Summary of: From entry barriers to mobility barriers

DRAFT

From the concept of Joe Bain's *"Conditions of entry and the Emerge of Monopoly"*

Investment decisions based on uncertainty – Which major factors to reflect

Elements of entering:

1. The rent presently earned by the market's occupants
2. The static or structural entry barriers identified by Bain
3. The incumbents' expected reactions to entry
4. Other members of the queue of potential entrants, and their likely behavior
5. Any relevant resource already in the hands of the entrant
6. The irreversible cost of gathering information and making decision

Every cost coming from the process of entering a market can be seen as an investment. The investment must yield a proper rate in contrast to the risk. When both cost and profit is analyzed and probability is taken account for, the true rate can be used as evaluation criteria for a decision.

Many entry deterring actions takes form of present outlays. Therefore...

Excess capacity/ unused production capacity makes credible a threat of price warfare against entrant firms. Product differentiation reduces cross- elasticity of demand between brand already represented in the market, and the new entrant's product. Therefore cost of branding may be taken to offset the already existing products in the market. Investments that augment product differentiations and absolute-cost barriers to entry can either increase the fixity of costs or shift the production function to display greater diseconomies of small scale. If a newcomer enters unintegrated, he faces uncertainty by the spot market. If he enters integrated, he may face augmented capital cost. The cost structure of a company (compared to the already participating firms) therefore also affects the decision.

Advantage of goodwill, knowledge and organization may be excess capacity. Since goodwill is an abstract advantage, entering into different markets (diversification) may hurt this advantage and therefore reflect a cost.

Entry barriers as a collective capital good.

Investments in entry deterrence generally protects all the members of the existing market. Investments in entry barriers by one firm will not be as profitable and efficient as an investment by the whole group. This raises special problems for the form and extent of collusion.

Even if the net joint profit of barrier investments is higher than net cost, the risk of such investments will add on to the totally risk of the market. Since the investments affect to whole group, the risk also will. A market consisting of rapidly barrier investments to lower risk, can be affected by the risk of failure of such an investment, making the market as risky as it was, with lower profit ability because of the investment-cost.

When analyzing barrier investment – risk/reward, higher cost for lower risk will decrease return. Exception; if monopoly profits are achieved from the investment.

Thoughts: (What about clusters?)

… Missing…

Group members are likely to respond in the same way to disturbances from inside or outside the group, recognizing their interdependence closely and anticipating their reactions to one another's moves quite accurately. (Characteristic behavior of a group)

Several studies find that a firm's profits vary systematically with its own share of its industry's sales as well as with the concentration of the top few sellers.

Different groups in the market reflect different barriers. It can be easy to enter into one industry, but almost impossible to enter into another.

Bain's queue

Different strategies affect costs and income. Depending on how a company is structured compared to the market, is a critical factor for the assessment of entrance.

For example scale-economy barriers can differ from different groups.
Because of this, an intra industry barrier faces its own queue of potential entrants because of the group-specific character of entry barriers and the differing initial resources of potential entrant firms.

Depending on the calculated alternative cost, a company may have greater probability of becoming an entrant to a market.

Intra Industry barriers may increase the total barrier for the market. Since different intra barriers have different risks and costs, it may be effective to enter other markets before entering the initial market. Time, risk, cost and cost of irreversibility should be taken into consideration when analyzing possibilities.

Strategic Groups and performance: The U.S Insurance Industry (70’-84’)

Hunt (1972) – Strategic Groups

Identifying Strategic groups

1. Map the characteristics of the competitive environment which we call the strategic space.
2. Determine whether corporate-, business- or functional-level strategies should be examined, and assess which dimensions best describe those strategies
3. Identifying the variables which best capture the firm’s scope and resource deployment decision in the competitive context under study
4. Identifying periods of homogeneity and similarity in competitive strategic behavior when defining meaningful competitive strategic groups
    a. Two statistical tests:
        i. For the first criterion - Bartlett’s test; used to test the equivalence of two sets of variance/covariance matrices
        ii. For the second criterion – Hotelling’s T^2 test; used to test the equivalence of the sets of mean vectors
5. Once SSTPs have been identified firms can then be clustered into strategic groups

Example: The insurance industry

The study focus on the top 30 firms in the period of 1970-1984

Strategic variables

Eight strategic variables reflecting scope and resource commitments are identified.

Strategic scope variables

Scope commitments in the U.S. insurance industry can be examined in terms of product scope, product diversification and size dimensions. Two variables describe product scope in terms of the focus (a) personal vs. commercial lines of insurance and (b) property/liability vs. life insurance.

Personal lines vs. commercial lines - commercial lines underwriting there is less reliance on advertising and market promotion and more emphasis on client relations; and commercial policies are often more complex and expensive, thus requiring more focused underwriting skills.

Property/liability proportion

Diversification – The diversification variable more particularly examines the broad extent of an insurance firm’s diversification across lines if businesses. The aims of greater line of business diversification typically include income improvement, risk reduction and the exploitation of economies of scope.

