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Does Market Share Drive Profits For An Organization? Not Always!

Janakiraman Moorthy & Monika Gupta

Problem of practice:

CXOs, business heads and general managers are often required to track, report and explain changes in market share. And yet, market share gain may not always result in an increase in profits. This presents twin dilemmas: When does market share matter and is there a right way to measure it? Recent research by Abhi Bhattacharya, Neil Morgan, and Lopo Rego provides valuable insights into these questions.[1] Our essay illustrates these insights and gives managers a decision-centric approach to reveal under which contexts – business-to-business, business-to-consumer, products or services – market share matters for profits. We also highlight a critical insight about the metric: Share of revenues is a better predictor of profits than unit-based metrics related to market share, potentially impacting your decision-making process

[1] Featured in the Volume 86, issue 4 of the *Journal of Marketing*, authors Abhi Bhattacharya, Neil A. Morgan and Lopo L. Rego in their article: 'Examining Why and When Market Share Drives Firm Profit' talk about when does market share matter and whether there is a right way to measure it

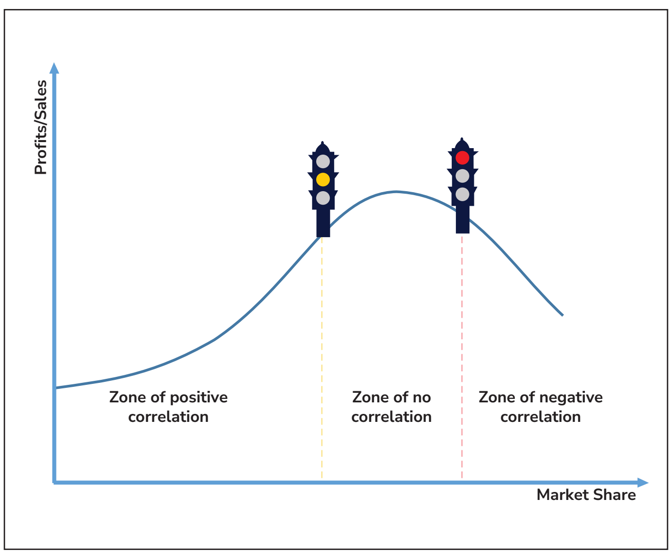
Devil lies in definition

Market share has been the performance metric that has ruled the business world for over half a century and these beliefs are bolstered by frameworks popularized by consultants, such as the growth-share matrix.[2] However, the supremacy of market share as a metric is not without its challenges: Academics and some consultants caution against using it without restraint.[3] For instance, McKinsey & Co. found that growth in market share hurt profits at about 15% of the companies they looked at and wrote, "At first blush, our findings seem counterintuitive".[4] Scholarly research also supports the same finding.[5]

The intuition behind using market share as a key performance indicator is strong: It is easy to understand at various levels of the organization; readily available through commercial databases such as Mentil, GMID, and PROWESS; and conforms to a widely-held managerial belief that market share has a close relationship with a company's scale, market power and perceptions of quality.

The good news? The intuition can be true in many contexts. The bad news? The effectiveness of the market share metric depends on how exactly you define it and the nature of your business. This complex story is illustrated in *Figure 1*, where it can be seen that some companies experience a positive correlation between market share and profitability, while other companies experience an either-or trade-off between the two.

Figure 1: Profitability – market share correlation zones



Source: Created by the authors based on the original article by Bhattacharya et al (2022)

Measure market share the right way

If you were to measure market share as a share of revenues or sales to that of industry revenue/sales, you would have a much more reliable predictor of profit – as is indicated by the research. Interestingly enough, CEOs seem to gravitate to a similar opinion. A periodic survey (by Ernst & Young) of 1200 CEOs from 21 countries reveals that most CEOs believe that a high growth in revenue market share has a positive impact on profitability.[6] At the same time, research indicates that when market share is measured in terms of unit sales, it is not a good predictor of profits.

