACTIONS

Over the first few years, the new entrants could be expected to focus on the "simpler" market segment, so a clear differentiation against them was indeed a priority. It was, however, just as important to observe the other incumbent's actions: As the higher-margin segment represented that company's main revenue source, it was likely to retaliate with a vengeance should there be any drastic shifts in competitive structures.

During the following phase it would be essential to monitor customers' actions: As soon as the first sophisticated, demanding customer would switch to one of the new entrants, that point would mark the end of the differentiation phase. Keeping in mind that large customers in that market pursued a dual sourcing strategy (so even if they replaced one of their existing suppliers, they would probably hold on to the other one) it was important to remain alert and well-prepared.

The third phase, the end of differentiation and the beginning of commoditization, was expected to bring a redistribution of volumes. Hence it was rather obvious that any further capacity expansion made little sense.

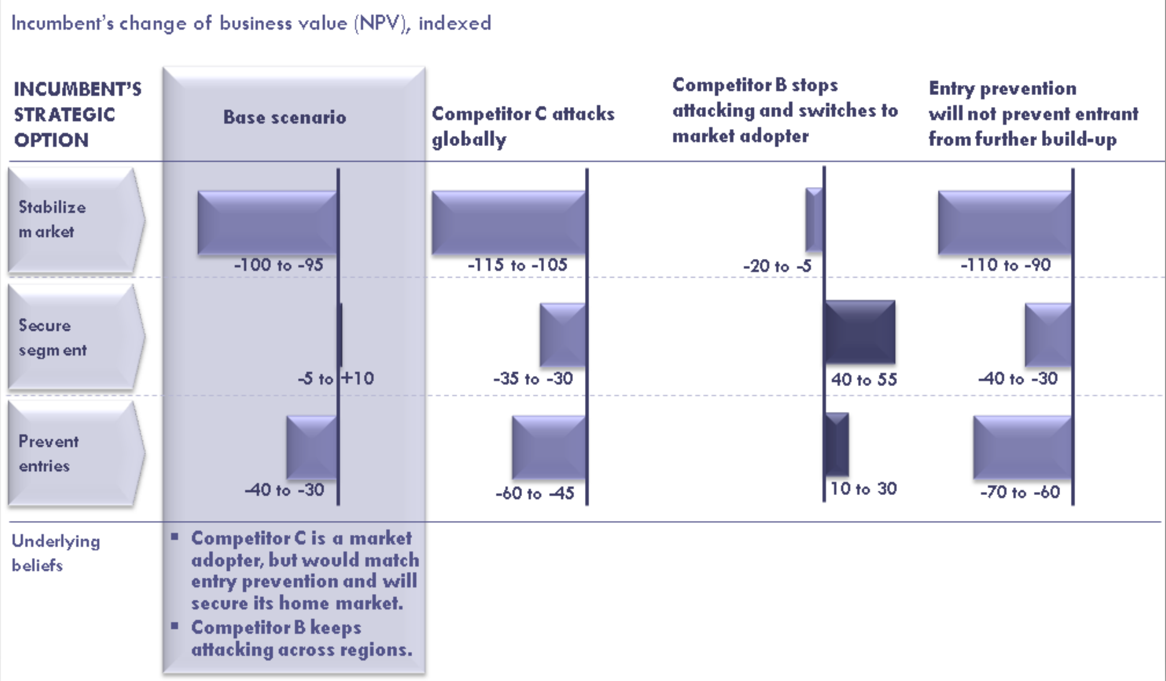
Case 2 – Chemical Industry

A new Asian competitor substantially invested in a market that had basically been divided up among one Japanese and two western suppliers. The Japanese player had consistently pursued a very cautious, low-key strategy, one of the western companies had basically "purchased" market share through cut-throat pricing. Differences in manufacturing technologies, access to raw materials and by-products were reflected by the incumbents' enormously differing cost structures.

FOCUSING ALL EFFORTS ON BASE SEGMENTS WAS THE MOST PROMISING WAY

Based on intense modeling and discussion, we found that the best option for our incumbent would be to introduce systematic customer segmentation (exhibit 3): A selective approach, focusing all efforts on base customer segments, was the most promising way to defend the company's position while maintaining the stability of the overall market.

