The effects of new competitors entering the market

The entry of a new competitor in a market has repeatedly been identified as one important determinant of a market's structure and profitability (Bain, 1956; Porter, 1980). Entrants (ie. firms that are new to the market) may affect incumbents (ie. firms that already operate in the market) by abstracting market share away from them, thus shrinking their share of the " profit pie", and by reducing prices to penetrate the market, in effect intensifying competition among players (Besanko, 2004). There is a variety of business strategies that an incumbent firm can follow against entrants, depending on whether it wants to deter entry, to battle with rivals and induce exit, or to accommodate entry (Tirole, 1998).

Deter Entry: Actions taken or barriers erected by incumbents in order to deter entry in an industry before it occurs.

Profitable industries attract newcomers who desire to enter the industry and share the existent profit pie with incumbents. Empirical research has shown that Êºprices and margins tend to move systematically towards their long-run levels whereby price equals marginal cost and economic profits equal to zero, and part of this movement can be associated with flows of entry by new and diversifying firmsÊº (Geroski, 2002). However, Bain (1956) argues that incumbents face minimal risk of their profits being eroded when barriers to entry are present in the industry. According to Bain (1956: 3), a barrier to entry is Êºan advantage of established sellers in an industry over potential entrant sellers, which is reflected in the extent to which the established sellers can persistently raise their prices above competitive levels without attracting new firms to enter the industryÊº. Barriers to entry can be either structural or strategic. Based on the entry deterring strategies employed by

the firm under investigation, this section will refer more extensively to structural barriers and concisely to strategic barriers to entry.

Structural Barriers to Entry

Bain (1956) and much of the following research during the 1970's focused on the structural factors, beyond the firms' control in a market, that affect entry decisions as an integral part of the Structure – Conduct – Performance paradigm. Within that paradigm, economists argued for a one way causal relationship between an industry's structure (ie. concentration), firm conduct (ie. choices of actions) and performance (ie. profitability) (Sutton, 2007). Structural Barriers to entry rise from incumbents' positional advantages within the industry and include scale advantages, cost advantages and product differentiation advantages (Bain, 1956).

Bain (1956) argued that the greater the market share as a percentage of the industry demand that a firm of minimum efficient scale needs to capture to be viable, the fewer the viable firms that can be sustained by the industry. In order to compete in an industry with large minimum efficient scale relative to demand, the entrant must produce and sell large volumes to enjoy economies of scale or accept a cost disadvantage (Porter, 2008). However, the increased output would only be absorbed if prices fell substantially, decreasing profits and leading to a possible negative Net Present Value of the venture of entering (Bain, 1956).

Incumbents may enjoy lower production costs achieved through better production processes, learning curves or research and development. On the other hand, entrants are required to invest substantial capital in order to

compete with incumbents. Sometimes these capital requirements involve unrecoverable investments in upfront advertising or research and development (Porter, 2008). Industries with large sunk investments are avoided by entrants, especially under uncertainty for future returns.

Product differentiation advantages may stem from patented innovations, access to scarce resources or consumer loyalty. This paper will focus on the latter, and more specifically on one way to achieve consumer loyalty, gaining more attention over the past decade, relational contracts. Even though product differentiation is typically regarded as a barrier to entry in an industry, developed relational contracts between firms and customers are generally difficult to discern, underestimated by outsiders (Dwyer, Schurr & Oh, 1987) and therefore can be disregarded when considering the venture of entry. Relational contracts formulate before the entry occurs, yet contribute to the costumer’s brand loyalty hindering the entrant’s market penetration and eventually inducing his exit. Macneil (1980) distinguishes a relational exchange from a discrete exchange, one that is characterized by restricted interactions and content, in that Êºthe relationship transpires over time, each transaction must be viewed in terms of its history and anticipated future, future collaboration may be supported by implicit and explicit assumptions, trust, planning, participants can derive complex, personal, non economic satisfactions and engage in social exchangeÊº (Dwyer, Schurr & Oh, 1987: 12). Such a relationship creates switching costs to new or existing firms and can provide a competitive advantage (Day & Wensley, 1983). However, it can be the case that the costs[1]of formulating or maintaining a relational exchange outweigh the benefits. In this case, one party privately evaluates

his dissatisfactions with the other party, negotiates any modifications to dissolve the dissatisfactions, and if no progress is reached the relationship becomes dissolute (Dwyer, Schurr & Oh, 1987).