In addition to share of revenues, one top-tier consulting firm recommends using 'relative market share' – which divides a company's market share with that of the market leaders.[7] A modern variation on this is to divide a particular firm's market share by that of the combined share of the top three players. This differs from the 'absolute market share' that we discussed previously, which divides the share of revenues of a firm by industry revenues. So, when is relative market share better than absolute market share and when is the reverse true?

A periodic survey by Ernst & Young of 1200 CEOs from 21 countries reveals that most CEOs believe that a high growth in revenue market share has a positive impact on profitability

The research by Bhattacharya and team shows that using share of revenues is a good predictor of profitability in both business-to-customer (B2C) and business-to-business (B2B) markets, especially when share is distributed across several competitors and not concentrated with just one or two dominant players. However, there is an important nuance related to absolute vs. relative market share — relative market share works better for B2C service markets (e.g. airlines and cab services) and B2B product markets (e.g. industrial equipment and capital goods). In contrast, absolute market share as a metric is better suited for companies that operate in B2C product markets (e.g. consumer packaged goods) or B2B service markets (e.g. consulting and legal services). Bhattacharya and team's research shows that market share is a good predictor of profit in business-to-customer (B2C) markets with less concentration. We illustrate this ruleset in *Figure 2*, in the form of a decision guide that should help when to use absolute vs. relative market share.

Figure 2: Decision Matrix to Choose Appropriate Market Share Metric

Nature of the Offer	B2C	B2B
Service	Relative Market Share	Absolute Market Share
Product	Absolute Market Share	Relative Market Share
	Nature of the Market	

Note: Relative Market Share is calculated by dividing a firm's share by combined share of the top three players in the industry. All estimations are in monetary terms.

Source: Created by the authors based on the original article by Bhattacharya et al (2022)

While the above discussion clarifies when to use what metric, there is one essential insight to be considered while using market share – the why. We discuss this why – the likely reasons for market share of revenues (and not units) driving business profitability. Another important consideration is the exceptions (such as banking firms) to the rule and why they occur.

Why market share drives profits

The research by Bhattacharya and collaborators highlights three ways in which market share performance can boost profits—market power, operational efficiency and quality signalling. We explain each of these driving mechanisms, along with examples.

Market Power: Can be defined as a company's ability to influence prices by controlling the demand and/or supply of their offerings. Companies with higher market power manage to get high profits relative to their rivals. Higher market power and subsequent market share help companies control cost and quality and give better value offerings with higher prices. Thus, market power is a good indicator of a firm's ability to sustain profit and resist increases to its total cost, which is nothing but total variable cost. Variable cost is essential in measuring a firm's health and profitability in the medium to long run. If the total variable cost is less than the total revenue, the operating profits earned ensure that the firm will offset its fixed cost and become profitable over time. For example, PepsiCo's market power explains how it maintained its market share and grew profitability despite increased prices.[8]

Operational Efficiency: As market share increases, firms can spread their overhead costs over a wider base, resulting in a lower average fixed cost. Thus firms gain in operating efficiency. These economies of scale also enable a business to offer products at lower prices while maintaining quality. As production and sales increase, the firm gains efficiency, and the learning and experience curves show it helps increase the employees' efficiency over time. Specialisation also helps in gaining expertise. Moreover, higher market share ensures high interaction with suppliers, retailers and buyers; over time, it helps reduce operation and coordination costs. Tesla is a good example of achieving operational efficiency through experience gained over time in producing electric vehicles at a lesser cost than other competitors.[9] Indigo Airlines, a low-price airline in India, holds a dominant 63% market share in the domestic flights segment.[10] It is able to translate this low-price high-share positioning into profits by keeping operating costs low.