Size – The absolute size of insurance firms has an important impact on firm performance.

Resource commitment variables

Measures of resource commitments were developed in order to reflect the bases for establishing competitive advantages in the insurance industry. (Operations and finance)

Expense ratio – The expense ratio is the ratio of underwriting expenses to net premiums written

Reinsurance – Reinsurance is "a contractual agreement under which one insurer known as the ceding company, buys insurance from another insurer, called reinsurer"

Financial leverage – The ratio of net premiums earn to policyholders' surplus

Investment strategy – Therefore investment gains are crucially important for the overall profitability of insurance companies. The choice of investment strategy will affect the overall returns as well as the risk of the investment portfolio.

Performance variables

a. The combined ratio – a common measure used in the industry to indicate the overall performance level of an insurance company
b. The firms share of industry volume
c. Weighted market share which indicates the firm's dominance of particular lines of insurance

Strategic groups

Firms having a strategic posture will be clustered in the same strategic group.

The case of insurance companies

Three basic patterns of competition (strategic groups) existed during the time period under the study. Other patterns of competition have emerged and disappeared during the time period.

Strategic group 1: Diversified strategy – Firms following this pattern of competition had chosen to de-emphasize personal lines of insurance, and to emphasize commercial insurance business. The broad diversification strategy was accompanied by complementary resource deployment decision. In terms of production expenses most of these firms were less efficient than the other firms in the industry. In all nine SSTPs their production costs were above the industry average. Also the firms had and preference to invest in stock. Stock investment was significantly above industry average (keep in mind; diversification lower the risk, stock investments will most likely raise the risk). The strategic group also was accompanied by relatively low reinsurance.

Strategic group 2: Focused Strategy (Life insurance) – Firms concentrate their activities in the life insurance segment, rather than in the property/liability segment. The focused strategy was accomplished by below-average leverage.

Strategic group 3: Focused strategy (Personal lines) Firms tend to focus on personal lines insurance, such as homeowners' multiple peril and automobile liability. Low level of diversification supports the argument that firms in this group focused on the personal segment rather than on other commercial segment. The focused strategy was accompanied by an efficient "production" strategy. In eight out of nine SSTPs the average production costs were significantly below the industry average. In five of the SSTPs, the proportion of stock in the investment portfolio was below the industry average (operational results were much better than those of the other strategic groups).

Strategic groups and intra industry performance differences

(The insurance industry case)

Three dimensions of firms performance

Economic
Risk
Risk-adjusted dimensions

It was found that the combined ratio, market share, weighted market share and the risk of the combined ratio and the risk of market share were almost always significantly different across strategic groups for each one of the nine SSTPs. When the performance dimensions were considered separately, the result indicate that consistent performance differences across groups existed over time for the combined ratio, market share, weighted market share, and the risk measures of return and market share.

Discussion and further directions

Methodological procedure identified relatively short time horizon for SSTPs in the insurance industry.

The study found that the number of strategic groups changed from five to seven over different SSTPs; yet three dominant groups were shown to exist over the entire 15 year period with the transient groups oscillating around the three dominant positions.

Dynamic analysis of the strategic group structure can enable the theory of strategic groups and mobility barriers to be tested.

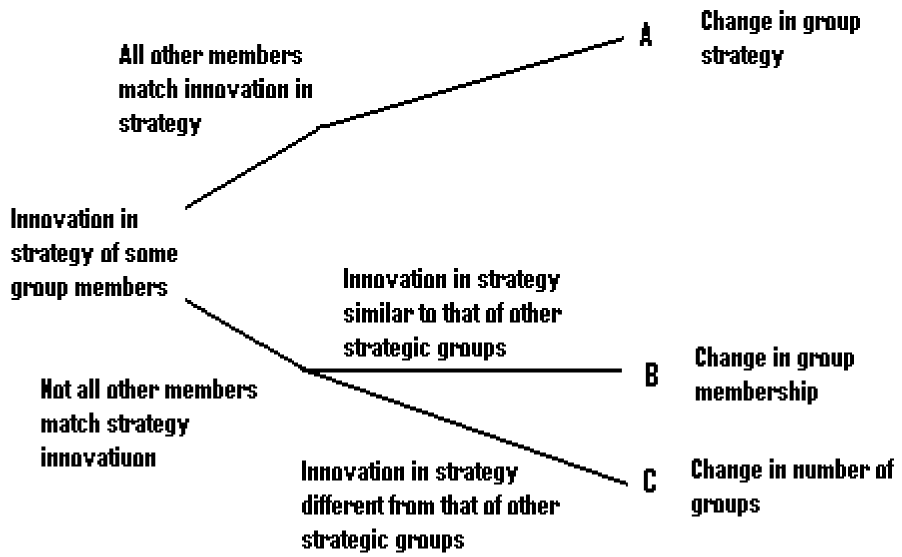
Thoughts – Excess profit may be invested in mobility barriers and, if effective invested (cost shared by the group) excess profit may still exist?