Recommendation for Case 2:
"Secure segment" is best value-optimizing strategy across scenarios

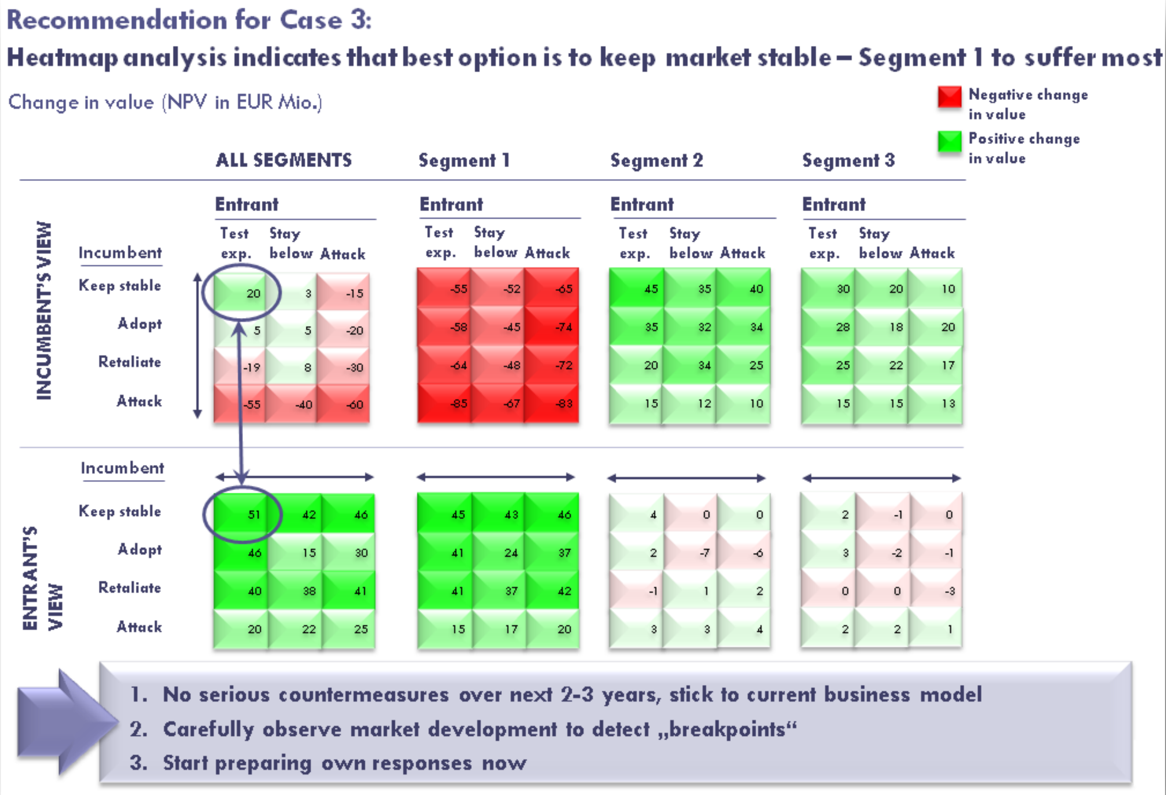


Case 3 – Health Care

After this supplier's patent expired, an Indian company entered the market and established enough production capacity to serve sizeable parts of it. Unfortunately, in this case – as opposed to most others – the largest and most attractive of the three market segments ("Segment 1") was also the one that most lent itself for entry. Discussions in the management team therefore concentrated on how to counter the attack in that segment, and perhaps test the entrant's response to such counter-action in a well-defined submarket.

ANY EARLY COUNTER-ATTACKS WOULD CAUSE THE ENTRANT TO MOVE ON TO OTHER SEGMENTS AND REGIONS

The strategic gaming exercise caused the team to rethink these plans. As it turned out, any real counter-action would make sense only after the entrant's production capacity would have reached a certain level of utilization, but well before that company would start thinking about further capacity expansion (exhibit 4). By contrast, any exaggerated, early counter-attacks in Segment 1 would make that segment less profitable and thus less attractive; moreover, it would cause the entrant to move on to other segments and regions, which would mean a major value decrease for our incumbent. By the same token, any "response test" at the present point would probably have provoked fierce reactions from the entrant; it was likely to produce more meaningful results in two or three years' time.



STRATEGIC GAMING PROVIDES A SOUND FOUNDATION FOR ASSESSING UPSIDE POTENTIAL AND DOWNSIDE RISK

Even the acutest analysis will never provide absolute certainty about future market developments and competitor actions. Yet by systematically defining and playing through each player's probable strategies and responses, it is possible to rule out a broad range of possibilities and narrow down the corridor of probable developments.

The strategic gaming technique thus provides a sound foundation for assessing the upside potential and downside risk of each of the options available. It enables top management to take a fact-based and well-substantiated decision on the best course of action, and to define the breakpoints for future strategic realignment.

Prof. Dr. Hagen Lindstädt (lindstaedt@ibu.uni-karlsruhe.de) is the head of the Institute for Management and the Scientific Director of the Center for Strategic Business Wargaming, both at Karlsruhe University/KIT.

As a renowned expert for Strategy, Competitive Intelligence, Pricing, and Strategy Simulation, Prof. Lindstädt is a sought-after adviser to leading German and European corporations (DAX30, Top 100).

Prior to his academic career, he was a management consultant with McKinsey&Company for five years.