Strategic Barriers to Entry

While considerable effort was devoted to defining and measuring the structural barriers, empirical evidence was inconclusive about their relationship with actual entry rates (Thomas, 1999). More specifically, within industry effects accounted for more variation in entry rates than between industry effects (Geroski, 1995). Most recent game theoretic models explain entry by examining how incumbents react to entry and what strategies they employ to encourage exit of rivals. Strategic barriers to entry include sunk cost expenditure, product proliferation, excess capacity and signaling (Schmalensee, 1978; Dixit, 1980; Milgrom & Roberts, 1982).

Battle with Rivals: Actions taken by incumbents to defend their market share and induce the entrant’s exit

While entry deterring strategies can be based on structural characteristics of the industry and therefore are more placid and passive, defensive strategies are usually more responsive. A particularly important determinant of an entrant’s penetration and profitability in a market is the existing competitor’s/competitors’ retaliation (Porter, 1980).

Literature on competitive dynamics indicates that incumbents’ strategic responses to entry can take the form of marketing mix retaliation (Kumar & Hadjinicola, 1996). More specifically, Hauser and Shugan (1983) developed the ÊºDefender ModelÊº, suggesting that as an optimal response to entrants,

incumbents should lower the budget for advertising and distribution and decrease their product price while improving the product's attributes in undifferentiated markets, but increase product prices in differentiated markets. In 1992, Gruca, Kumar and Sudharshan found that non-dominant firms (with market share less than 50%) respond exactly as Hauser and Shugan predicted, but dominant firms (with market share more than 50%) respond to entry by reducing price and increasing marketing expenditure. Realizing the heterogeneity of firm resources, Gatignon, Anderson and Helsen (1989) argued that firms respond with their most effective Êºmarketing mix weaponsÊº and retreat with the most ineffective.

Game Theory suggests that price cutting in particular constitutes the dominant strategy for incumbents in the face of entrants and rivals more generally. Especially in undifferentiated markets, where goods and consumers are identical, a small price cut can lead to the acquisition of all the demand. However, these price cuts can lead to costly price wars, or else known Êºwars of attritionÊº. In a war of attrition, the firm with a greater capacity to sustain losses will be the victor claiming his reward of higher profits, while the loser regrets even participating. Perceptions of the ability to survive and great winning incentives encourage firms to enter and endure the war by investing and therefore sinking more resources. Conversely, signaling greater capacity to sustain the war by achieving lower costs, higher earnings and commitment to win than the entrant may induce him to exit the industry (Besanko, 2004).

Accommodate Entry: Incumbents do not react to entry at all, but rather retreat and allow the entrant to gain some market share

Bain (1956) suggested that incumbents might accommodate entry if structural barriers are low, and either entry deterring strategies are ineffective, or the costs to the incumbent of attempting to deter entry outweigh the benefits from keeping the entrant out of the industry. More specifically, research has shown that incumbents do not respond to entry either it is not clear which strategy is more appropriate (Gatignon, Anderson & Helsen, 1989), or because encountering the entrant would result in potential price wars.

Kumar & Hadjinicola (1996) argue that incumbents' strategic response to entry can also take the form of product repositioning. In order to avoid any direct confrontation with the entrant, incumbents can chose to differentiate themselves after entry occurs to avoid price competition, especially in industries with low barriers to entry. In many cases, where incumbents can not deter newcomers from entering, reviewing the current position of the product and its marketing elements would be more effective. Empirical evidence has shown that firms have an incentive to reposition, through product improvement, new product introduction, promotion or distribution in order to increase their profits in the face of new entry (Hauser & Shugan, 1983; Carpenter, 1989). In contrast to homogeneous products, differentiated products shift the demand attracting new market share and allow the firm to charge a price premium to the more price-inelastic demand.

Finally, incumbents may find it more profitable to accommodate the entrants if there is the perception that the newcomer will only gain an insignificant part of the incumbent's market share. By reducing product prices to prevent entrants from acquiring market share, incumbents forgo their short term

gains. However, if the entrant convincingly commits not to pose a long term threat to the incumbent, the latter may refrain from reducing prices and incur the losses (Besanko, 2004). This strategy is known in the field of strategy as ʺJudo Economicsʺ, a metaphor used to illustrate a battle where skill rather than size will determine the winner.

It is worth noting at this point that empirical research on the type of strategy that an incumbent would choose in response to entry has been inconclusive (Simon, 2005). More recent work suggests that incumbent firms chose to respond aggressively or not to new entrants depending on the incentives to do so. More specifically, Simon (2005) argues that newer incumbents retaliate more aggressively than older incumbents, as they are more vulnerable to new entrants. In addition, multi market incumbents respond more aggressively to the event of entry in order to signal the inclination to retaliate in other markets in order to deter entry. Finally, incumbent firms that possess higher market shares prior to entry have a greater incentive to respond more aggressively as they stand to lose more by the entry.