Quality Signalling: It is when a company can effectively communicate the quality of its product or service, especially when it is hard for customers to directly observe the same. Growing market share can be an effective way of signalling this quality to potential customers. The intuition behind this phenomenon is that customers see rising market share for a company's offering, and infer "Everyone can't be wrong, we should try this". Vital to this quality signalling is that the business must maintain and enhance the intrinsic or underlying quality of its offering. If the business fails to maintain true quality, the signalling will fade and credibility will be lost. For example, Toyota's penetration of car markets the world over signals quality and, in turn, results in increased demand, consumer loyalty and price.[11]

Three ways in which market share performance can boost profits

- Market Power: A firm's flexibility to change prices and influence the demand or supply
- Operational Efficiency: Helps firms offer products at lower prices and maintain quality
- Quality Signalling: When a company can effectively communicate the quality of its product or service

When market share doesn't work

The first limitation of market share lies in how one measures it. As mentioned before, share of units sold does not work as well as share of revenue in predicting profitability. Another limitation relates to how established the company is. In cases of mature companies, market share growth and declines are not good predictors of profitability.

In case of niche firms targeting specific customer segments, there can be a negative relationship between market share and profits since their value proposition only focuses on a particular market segment. Since these firms focus on a particular need or requirement, this ensures less competition and higher profits. An example of a profitable niche player is Louboutin, an Italian luxury shoe brand, addresses a specific need in a narrow market; hence, it is classified as a niche firm. Though it has a low market share compared to its top rivals, it is highly profitable.[12]

Sometimes, firms are involved in price wars and gain market share by lowering prices and deliberately sacrificing profit. Such actions are not long-lasting since customers perceive the product as low quality, offset by the quality-signalling advantages of high market share that gradually decay. Such a strategy is also called buying market share, wherein the firms sacrifice profits to gain market share and cannot maintain efficiency and quality at lower prices.

Beyond the above exceptions, one specific industry that does not behave as predicted is banking – in banks, increases in market share often do not lead to profitability – and sometimes result in just the opposite – a decline in profitability.

We also acknowledge here the general limitations of the spotlighted research: A US-centric dataset would need validation for other markets; while multiple contexts were included – the results for a particular industry might differ and more granular definitions of industry might yield further practical insights.

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The dark side of market share

As discussed above, some companies might intentionally choose to gain market share at the expense of profits at the initial stage. In some situations, this creates another risk: High levels of market concentration could invite the attention of regulators, who will suspect tacit collusion that may not be in the best interests of customers. For instance, in the search engine market, Google is not only under intense scrutiny, but is even facing calls for breaking up the company.[13]

While regulators act with the best interest of consumers and customers as a focus, it is important for policy makers to balance these interests with the insight – that if high levels of market share are accompanied with broad perception of high quality, then customer interests may not be at risk.

Beyond just market share

To sum, revenue market share can be an important metric for predicting profits and hence can be a basis of early intervention. This observation is strengthened by the right choice of metric (share of revenue) and being mindful of boundary conditions such as niche markets and monopolistic practices. However, most contemporary companies use not one, but many metrics to track value for multiple stakeholders. Recently, a leading consultancy has observed that despite many companies claiming to be customer-centric, they often prioritise metrics centred around the company itself. As an alternative, the consultancy suggests adopting Customer Performance Indicators that align with the company's Key Performance Indicators.[14] We agree with this principle as an overweening focus on market share could be counter productive. Instead, an inclusive system that engages multiple stakeholders involved in the value co-creation process, including marketing, operations, customer service and finance, should use multiple metrics to monitor operational performance and identify intervention points.

Janakiraman Moorthy *is Professor in the Marketing department at SPJIMR. He also serves as Chairperson of Marketing department. You can reach out to him at* **janakiraman.moorthy@spjimr.org**

Monika Gupta *is Assistant Professor in the Finance and Economics department at SPJIMR. You can reach out to her at* **monika.gupta @spjimr.org**

If you have some inputs you would like to share, you can also reach out to us at **mpi@spjimr.org**

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