We find consistent evidence of performance differences across strategic groups and that these differences appear to be persist over time.

Thoughts – A strategy may not be criteria for outperformance, but a criterion for survivorship over time (criteria of existence). Combination of strategy and game theory may explain excess performance?

Strategic group dynamics

In the present context, group strategy refers to the strategies of all members of a group and not a collusive strategy at a group level. Strategies of group members may not be identical. If an initial change results in a strategy that parallels the strategy of another strategic group and if all the other members of the initial group do not follow, group membership shifts occur. Finally, if the initial change does not result in a strategy that coincides with the strategy of another existing strategic group and if not all other members match the strategy change and additional strategic group will be formed.



The framework figured suggests that an initial strategy change by some firms in a group can result in three different outcomes: a change in group strategy, a change in group membership, or a change in the number of groups.

Change in group strategy may occur under conditions of economic stability, growth and decline.

Organizations are mostly inadaptable because of constraints in their founding technologies and because environmental changes select particular organizations rather than promote adaption.

According to the adaption perspective, in contrast, organizations are, in fact, adaptable and try to adapt to environmental change.

Similarly, the Mason-Bain industrial economics paradigm holds that industry structure drives firms conduct and performance.

The adaption and industrial organization economics perspective suggest that environmental shifts drive strategy changes that may result in changes in group strategy.

Thoughts: Environmental shifts possibly are economical changes - Growth strategy, "Safe" strategy?

Change in group membership

Survival search is more focused and problem-oriented and involves more risk-taking than slack search, which involves unfocused dabbling in new and untried activities.

As the performance of a firm improves, slack driven search partially replaces solution-driven search, so the relation-ship between firm performance and composite search (solution-driven search plus slack driven search) may be U-shaped, higher are low- and high- performance levels than at intermediate performance levels.

Entry may be more difficult when industry conditions are stable and the bases of competitive advantage are not changing. Decline, however, may motivate survival search, which may result in changes in domains and group membership. Thus, the ability to achieve a cost advantage, through levels, mixes or prices of inputs that are superior those of existing firms tied by prior contractual arrangements may encourage new entrants.

Thoughts: Economical advantages are not lasting and reduce the mobility/entry barriers?

Changes in number of strategic groups

Groups disappear when members' strategies were no longer viable or when all members shifted to their groups. In the population ecology view, those two conditions suggest the presence of selection process, and in the environmental adaption tradition, they suggest systematic adaption process.

A group may be formed if one or more firms choose a new strategy that other firms choose not to follow or are unable to imitate and that does not parallel the strategy of an existing group.

Case – International offshore drilling

1a – To what extent do groups change their strategy across periods of economic stability, growth and decline?
1b – What factors motivate changes in group strategy?

Identifying economic periods

Growth and decline

Identifying strategic groups

Product line diversity
Technological capability
Global Spread
Vertical integration
Marketing orientation

Characteristics of strategic groups

Group 1 – Firms have a floating rig capacity, a broad product line and operations in numerous markets. Group 1 also had the highest proportion of firms owned by oil companies. Group 1 can be labeled multinational-multiproduct
Group 2 – Is made up of firms that are less likely to have a floating rig capacity that group 1 firms and that have more moderate international scope and less product diversity that those firms. Smith and Grimm (1987) also observed a group of firms that was in the middle on all dimensions. They referred to this group as having a contingency strategy, as member firms appeared well positioned to move in any direction.
Group 3 – Contains many firms with narrow product lines, operating locally instead of internationally. Few of these firms have a floating rig capability. This group can be labeled domestically oriented.

Thoughts: Cluster analysis……

Results – Se article: 1a, 1b, hypothesis 1 and hypothesis 2: Change in group strategy, change in group membership, and change in number of groups…

Conclusions

The study examined the extent of and motivation for group strategy changes during periods of economic growth, stability and decline.

1. Changes in group membership were less frequent during times of economic stability and growth than during decline.
2. During economic growth, although market entry from outside the industry was high, little intergroup mobility was observed, possibly because under conditions of growth, search is slack-driven and unfocused.
   Thoughts – Companies are milking the industry in growth periods to get profit from their investments in the unstable periods. (Buy low, sell high…). If too much slack are accepted, and the returns are better than great, or some other environmental changes than economic change makes it possible for other entrants to mobilize, the growth period can be as challenging as the unstable period.
3. Mobility rates were higher in downturn, however, possibly because of high levels of goal consensus and of solution-driven search, which involves a focus on survival and high risk taking.
4. Mobility was also higher between less protected, similar groups
5. After a long period of stability in the number of groups, the study detected the formation of an additional strategic group. Group formation appeared to be creative response to increase intra- and intergroup competition.
   a. Environment and industry structure, therefore, may not totally determine strategy changes: strategic choice and individual firm characteristics play an important role.